

1-1-2007

Market Power and Inequality: A Competitive Conduct Standard for Assessing When Disparate Impacts are Justified

Ian Ayres
Yale Law School

Follow this and additional works at: http://digitalcommons.law.yale.edu/fss_papers

 Part of the [Law Commons](#)

Recommended Citation

Ayres, Ian, "Market Power and Inequality: A Competitive Conduct Standard for Assessing When Disparate Impacts are Justified" (2007). *Faculty Scholarship Series*. Paper 1168.
http://digitalcommons.law.yale.edu/fss_papers/1168

This Article is brought to you for free and open access by the Yale Law School Faculty Scholarship at Yale Law School Legal Scholarship Repository. It has been accepted for inclusion in Faculty Scholarship Series by an authorized administrator of Yale Law School Legal Scholarship Repository. For more information, please contact julian.aiken@yale.edu.

Market Power and Inequality: A Competitive Conduct Standard for Assessing When Disparate Impacts are Unjustified

Ian Ayres†

INTRODUCTION

Policies that exploit a firm's market power to extract supra-competitive profits from employees or consumers should not fall within the limits of the business necessity defense in disparate impact litigation. Even though such policies can substantially enhance a firm's profitability, profits that are the byproduct of market failure are less justified than those that are a byproduct of competition. By enjoining employment and consumer policies that extract supra-competitive profits disproportionately from racial minorities and other protected classes, disparate impact law can help make markets both more competitive and less racially discriminatory.

Imagine that an employer's promotion criteria have been shown to disparately exclude African American employees from higher-paying jobs within a company. What standard should a court apply to assess whether the promotion criteria are justified despite their racially discriminatory impact?¹ In

Copyright © 2007 California Law Review, Inc. California Law Review, Inc. (CLR) is a California nonprofit corporation. CLR and the authors are solely responsible for the content of their publications.

† Townsend Professor, Yale Law School. ian.ayres@yale.edu. Rick Brooks, Mark Cohen, Cynthia Estlund, Mitu Gulati, Al Klevorick, Dan Markovitz, George Rutherglen, Peter Schuck, Vicki Schultz, and workshop participants at New York University School of Law, University of Virginia School of Law, and Yale Law School provided helpful comments. While serving as a paid expert witness in *Cason v. Nissan Motor Acceptance Corp.* (2001) 3-98-0223 (M.D. Tenn.) and a number of parallel pieces of litigation, discussed *infra* in Part III, I offered opinions on the scope of the business justification defense in disparate impact cases that directly relate to the issues discussed in this article.

1. The disparate impact and disparate treatment causes of action have distinct elements. Disparate treatment litigation challenges employer policies that are contingent on race, sex or some other protected characteristic. Disparate impact plaintiffs in contrast do not need to prove

other words, what should be the scope of the business justification defense in disparate impact litigation? A persuasive answer has eluded both scholars and judges.² On the one hand, civil rights advocates have tended to answer this question by focusing on the term “business necessity,” suggesting that any policy that is not strictly necessary to prevent a firm’s bankruptcy is not justified.³ Opponents, on the other hand, have tended to focus on the term “job related” in arguing that any policy that increases a firm’s profitability (even infinitesimally) is justified.⁴

The conflict over the appropriate scope of the business justification defense is longstanding. It was at the heart of the stalemate over the proposed Civil Rights bill that passed both houses of Congress in 1990⁵ but was vetoed by President George H.W. Bush, who felt that the “business necessity” definition created a de facto quota employment requirement.⁶ The following year, Congress passed the Civil Rights Act of 1991, which contained compromise language on business justification.⁷ The compromise language (which was taken word-for-word from the Americans with Disabilities Act),⁸ however, did little to resolve the dispute. It defined a defendant’s policy as unjustified if “the respondent fails to demonstrate that the challenged practice is job related for the position in question and consistent with business necessity.”⁹

Since Congress’s passage of the new language, some courts have continued to allow a broad justification defense. For example, Judge Richard

race-contingent policies. To make out a prima facie case plaintiffs need only prove that a defendant’s policy disparately impacts a protected group. *See* 42 U.S.C. §§ 2000a - 2000h-6 (2000).

2. Christine Jolls, *Antidiscrimination and Accommodation*, 115 HARV. L. REV. 643, 655 (2001); *see also* Steven R. Greenberger, *A Productivity Approach to Disparate Impact and The Civil Rights Act of 1991*, 72 OR. L. REV. 253, 257 (1993); Andrew C. Spiropoulos, *Defining the Business Necessity Defense to the Disparate Impact Cause of Action: Finding the Golden Mean*, 74 N.C. L. REV. 1479, 1484 (1996).

3. *See, e.g.*, Linda Lye, *Title VII’s Tangled Tale: The Erosion and Confusion of Disparate Impact and the Business Necessity Defense*, 19 BERKELEY J. EMP. & LAB. L. 315, 349 (1998); *see also* *Wards Cove Packing v. Atonio*, 490 U.S. 642, 671 (1989) (Stevens, J., dissenting).

4. *See, e.g.*, Robert Belton, *The Dismantling of the Griggs Disparate Impact Theory and the Future of Title VII: The Need for a Third Reconstruction*, 8 YALE L. & POL’Y REV. 243, 243-44 (1990); Pamela L. Perry, *Two Faces of Disparate Impact Discrimination*, 59 FORDHAM L. REV. 523, 582-83 (1991).

5. S. 2104, 101st Cong. (2d Sess. 1990).

6. *See, e.g.*, Neil A. Lewis, *President’s Veto of Rights Measure Survives By 1 Vote*, N.Y. TIMES, Oct. 25, 1990, at A1. The 1990 bill explained that, in the case of employment practices, the term “required by business necessity” meant that practices “must bear a significant relationship to successful performance of the job.” S. 2104, 101st Cong. § 3(o)(1)(A). *See generally* Ian Ayres & Peter Siegelman, *The Q-Word As Red Herring: Why Disparate Impact Liability Does Not Induce Hiring Quotas*, 74 TEX. L. REV. 1485 (1996).

7. Civil Rights Act of 1991, Pub. L. No. 102-166, 105 Stat. 1071 (codified as amended in scattered sections of 42 U.S.C.).

8. *Id.*; *see* 42 U.S.C. § 12112(b)(6) (1994).

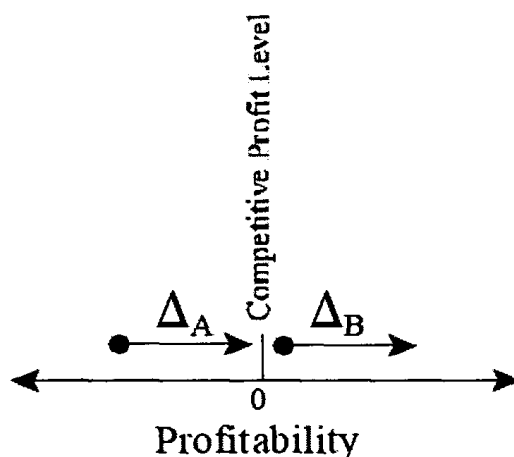
9. 42 U.S.C.A. § 2000e-2(k)(1)(A)(i) (1994).

Posner has written that disparate impact liability exists to identify situations in which, “through inertia or insensitivity, companies [are] following policies that gratuitously—needlessly—although not necessarily deliberately, exclud[e] black or female workers from equal employment opportunities.”¹⁰ This formulation resonates deeply with a profitability definition; an employer who can show it adopted a policy to increase its profits, even infinitesimally, arguably did not adopt the policy “needlessly.” There is of course a huge difference between Posner’s “needlessly” standard and the “business necessity” definition favored by civil rights advocates. One requires the smallest of reasons, while the other seems to demand the largest of reasons.¹¹

The dispute over the appropriate scope of the defense has, however, masked a deeper consensus about the relevance of profitability. All sides to the debate have implicitly agreed that policies that produce greater profits are more justifiable. Civil rights advocates and their opponents disagree about how much a policy needs to increase profits to provide a defense against disparate impact liability, with the former saying a lot, the latter saying a little. Nevertheless, both sides equate more profits with more of a justification, without taking into account how the profits were extracted.

Figure 1 Pro- and Anti- Competitive Policies

This Article contests the view that profitability should necessarily



(positively) correlate with justifiability. The problem with the received wisdom is that it fails to distinguish between pro- and anti-competitive behavior. Figure

10. *Dormeyer v. Comerica Bank*, 223 F.3d 579, 583 (7th Cir. 2000) (quoting *Finnegan v. Trans World Airlines, Inc.*, 967 F.2d 1161, 1164 (7th Cir. 1992)).

11. See Ernest F. Lidge, *Financial Costs as a Defense to an Employment Discrimination Claim*, 58 ARK. L. REV. 1, 2 (2005) (discussing the hypothetical example of an employer that would be bankrupted by hiring women).

I, above, depicts two policies that equally increase a firm's profitability. Policy A increases the firm's profit, by the increment ΔA , from a sub-competitive position to the competitive level of zero economic profits. This includes a reasonable return on capital; a firm earning zero economic profits covers its overhead and is able to pay a reasonable, risk-adjusted dividend to its shareholders. Policy B increases the firm's profitability by the same amount, by the increment ΔB , but from the competitive level to a supra-competitive level.¹² The thesis of this Article is that increases in profits that stem from market failure and rise to supra-competitive levels, such as caused by policy B, should not provide a business justification for policies that have disparate impacts on protected groups.

Admittedly, the above test is one-sided: it definitively adjudicates that anti-competitive policies are unjustified, but it does not answer whether, or to what extent, pro-competitive policies are justified. With regard to pro-competitive policies, like policy A, courts will still need to consider the extent to which firms might need to sacrifice profits to mitigate the adverse impacts of their policies. They will need to decide the extent to which the law will impose what Mark Kelman refers to as an "accommodation requirement."¹³ This Article does not resolve this important and longstanding accommodation issue. Defendant policies that are pro-competitive might nevertheless be unjustified if one reads the statute as requiring businesses to sacrifice a reasonable amount of profit to promote participation by protected class members.

However, this Article's largest contribution is in noticing that not all increments to profitability deserve equal judicial respect. When a policy is anti-competitive, larger increments to profitability make it less justifiable. A purpose of extracting supra-competitive profits should not justify policies that disproportionately hurt protected workers. While it strikes many that "profits are profits" and any policy that enhances them is consistent with first principles of a free market, the burden of this Article is to show that not all increments to profitability should be given equal respect at the bar. In a sense, the Article calls for civil rights to be more informed by an antitrust sensibility. Viewed through an antitrust lens, supra-competitive profits presumptively reduce social welfare and are suspect.

To see this intuition in the disparate impact context, consider the following example: An employer pays high-school graduates an amount equal to their marginal productivity but institutes a new policy of paying non-high-

12. The reasonable return on capital should be "risk-adjusted" because investors reasonably expect a higher return on more risky investments. The reasonable risk-adjusted return on particular company assets can be derived from beta regressions using the Capital Asset Pricing Model. RONALD J. GILSON & BERNARD S. BLACK, (SOME OF) THE ESSENTIALS OF FINANCE AND INVESTMENT 107-35 (1993).

13. Mark Kelman, *Market Discrimination and Groups*, 53 STAN. L. REV. 833, 850 (2001).

school graduates less. Imagine that the policy has a disparate impact against African Americans, who, in this hypothetical, are less likely to have a high school diploma.¹⁴ The employer might justify the pay difference by arguing that non-graduates tend to be less productive than high-school graduates. I will call this the productivity defense.¹⁵ In the alternative, the employer might try to justify paying non-graduates less, not because the non-graduates are less productive, but solely because these employees have fewer employment alternatives than high-school graduates. For example, imagine that non-graduates were more tied to their hometown than graduates and hence had fewer work alternatives. I will call this the market power defense, because the lower pay is a function of the employer's greater market power over the non-graduates.

Note that both of these defenses are, at core, about profitability. The productivity defense in essence says that the policy enhances the firm's profitability because the employer will be more profitable if it is not forced to pay workers more than their marginal productivity.¹⁶ A firm that pays less productive workers the same as more productive workers will tend to be unprofitable. But the market power defense is also about profitability, because finding a group of workers who will work for a sub-competitive wage is also an effective way for a firm to increase its profits.

My primary thesis is that courts should reject the market power defense when it is used to extract supra-competitive profits. Anti-competitive conduct should not justify policies that would otherwise violate civil rights law because they produce racially disparate outcomes. More generally, anti-competitive policies should not be recognized as a defense in a disparate impact case. Indeed, anti-competitive policies that more radically increase an employer's profits become *ceteris paribus* less justifiable. An employer who is able to more profoundly take advantage of non-graduates by paying them a starvation wage should not be able to point to the enormous profitability of the policy as a mitigating factor in a disparate impact suit.¹⁷ The above example depicts a kind

14. The hypothetical is, of course, inspired by *Griggs v. Duke Power Co.*, 401 U.S. 424, 431-32 (1971), where the employer had a policy of only hiring and promoting high-school graduates. But our civil rights laws currently may not allow disparate impact suits with regard to equal pay act violations. See *County of Washington v. Gunther*, 452 U.S. 161, 170-71 (1981).

15. Alternatively, the employer might justify the lower pay by showing that non-graduates impose higher (training) costs on the employer. But this would still be a defense about their net productivity—net of training costs.

16. Remember in this hypothetical that the high-school graduates are being paid the competitive wage (equal to their marginal productivity).

17. Forcing an employer to forego a policy that has a disparate racial impact in favor of a less profitable policy becomes increasingly problematic when, in doing so, the employer is asked to accept sub-competitive profitability. An employer is *prima facie* justified in trying to cover its costs. In the foregoing example, trying to construct a wage policy where worker productivity does not fall short of an employer's wage bill is accordingly a reasonable concern. But forcing an employer to forego an anti-competitive policy in favor of a less profitable, but more pro-

of wage-gouging—a policy of systematically paying non-graduates less than their marginal product.¹⁸ Wage-gouging should not be a business justification for employment policies that disproportionately burden women or minorities.

Although civil rights law has historically been understood to be at odds with a free market,¹⁹ in the wage-gouging context, disparate impact law can complement antitrust and consumer protection law to make markets more competitive and more equitable. Civil rights law can stimulate market competition²⁰ by raising the cost of anti-competitive conduct, such as wage-gouging market niches that are disproportionately minority, and thus increase the relative attractiveness of competitive behavior.²¹

The combination of antitrust and consumer law concepts with employment discrimination law is not a mere marriage of convenience; racial disparity and market failure often go hand in hand.²² In the consumer context, “the poor pay more” not just because of higher costs of supply but often because sellers prey on consumers’ limited access to information and competitive alternatives.²³ Although, the first principles of economic theory

competitive policy is not problematic—even if the employer is asked to forego a substantial, supra-competitive profit. This is the standard demand of both antitrust law and the common law of unconscionability.

18. Wage-gouging is analogous to price-gouging. A firm that wage-gouges earns a supra-competitive profit by paying workers less than they would earn if wage competition raised the wage to equal the worker's marginal product.

19. See generally RICHARD A. EPSTEIN, *FORBIDDEN GROUND: THE CASE AGAINST EMPLOYMENT DISCRIMINATION LAWS* (1992) (arguing that antidiscrimination law is antithetical to freedom of contract and that the problems to which it is addressed are not the types of coordination problems or externalities that typically justify state intervention). See also Richard Posner, *The Efficiency and the Efficacy of Title VII*, 136 U. PA. L. REV. 513 (1986) (“Social welfare legislation, notably including legislation designed to help minority groups, is usually thought to involve a trade-off between equity and efficiency, or between the just distribution of society’s wealth and the aggregate amount of that wealth.”).

20. Daria Roithmayr is one of the few scholars to analyze how antitrust laws might be used to attack the problem of civil rights. See Daria Roithmayr, *Barriers to Entry: A Market Lock-in Model of Discrimination*, 86 VA. L. REV. 727 (2000). See also Ruby Z. Afram, Comment, *Civil Rights, Antitrust, and Early Decision Programs*, 115 YALE L.J. 880 (2006) (arguing that college early admission programs raise both antitrust and disparate impact concerns); Edward B. Rock, *Antitrust and the Market for Corporate Control*, 77 CALIF. L. REV. 1365 (1989) (showing how antitrust analysis could be used to improve markets for corporate control). Dana L. Kaersvang has recently shown how disparate impact can be used to make basic housing more accessible. *The Fair Housing Act and Disparate Impact in Homeowners Insurance*, 104 MICH. L. REV. 1993 (2006).

21. The potential pro-competitive impact of civil rights law was first seen by John Donohue. See generally John J. Donohue, *Is Title VII Efficient?*, 134 U. PA. L. REV. 1411 (1986). Donohue saw that imposing extra costs on employers with discriminatory tastes could hasten their exit from the market and thus dynamically improve market efficiency.

22. Gary Becker long ago emphasized that certain racial disparities were more likely to persist in the absence of competition. GARY S. BECKER, *THE ECONOMICS OF DISCRIMINATION* 46-52, 159 (2d ed. 1971).

23. See DAVID CAPLOVITZ, *THE POOR PAY MORE: CONSUMER PRACTICES OF LOW-INCOME FAMILIES* 19-20 (1967).

might suggest that their disproportionate poverty would tend to protect minorities from the most rapacious excess of capitalism, study after study has shown—in car negotiations, predatory lending, rent-to-own markets, and dozens of other contexts—that sellers are able to extract disproportionate profits from poor and disproportionately minority consumers.²⁴ Refusing a defense to anti-competitive employment policies is a simple way to make progress on two fronts that are inextricably linked.

Disparate impact analysis has been conceived as a cause of action that allows the plaintiffs to act against instances of disparate treatment that would otherwise fly below the law's radar. But this Article argues that disparate impact analysis can also be used to allow plaintiffs to act against instances of advantage-taking conduct that would otherwise fly below the radar of antitrust, unconscionability or consumer/worker protection law.²⁵ The exploitations of market power discussed here might not be actionable in and of themselves. But when they give rise to otherwise actionable disparate impacts, it is appropriate for them to be enjoined.

The remainder of this Article is divided into three parts. Part I elaborates on the relationship between market competition and policies that produce disparate impacts. It shows why limiting the business justification defense to pro-competitive policies promotes both equity and efficiency. Part II argues that this legal limitation is consistent with both “business necessity” and “job related” conceptions of the defense. Part III then demonstrates how the theory has been applied in analogous non-employment settings where anti-competitive motives may create unjustified disparate racial impacts. The discussion in this last Part will draw upon my experience as an expert witness in litigation against the nation's major automobile lenders, in which I promoted the idea that price-gouging is not a business justification. The Article will present not only my views, but also the responses of three prominent experts for the defendants—

24. See IAN AYRES, PERVERSIVE PREJUDICE? UNCONVENTIONAL EVIDENCE OF RACE AND GENDER DISCRIMINATION 19-44 (2001); JOHN YINGER, CLOSED DOORS, OPPORTUNITIES LOST: THE CONTINUING COST OF HOUSING DISCRIMINATION 89-103 (1995); Ian Ayres, *Further Evidence of Discrimination in New Car Negotiations and Estimates of its Cause*, 94 MICH. L. REV. 109 (1995); Ian Ayres & Peter Siegelman, *Race and Gender in New Car Bargaining*, 85 AM. ECON. REV. 304 (1995); Kathryn Graddy, *Do Fast-Food Chains Price Discriminate on the Race and Income Characteristics of an Area?*, 15 J. BUS. & ECON. STAT. 391 (1997); Howell E. Jackson & Jeremy Berry, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 9 (2002), available at http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf; Jane Kolodinsky, et al., *Time Price Differentials in the Rent-to-own Industry: Implications for Empowering Vulnerable Consumers*, 29 INT'L J. CONSUMER STUD. 119 (2005); John Yinger, *Evidence on Discrimination in Consumer Markets*, 12 J. ECON. PERSP., Spring 1998, at 23 (describing evidence of discrimination in several different consumer markets).

25. It is striking, however, that the sales practices found below with regard to car loans, see *infra* Part III, would almost certainly be deemed independently illegal if the underlying financial assets being traded were characterized as “securities” rather than loans and thus subject to the full panoply of (a) the know-your-customer rules; (b) the NASD/NYSE mark-up rules; and (c) the anti-fraud rules (i.e. the SEC's Rule 17 C.F.R. § 240.10b-5 (2005)).

Richard Epstein, Nobel Prize-winning economist James Heckman, and George Priest.

I

THE RELATIONSHIP BETWEEN MARKET COMPETITION AND RACIAL DISPARITY

An economic analysis of market competition supports the argument that pro- and anti-competitive policies should be legally distinguishable in disparate impact analysis. In competitive markets, sellers are driven to pay workers their marginal product and price products at their marginal cost. Market competition accordingly puts pressure on a firm to pay non-graduates less if this group of employees tends to have lower productivity. If there really is a productivity difference between different types of workers, then a firm that pays non-graduates and graduates the same will be at a competitive cost disadvantage relative to competitor firms that pay non-graduates less. Therefore, employers in competitive markets cannot (absent legal intervention) ignore differences in marginal productivity in determining salaries and wage distinctions that are byproducts of market competition. Market competition, however, does not put pressure on a firm to gouge wages (pay a group of workers substantially less than their marginal productivity) or to gouge prices (charge a group of consumers substantially more than the product's marginal cost).

In the employment context, the core competitive distinction is between policies motivated by an attempt to compensate workers at or above their marginal productivity and those motivated by market power. Competition tends to drive out the latter type of pricing distinctions. Rival employers in a competitive market will tend to bid up sub-competitive wages. They will drive all wages toward employees' marginal productivity. But competition will tend to reinforce pricing distinctions based on marginal productivity.²⁶ Market competition reinforces the tendency of firms to adopt productivity-based wage policies and undermines the tendency of firms to adopt market-power-based wage policies. Thus, pricing distinctions that are a byproduct of market competition provide a stronger business justification than pricing distinctions that are the byproduct of market failure and only persist in the absence of competition.

A. A Competitive Conduct Standard

A standard of perfect competition can be used as a benchmark to distinguish policies that are potentially justified from those that are not. The core idea is to imagine the policies that a decision-maker would adopt if forced to compete with a large number of rival decision-makers. Hypothetical perfect

26. Severin Borenstein, *Price Discrimination in Free-Entry Markets*, 16 RAND J. ECON. 380 (1985).

competition drives out policies based on exploitation of a decision-maker's market power, but drives in (or reinforces) policies that are based on real differences in cost or productivity. Woe be it to a firm that ignores real differences in cost or productivity. And woe be it to a firm in competition that tries to pay a sub-competitive wage or charge a supra-competitive price.

The discussion of competition up to this point may strike many readers as odd. The free-wheeling market forces that bring buyers and sellers together in marketplace negotiations seem like competition in its purest form. From this perspective, all this talk about supra-competitive pricing seems to be a misnomer because, under this conception, there can be no such thing as a supra-competitive price. The competitive price or the competitive wage is whatever the market can bear.

The problem here is that there are competing ideas of what "competition" means. In one sense, competition is the struggle between an employer and a worker (or a buyer and a seller) to determine how they will split the potential gains from trade between them. But economic analysis and the law itself have long ago rejected this form of competition as a normative benchmark. Monopolists have never been able to protect themselves by arguing that they were only charging what the market could bear or that consumers had consented to pay the contract price.

It initially seems plausible to argue that employers are justified in maximizing their profits by paying whatever wage the market will bear. This argument (again, putting aside the important issue of accommodation) makes sense when the market is sufficiently competitive. Competition disciplines employers to set wages so as to at least equal the employee's marginal product. But when there is a market failure, either because of a lack of alternative employment opportunities or because employees are imperfectly informed about alternative opportunities, the wage paid may bear no relation to the worker's expected productivity. When the market fails, the wage that employers can pay will not be the amount that the market can bear, but instead will be determined by what the individual consumer can bear.

Civil rights law should follow the standard antitrust approach and focus on the degree of competition among multiple sellers. An analysis of how multiple employers would compete for the services of individual employees can produce a competitive conduct benchmark for both wage and non-wage policies against which one could judge real-world decisions.²⁷ This benchmark is normatively attractive as promoting not only efficiency but also multiple

27. Traditionally, the antitrust inquiry has been firm-centric instead of consumer- or worker-centric. While it would be theoretically comprehensible to analyze how multiple workers might behave in competing for an individual job, or how multiple consumers would behave in competing for an individual product, the standard normative lens to judge the behavior of firms (qua both sellers and employers) is to ask how multiple firms would compete for the services of employees or the patronage of customers.

dimensions of equity. Competition tends to transfer the gains of trade from producers to consumers and workers and tends to reduce inequalities that are not based on productivity or cost of production.²⁸

An analysis of competition (and its absence) also explains how anti-competitive policies can have disparate racial impacts. The next two subsections will show that: (1) both wage and price discrimination (paying different wages or charging different prices to different groups) and supra-competitive pricing (paying a sub-competitive wage or charging a single, supra-competitive price) can produce civil rights disparities; and, (2) enjoining these practices can simultaneously promote efficiency and equity. To make clear the connection with standard antitrust analysis, the focus here will mostly be on anti-competitive conduct regarding product-pricing decisions. But Section III will show how the same anti-competitive motives can give rise to more traditional disparate impact suits concerning hiring, firing, promotion, and terms and conditions of employment.

B. Disparate Racial Impacts of Price Discrimination

The term “discrimination” is not just a creature of civil rights law. Antitrust law and economics has long understood that firms with market power may have incentives to price discriminate as a means of making supra-competitive profits. Price discrimination is at play whenever a firm makes systematically different rates of profit from different groups of consumers for similar products or different groups of employees for similar work. For example, an airline with market power on a particular route may charge business travelers higher fares than tourists, not because business travelers impose higher costs on the airline, but because business travelers have a less elastic demand for air travel and hence are willing to pay more. Policies that implement price discrimination can directly cause disparate impacts if minority racial groups are disproportionately represented in the groups from which the firm is extracting high profits. Employers can price discriminate in the wages they pay by, for example, paying non-graduates less than graduates, not because the former are less productive, but because non-graduates have a less elastic supply curve and hence are willing to work for less.

Some scholars, like Judge Posner, would only invalidate policies that “gratuitously” or “needlessly” burden minorities—in the sense that alternative policies could have been employed that were equally profitable.²⁹ This standard suggests a very narrow ground for liability, because profit-maximizing firms tend to seek out the policies that are the most profitable. The “gratuitous standard” would only tend to smoke out instances of covert animus, where a firm was willing to accept lower profits to further a discriminatory motive. But

28. Kelman, *supra* note 13, at 850.

29. *Dormeyer*, 223 F.3d at 583 (quoting *Finnegan*, 967 F.2d at 1164).

a broader appreciation of price discrimination suggests that a profit motive can be unjustified if the profits result from exploiting a failure of market competition. Non-gratuitous, profit-maximizing policies can disproportionately hurt minorities, even when motivated only by a decision-maker's desire to exploit its market power.

Why are policies that induce supra-competitive profits less justified? The next section will provide a doctrinal legal answer. The policy reason is that price discrimination is inimical to well-accepted notions of both equity and efficiency. The equitable case against price discrimination is straightforward. The idea of extracting different rates of profit from different classes of consumers or employees, not because of the costs they impose but because of differences in their need, is inconsistent with basic notions of equality and fair play. In fact, the same equal protection norm undergirds the social concern with both civil rights and antitrust discrimination. The argument that discriminating policies are inefficient, however, requires more elaboration. As an initial matter, the competition standard for adjudicating business justification is also supported by a straightforward analysis of allocative efficiency.³⁰ Competitive pricing (including competitive wage setting) promotes economic efficiency—as goods and services tend to flow toward their highest use.³¹ When prices are based on cost, consumers will only buy when they value the good or service more than its cost of production. A competition standard for “business justification” would accordingly tend to validate cost-based pricing of products and productivity-based wages for labor, even if these policies induced disparate racial impacts.

In contrast, supra-competitive pricing (and sub-competitive wages) can retard economic efficiency. Supra-competitive prices can create what economists call dead-weight losses in efficiency, where consumers who value the product more than its cost are nonetheless deterred from buying because of its inflated price.³²

As depicted in Figure 2, a non-discriminating monopolist that charges a single price to all consumers causes a group of marginal consumers to stop purchasing (the striped area 3). The inefficiency of supra-competitive pricing comes from the dead-weight loss of people who value the good more than its cost but are nonetheless deterred by supra-competitive pricing from purchasing. A competitive standard for business justification would accordingly tend to

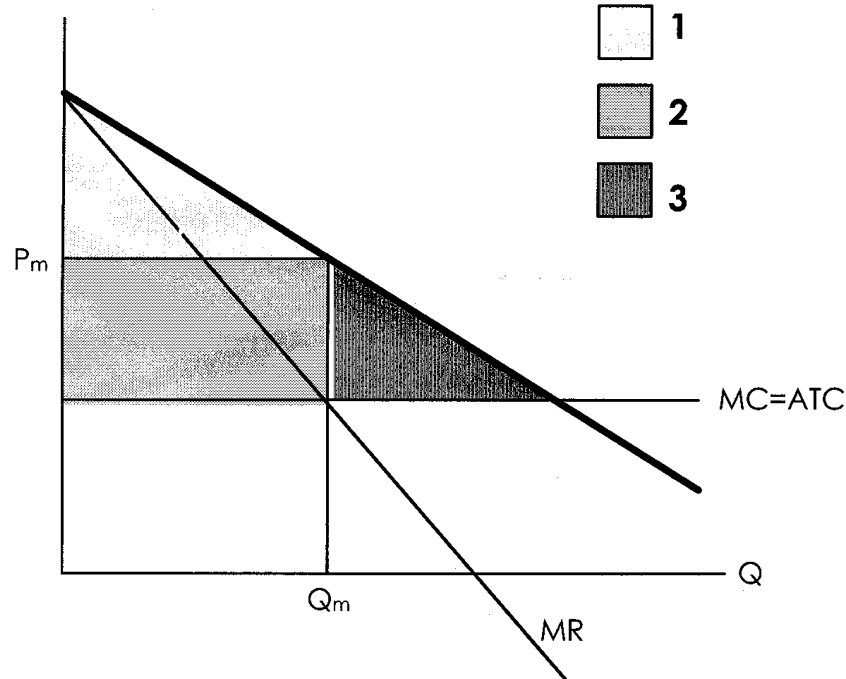
30. Allocative efficiency ensures that goods and services end up in the hands of (in other words, are allocated to) the people who value them the most highly. *See generally* IAN AYRES, *OPTIONAL LAW* (2005) (analyzing the impact of law on allocative efficiency).

31. *Id.*

32. For more on dead-weight losses, *see* William M. Landes & Richard A. Posner, *Market Power in Antitrust Cases*, 94 HARV. L. REV. 937, 954, app. (1981) (defining dead-weight loss as “loss of consumer and producer surplus when output declines from the competitive to the monopoly level; it is the most common measure of the social costs of monopoly”).

exclude this kind of single-price, supra-competitive price setting.³³

Figure 2: Monopoly Overcharge



But the impact of price discrimination on allocative efficiency is more complicated. Certain types of price discrimination have the potential for reducing the allocative inefficiency of supra-competitive pricing.³⁴ Price discrimination holds the potential of reducing the dead-weight loss depicted in Figure 2 by allowing the seller with market power to set different prices for different types of consumers. In theory, if a monopolist could perfectly price discriminate—charging each consumer their actual value for the product—there would be no inefficiency from price discrimination, as the monopolist would sell the efficient amount by lowering the price just enough to attract each consumer.³⁵

33. The next section will show this tendency more explicitly. See *infra* Section I.C.

34. See generally RICHARD POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* (2d ed. 2001).

35. Even if price discrimination were a net improvement in allocative efficiency relative to an inflated single-price (or a deflated single-wage) equilibrium, it still might not constitute a business justification under the competition standard. Less than perfect price discrimination would still not represent an enhancement in allocative efficiency relative to a competitive single-price equilibrium. As in antitrust, the crucial question is whether the competitive or the non-discriminatory (but possible supra-competitive) is used as the allocative benchmark. At a minimum, any price-discrimination that does not increase the quantity of goods sold (relative to the quantity that would be sold under a non-discriminatory scheme) should not be viewed as business justified.

However, in practice, perfect price discrimination (also called first-degree price discrimination) is not feasible. Sellers with market power do not know how much individual consumers are willing to pay. Sellers who try to use more extreme forms of price discrimination may find that consumers who are offered lower prices resell the goods to consumers who are offered higher prices. Normally, the best that sellers can implement is what economists call second- or third-degree price discrimination.³⁶ The sellers place different types of consumers in different groups and charge the groups different prices. Unlike first-degree price discrimination, second- and third-degree price discrimination is less efficient than the competitive equilibrium, and may even be less efficient than allowing a seller with market power to set a single, anti-competitive price for all consumers. In equilibrium with second- or third-degree price differences, the low-price group experiences less dead-weight loss compared to the single-price model, but the high-price group experiences greater dead-weight loss, and this latter effect may dominate to create a net loss in efficiency.³⁷

Because of both the efficiency and equity concerns with price discrimination, it is not surprising that there has been a fair amount of legal hostility to this practice—for example, in the Robinson-Patman Act's prohibition of price discrimination.³⁸ But Robinson-Patman's coverage is incomplete because it only protects wholesale consumers, not retail consumers.³⁹ Hence many forms of discriminatory pricing can fly under the radar of our antitrust statutes.

A competition standard would find that second-degree and third-degree price discrimination policies aimed at raising profits above the competitive level do not constitute a valid business justification. The competition standard would not render price discrimination per se illegal; it would only mean that price and wage discrimination policies that disparately burdened racial minorities and other protected classes would not be saved because they

36. With second-degree price discrimination, the seller gives quantity discounts or charges different prices for versions of the same product with different qualities. With third-degree price discrimination the seller separates consumers into different groups (for example, by age or geography) and charges different prices to each group. See DOUGLAS A. RUBY, PRICE DISCRIMINATION (2003), http://www.digitaleconomist.com/pd_4010.html.

37. Moreover, the price discrimination tends to be inefficient in a more dynamic sense because it gives firms a bigger incentive to invest in creating market power. Prohibitions of price discrimination, by reducing the incentive to invest in barriers to entry and the like, may produce more competitive equilibria. See Richard A. Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807, 822 (1975) (additional profit created by price discrimination creates social costs, because it gives monopolists increased incentives to undertake socially wasteful investments to create or maintain market power).

38. See 15 U.S.C. § 13(a). The Robinson-Patman Act prohibits price discrimination on goods sold to equally situated distributors where the effect of the discrimination is substantially to lessen or eliminate competition.

39. *Id.*

successfully extracted supra-competitive profits.⁴⁰

C. Disparate Racial Impacts Caused by Simple Monopoly Overcharges

Price discrimination is not the only anti-competitive policy that can produce disparate racial impacts. Just charging a supra-competitive price (or a sub-competitive wage) can disparately burden minorities. Returning again to Figure 2, we see that monopoly pricing can harm consumers in two different ways. First, it hurts high-value consumers who pay the supra-competitive price—effectively extracting some of the consumer surplus that high value consumers would have received under competition and transferring it via the higher price to the seller. Second, it hurts low-value consumers who refuse to pay the supra-competitive price, but would have purchased at the competitive price. If minorities are disproportionately represented in either of these groups, supra-competitive pricing could cause a disparate racial impact.

For example, if minority consumers have a lower ability to pay and consequently tend to be over-represented in the lower right portion of the demand curve, then supra-competitive pricing will disproportionately exclude minority consumers from the market (relative to what their participation would have been at a competitive price). Alternatively, minorities may be over-represented in the purchasing group that knuckles under and pays the supra-competitive overcharge. This might happen, for example, at an inner-city grocery store, where a minority consumer might have less access to transportation to alternative stores and is consequently more likely to use the local grocery. Again, notice the difference between pro- and anti-competitive behavior: an inner-city store might charge higher prices either because it has higher costs or because it has more market power over its customers. Both policies would enhance the store's profitability, but only the first would be consistent with a competitive standard.

The possibility that minorities could be burdened by either being disproportionately excluded by a monopoly overcharge or bearing the overcharge itself creates a kind of Catch-22 for the monopolist. Unless

40. A competition standard should also take into account the requirement that businesses cover their fixed costs. For example, price discrimination might be justified by the attempt of sellers to cover their legitimate fixed costs by charging higher prices to a class of consumers who have less elastic demand. But the discussion of automobile dealerships in Part III illustrates that some of the fixed costs may be the costs of implementing a price-discrimination system and would not be justified. *See infra* Part III. A natural standard for assessing whether fixed costs justify a particular policy is to ask whether enjoining the policy would lead to a reduction in industry output. As applied to automotive lending, the evidence suggests that two states, Arkansas and Ohio, that severely limited price-gouging did not experience a disruption in consumers' ability to finance cars. *See infra* Part III; Ian Ayres, Expert Report, *Willis et al. v. American Honda Finance Corp.* No. 3-02-0490, at 34 (M.D. Tenn. Jun. 30, 2004) [hereinafter Ayres, Honda Report]. This suggests at least that lending markups detailed below were not justified by lenders' or dealerships' need to cover fixed costs.

minorities are equally represented in the purchasing and non-purchasing groups, it will always be the case that under-representation in one group will mean over-representation in the other. For example, imagine that minorities would have made up 25% of customers if a competitive price had been charged. Then a showing that minorities are underrepresented (<25%) in the purchasing group perforce means that minorities must be overrepresented in the non-purchasing group. The opposite scenario is, of course, also possible. This possible liability for multiple dimensions of disparity raises important *Connecticut v. Teal* issues.⁴¹

Moreover, minorities and women are not the only potential plaintiffs who could bring a disparate impact challenge. Non-minorities who are disproportionately burdened might be able to challenge the supra-competitive policy as well.⁴² In theory, it would only be a truly pathological case where an anti-competitive policy would not burden any protected group or its complement.

But this problem of multiple disparate impact plaintiffs with multiple disparate impact claims is present with regard to any business justification standard—not just the competition standard. A test that does not have a disparate impact against minorities will by definition have a disparate impact against non-minorities, unless equal percentages of minorities and non-minorities make up each group. Any business practice that does not pass a business justification test (whatever that test is) is likely to be subject to challenge, because in all likelihood, some protected class of workers or consumers would be disproportionately burdened by the practice. But in the real world, courts rarely hold businesses liable for practices that disproportionately burden whites.⁴³

41. *Connecticut v. Teal* said that individual questions on a test can give rise to disparate impact liability even if the overall results on the test did not produce a disparate impact. 457 U.S. 440, 452 (1982) (rejecting the “bottom line” defense; that is, a disparate impact in any one stage in the hiring process will still give rise to a prima facie employment discrimination claim even if the employer’s resulting hiring profile exhibits no disparate impact in the end); see also Ayres & Siegelman, *supra* note 6, at 1489-91 (arguing that disparate impact liability might actually induce employers to discriminate against minorities in hiring because disparate impact liability can also attach to employers’ firing decisions). At least as an analytic matter it would be possible to aggregate the various types of harm to assess whether the monopoly overcharge disproportionately hurt minorities. In economic terms, both the purchasing and non-purchasing consumers are forced to sacrifice some of their consumer surplus and it would be possible to assess whether minority consumers sacrificed a disproportionate amount of the consumer surplus they would have enjoyed if a more competitive price had been offered. (Even more expansively, one might consider the potentially offsetting incidence of such impacts on minority shareholders or employees). But the burdens of exclusion from employment and consumption markets could create distinct burdens on minority communities that might justify the more disaggregated analysis of impacts on the non-purchasing and purchasing groups.

42. See Charles A. Sullivan, *The World Turned Upside Down?: Disparate Impact Claims by White Males*, 98 Nw. U. L. REV. 1505, 1512 (2004).

43. See *id.* at 1524-26; see also Woods v. Perry, 375 F.3d 671, 673 (8th Cir. 2004) (noting that in reverse discrimination claims, plaintiffs must also demonstrate background circumstances

Thus, a competition standard is unlikely to render all anti-competitive practices subject to successful challenge under the disparate impact laws. Regardless of whether courts overrule *Teal* (and allow a bottom line defense) or otherwise reign in the multiple plaintiffs problem,⁴⁴ the argument of this Article is simply that an otherwise objectionable practice (i.e. a prima facie disparate impact) is not rendered less objectionable by a showing that the practice was instituted to exploit the defendant's market power.

In sum, this section has shown how the competitive standard furthers both equity and efficiency. But stepping back, we can now see that this standard is an attempt to make civil rights law continuous with and complementary to other laws of advantage-taking—including the law of antitrust (which attempts to discourage supra-competitive pricing) and the law of consumer protection (which attempts to discourage unconscionable pricing). While this attempt might at first seem strained, it is not, because market failure and racial disparity often appear hand in hand. Minorities are disproportionately the victims of anti-competitive and unconscionable practices. It is therefore natural to build bridges across these areas of law.⁴⁵

II

THE COMPETITION STANDARD COMPORTS WITH EXISTING PRECEDENT

This competition standard also comports with a careful reading of the Civil Rights Act of 1991 and its judicial interpretations. The Act requires an employer “to demonstrate that the challenged practice is job-related for the position in question and consistent with business necessity.”⁴⁶ The simplest and strongest reason to reject a business necessity defense for anti-competitive practices is that firms are not forced to act anti-competitively to survive financially; it is not consistent with business necessity to wage- or price-gouge. Competition may force firms to pay employees wages commensurate with their productivity (or to charge prices commensurate with their costs), but

establishing that the defendant is “that unusual employer who discriminates against the majority”); *Mattioda v. White*, 323 F.3d 1288, 1293 (10th Cir. 2003) (same); *Russell v. Principi*, 251 F.3d 815, 818 (D.C. Cir. 2001) (same).

44. I have argued that *Teal* should be repealed, because it perversely punishes firms for success in hiring minorities. Specifically, *Teal* holds liable firms that fire minorities at disproportionately high rates even when the firm's minority employee share remains greater than the minority share of the qualified applicant pool after the firing. See Ayres & Siegelman, *supra* note 6, at 1517; see also Cynthia Estlund, *Wrongful Discharge Protections in an At-Will World*, 74 TEX. L. REV. 1655, 1679-82 (1996).

45. Harmonization is a two-way street. The analysis also suggests that antitrust and consumer protection enforcement can be mobilized to make markets less discriminatory. Indeed, enforcement authorities in these related areas might do well to look for market processes that produce racial disparities as a guide to consumer-oriented intervention more generally. And civil rights authorities might do well to look for places of market failure as a likely indicator of discrimination.

46. Civil Rights Act of 1991 § 105, 42 U.S.C. § 2000e-2(k)(A)(ii) (1991).

competition does not force an employer to exploit its market power.

A. The “Job Related” Standard

Opponents of disparate impact liability tend to focus on the “job related” language instead of the “business necessity” language of the defense.⁴⁷ But it turns out that even if the “consistent with business necessity” requirement were somehow read out of the statute, the “job related” requirement would by itself exclude as a defense the exploitation of market power. The statute does not speak in terms of “business related” or “profitability related” justifications. It instead restricts the defense to policies that are “job related for the position in question”—that is, related to employees’ ability to do the particular job.⁴⁸ Hence, the phrase “job related” can be used to restrict analysis to policies that screen for differences in employee productivity on the job. The phrase would exclude market power differences, which often relate to an employee’s opportunities to perform other jobs rather than the employee’s ability to perform the job at hand.

Returning to our original example, an employer who pays non-graduates less, not because they are less productive, but only because they have fewer employment alternatives, should fail in an attempt “to demonstrate that the challenged practice is job-related for the position in question.” Far from being related to the job in question, the practice of paying lower wages is instead related to the absence of other job opportunities.

This reading of the statute also resonates with the Supreme Court’s first attempt to grapple with the contours of the defense. In *Griggs*, the Supreme Court repeatedly emphasized that to qualify as a defense the practice had to be related to job performance:

The Act proscribes not only overt discrimination but also practices that are fair in form, but discriminatory in operation. The touchstone is business necessity. If an employment practice which operates to exclude Negroes cannot be shown to be related to job performance, the practice is prohibited.⁴⁹

And:

47. See *Teal*, 457 U.S. at 446-47 (1982) (noting that the employer must demonstrate job-relatedness); *Albemarle Paper Co. v. Moody*, 422 U.S. 405, 408, 425 (1975) (reaffirming that the burden of proving job-relatedness is the employer’s and discussing the question of “what must an employer show to establish that pre-employment tests racially discriminatory in effect, though not in intent, are sufficiently ‘job-related’ to survive challenge under Title VII”); Pamela L. Perry, *Two Faces of Disparate Impact Discrimination*, 59 *FORDHAM L. REV.* 523, 582-83 (1991). In doing so, such opponents ignore the use of the phrase “business necessity” in three parts of the statute. See 42 U.S.C.A. § 2000e-2(k)(1)(A)(i) (West 2006); 42 U.S.C.A. § 2000e-2(k)(1)(B)(ii) (West 2006); 42 U.S.C.A. § 2000e-2(k)(2) (West 2006).

48. 42 U.S.C. § 2000e-2(k)(A)(ii) (1991).

49. *Griggs*, 401 U.S. at 431. See also *id.* at 426 (stating that the practice must be “significantly related to successful job performance”).

[G]ood intent or absence of discriminatory intent does not redeem employment procedures or testing mechanisms that operate as ‘built-in headwinds’ for minority groups and are unrelated to measuring job capability.⁵⁰

An employment practice that exploits an employer’s market power is not related to job performance or to measuring job capability. The court concluded that the high school diploma requirement at issue in the case was not “shown to bear a demonstrable relationship to successful performance of the jobs for which it was used.”⁵¹ It is fairly clear under *Griggs* that a policy of refusing to promote workers to higher-paying jobs would be unjustified if it was motivated, not by the workers’ ability to perform the job in question, but simply as a way to exploit the employer’s market power over un-promoted workers. Even if profitable, the practice would be unjustified because *Griggs* limited the defense to practices that were related to job performance.

We see a similar analysis in *Dothard v. Rawlinson*.⁵² In reviewing a minimum weight requirement shown to have a disparate impact against women applicants, the Supreme Court held that, to establish a business justification, the defendant must show that the criterion was “necessary to safe and efficient job performance.”⁵³ Indeed, this emphasis on job performance is central to the established tripartite methods of validating employment tests. Under the Equal Employment Opportunity Commission Guidelines, there are three techniques of validation: criterion, content, and construct validation.⁵⁴ Criterion validation requires the employer to establish a statistically significant correlation between successful performance on a selection device and successful performance of the job.⁵⁵ Content validation requires the employer to establish that the selection device directly measures important job-related behaviors (such as a typing test for a typist).⁵⁶ Construct validation requires the employer to establish that the test measures the more abstract characteristic it claims to measure, and that this characteristic is important to successful performance on the job.⁵⁷ The touchstone of all validation is relating the selection criterion to the ability to perform the job in question. It is easy to imagine a test that elicited information not about an applicant’s ability to perform the job but instead about the

50. *Id.* at 432.

51. *Id.* at 431. *See also id.* at 432 (practice must have “a manifest relationship to the employment in question”).

52. *See* 433 U.S. 321, 331 (1977).

53. *Id.* at 331 n.14.

54. *See, e.g.,* *Davis v. Washington*, 352 F. Supp. 187, 191 (1972) (“The [EEOC] guidelines recognize the fact that basically there are three methods of validating the job-relatedness of a given test: criterion, content, and construct.”).

55. 29 C.F.R. § 1607.5.

56. *Id.*

57. *Id.*

applicant's bargaining power.⁵⁸ But a test which succeeded in identifying applicants with low market power—even if it dramatically increased the employer's profits—could not meet the demands of criterion, content, or construct validation because it is not related to the ability of applicants to perform the job in question.

B. The "Legitimate Business Objective" Standard

In struggling to define the contours of the business justification defense, courts have not spoken with a single voice, however. While the Supreme Court's early disparate impact cases tied the defense to job performance, *New York City Transit Authority v. Beazer*, in its brief analysis of business necessity, shifted the emphasis toward whether the practice furthered the employer's "legitimate employment goals."⁵⁹ As Linda Lye has observed: "With a deft sleight of pen, the *Beazer* Court shifted the focus away from the narrow requirement of job performance to the more amorphous category of employment goals."⁶⁰

The embrace of legitimate business objectives as an alternative to job performance could also be seen in lower court opinions. For example, in *Christensen v. Iowa*,⁶¹ a class of female employees at a state university brought a disparate impact action challenging the university's practice of paying less for clerical work than it did for maintenance work of "comparable value to the employer."⁶² The Eight Circuit summarily rejected the plaintiffs' claim:

[Plaintiffs'] theory ignores economic realities. The value of the job to the employer represents but one factor affecting wages. Other factors may include the supply of workers willing to do the job and the ability of the workers to band together to bargain collectively for higher wages. We find nothing in the text and history of Title VII suggesting that Congress intended to abrogate the laws of supply and demand or other economic principles that determine wage rates for various kinds of work. We do not interpret Title VII as requiring an employer to

58. For example, an employment application might ask employees about their ties to the community, willingness to move or even their amount of indebtedness. The Graduate and Professional School Financial Aid Service Form that many students fill out can be seen as just such a "test." The University says, "You tell us (under penalty of perjury) how much you can pay, and then we'll tell you how much (net of scholarship) we'll charge you to attend." See Aaron Edlin & Ian Ayres, *Why Legislating Low Tuitions for State Colleges is a Mistake*, Findlaw's Legal Commentary, Oct. 30, 2003, http://writ.news.findlaw.com/commentary/20031030_ayres.html.

59. 440 U.S. 568, 587 n.31 (1979).

60. Lye, *supra* note 3, at 328.

61. 563 F.2d 353 (8th Cir. 1977); see *infra* note 73.

62. 563 F.2d at 354. See also Kingsley R. Browne, *The Civil Rights Act of 1991: A "Quota Bill," a Codification of Griggs, a Partial Return to Wards Cove, or All of the Above?*, 43 CASE W. RES. L. REV. 287, 348-62 (1993) (discussing the application of business necessity under the 1991 Civil Rights Act, including whether an employer is limited to performance-based justifications).

ignore the market in setting wage rates for genuinely different work classifications.⁶³

I will return to this case when we discuss the Supreme Court's recent decision in *Smith v. City of Jackson*.⁶⁴ Now, it suffices to say that the decision cannot be read as merely judging whether the university's pay practice was geared to job performance; instead, it embraced as legitimate the objective of matching market-generated wages.

This shift from a "job performance" to a "legitimate business objective" requirement also played out in the struggle to pass what ultimately became the Civil Rights Act of 1991.⁶⁵ Senator Edward M. Kennedy originally introduced a bill that required that "the practice must bear a significant relationship to successful performance of the job."⁶⁶ But the first Bush Administration "insisted that it would only sign a bill that permitted employers to use selection practices that served legitimate business objectives, even if these objectives did not concern successful performance of the particular job in question."⁶⁷

A fair reading of the post-1991 cases suggest that lower courts have continued at times to ask whether an employer's practice furthers a legitimate business goal, even if the goal is unrelated to the employee's job performance. For example, in *Fitzpatrick v. City of Atlanta*,⁶⁸ the Eleventh Circuit found that a fire department's interest in worker safety was "an important business goal" and that the department's "clean shaven" requirement was reasonably necessary to achieve this goal.⁶⁹ A central contention in the litigation was that

63. 563 F.2d at 356; *see also* *Am. Fed'n of Mun. Employees v. Washington*, 770 F.2d 1401, 1407 (9th Cir. 1985) ("We find nothing in the language of Title VII or its legislative history to indicate Congress intended to abrogate fundamental economic principles such as the laws of supply and demand or to prevent employers from competing in the labor market."); *Lemons v. City & County of Denver*, 620 F.2d 228, 229 (10th Cir. 1980).

64. *See* 544 U.S. 228, 242-43 (2005).

65. Pub. L. No. 102-166.

66. S. 3239, 101st Cong. (2d Sess. 1990).

67. *See* Spiropoulos, *supra* note 2, at 1510.

68. 2 F.3d 1112 (11th Cir. 1993).

69. *See id.* at 1119. The idea of non-job-related but legitimate business goal practices is also discussed in *Browne*, *supra* note 62, at 348:

[H]iring procedures may be adopted for legitimate business reasons other than prediction of future job performance. For example, in *Wards Cove* the employers had entered into a hiring-hall agreement with a largely Filipino union local in Seattle. As a result, the positions for which the union supplied employees were held disproportionately by Filipinos. If a black person had challenged the employers' use of a hiring hall on the ground that a disproportionately small number of blacks were hired for cannery positions, the employers could not possibly defend on the basis of "job performance," since that would require a showing that employees procured through the hiring hall performed better than potential employees who were excluded because of the hiring-hall agreement. However, the usual reason for an employer's entering into a hiring-hall agreement is not that employees hired under such an agreement will perform better than other employees. Rather, it is to maintain a

oxygen masks might work better on clean-shaven firemen, meaning that bearded employees may not be as effective at putting out fires. But even if we take the emphasis on employee safety as a legitimate business objective that is separate from the employee's ability to perform the job, we should see that this objective is radically different from the objective of an employer to exploit its market power over a worker. The first is an objective to protect the employee; the second is an objective to profit by injuring the employee. So even a more expansive reading of business goals would read wage-gouging, or the exploitation of an employee's lack of market power, as illegitimate.

The most recent precedent about what might count as legitimate business objectives is also the most troubling. In *City of Jackson*, the Supreme Court rejected an age-based disparate impact claim against a city's plan for raising the wage of its police officers.⁷⁰ The policy caused "almost two-thirds (66.2%) of the officers under 40 [to receive] raises of more than 10% while less than half (45.3%) of those over 40 [received a raise]."⁷¹ Notwithstanding this disparity, the Court found the city's plan justified:

Thus, the disparate impact is attributable to the City's decision to give raises based on seniority and position. Reliance on seniority and rank is unquestionably reasonable given the City's goal of raising employees' salaries to match those in surrounding communities. In sum, we hold that the City's decision to grant a larger raise to lower echelon employees for the purpose of bringing salaries in line with that of surrounding police forces was a decision based on a "reasonable factor other than age" that responded to the City's legitimate goal of retaining police officers.⁷²

Even though the Court was evaluating the plan in terms of the Age Discrimination Act's specialized reasonable factor other than age ("RFOA") affirmative defense, the Court's reasoning harkens back to the Eight Circuit's analysis in *Christensen*: "We find nothing in the text and history of Title VII suggesting that Congress intended to abrogate the laws of supply and demand or other economic principles that determine wage rates for various kinds of

reliable source of labor.

70. *City of Jackson*, 544 U.S. at 228.

71. *Id.* at 423. This evidence about the percentage increase in wages may not be the most accurate measure of impact. Because more senior workers earned a higher base wage, a smaller average percentage increase might still represent a higher absolute dollar increase. But the Court bizarrely ruled that the plaintiffs had "not identified any specific test, requirement, or practice within the pay plan that has an adverse impact on older workers"—even though the very next paragraph described in detail the operation of the city's algorithm of dividing the five basic police officer positions into "a series of steps and half-steps." *Id.* at 422. As a result of the algorithm, officers in the lowest steps that were disproportionately under 40 received larger percentage wage increases. See *id.* If *City of Jackson* does not constitute a specific practice, one wonders, what does?

72. *Id.*

work.”⁷³ But, like *Christensen*, the Supreme Court was wrong to say it is unquestionably reasonable to raise “employees’ salaries to match those in surrounding communities.”⁷⁴

The problem is that the Court has been focusing on the wrong half of the equation. It is indeed reasonable for an employer to pay high wages to those workers who are in high demand. Profit-maximizing firms have strong incentives not to overpay employees. Accordingly, the willingness of other firms to pay a high wage is strong evidence that the high market wage is deserved. But the problem lies with regard to the low-wage employees. An employer who merely matches the market salaries of low-wage employees may merely be reflecting these employees’ relative lack of market power. The market wage for these employees may be low because they are more dependent on a particular job, not because they are less productive.

Indeed, the foregoing example of wage-gouging might be hidden within the *City of Jackson* record, which the Supreme Court found unproblematic as a matter of law.⁷⁵ The police officers who garnered low raises under the system geared to match salaries in other communities might end up with less simply because this type of worker in community after community has low mobility and thus has fewer employers vying for her labor. The wage setting of a monopsonist, however, is not rendered more reasonable merely because another monopsonist charges a similarly low wage.

In a sense, the Supreme Court’s ruling in *City of Jackson* supports the thesis of this Article because it seems to be relying on a competition test in determining the reasonableness of an employer’s wage-setting.⁷⁶ But relying on a market test without credible evidence of actual competition for low-wage employees can reify market failure. When there is not sufficient competition for immobile workers, “meeting competition” becomes simply another phrase for paying as little as the market will allow.

My analysis of wage setting in labor markets can of course be criticized as overly stylized. In the real world, employers do not set the wage to exactly equal the marginal product of each worker. Still, it is reasonable to assume that profit-maximizing employers will be reluctant to pay workers more than their marginal product. In a *City of Jackson* case, the employer might not be called upon to show that the wages of all its employees were commensurate with their marginal product, but an employer might be called upon to show that the favored workers were in fact more productive than the disfavored workers. In response to a showing of disparate impact, the employer should be asked to produce some evidence that it was not merely exploiting its bargaining power.

73. 563 F.2d at 356.

74. 544 U.S. at 242.

75. *Id.* at 241.

76. *Id.* at 242.

The possibility that wage setting can be driven by market power is not a foreign concept to academics. For example, deans can exploit immobility by paying less to professors who are immobile. In fact, the source of market power is not limited to immobility, but may also include imperfect information or aversion to bargaining. For instance, Linda Babcock and Sarah Laschever in *Women Don't Ask* document the disproportionate impacts that can be visited upon women workers who are reluctant to ask for a higher wage.⁷⁷ An employer's decision to establish a negotiated wage-setting process might be motivated by a simple desire to exploit the reluctance of certain employees to ask for a higher wage. If addressed head on, I predict that courts would be reluctant to accept the exploitation of worker bargaining weakness as a legitimate business justification for paying equally productive workers less.

In sum, neither of the existing standards for consideration of a business necessity defense support exploitation of market inequality by employers. The job-related standard focuses on an employee's ability to perform the job in question, and not his relative ability to perform other jobs in the market. Though the interpretation of the legitimate business objective standard has been less uniform, it also should be read to exclude a defense that relies on anti-competitive market exploitation.

The competitive conduct standard has potential relevance in resolving both hiring and promotion cases. Although it is obvious that employers cannot exploit workers that they do not hire, the earlier discussion of dead-weight loss showed that the motive to exploit market power against workers could disproportionately harm minorities by inducing them not to contract.⁷⁸ Hence, a policy that disproportionately harmed women or minorities by refusing to contract with them might be actionable if the rationale for the policy was solely to extract a supra-competitive return from other workers. Moreover, hiring decisions might be challenged if they were conjoined with assignment to different level jobs. In other words, a policy that tended to place workers with lower bargaining power in low-paying jobs and workers with higher bargaining power in higher-paying jobs would run afoul of the competition standard if the workers were equally productive.

Promotion cases also provide fertile ground for application of the theory. If an employer sets up a promotion system that fails to promote workers not because they are less productive than promoted workers, but because they are more willing to work at lower wages, promotion rules can have the same effect as the wage story told above. Indeed, because promotions are routinely accompanied by wage increases, a promotion system that is based on an employer's relative market power can be an effective tool for implementing

77. LINDA BABCOCK & SARAH LASCHEVER, *WOMEN DON'T ASK: NEGOTIATION AND THE GENDER DIVIDE* 41-61 (2002).

78. See *supra* Section II.B.

wage-gouging over time. Our earlier discussion of the Supreme Court's recent decision in *City of Jackson* shows just this possibility.⁷⁹ Finally, while this section has focused on the applicability of the competition standard to disparate impact law, it is worth noting how the analysis applies to two different disparate treatment defenses. First, the foregoing theory should not limit defendant's ability to rebut a plaintiff's prima facie case of disparate treatment by proposing a nondiscriminatory rationale for an employment decision.⁸⁰ An employer who adopted a race-neutral policy is not acting pretextually if its real motive is to increase profits by exploiting its power over weak employees. But this Article's analysis should limit a defendant's bona fide occupational qualification ("BFOQ") defense.⁸¹ A defendant who admits to disparate treatment but who wishes to establish that "religion, sex, or national origin is a bona fide occupational qualification reasonably necessary to the normal operation of that particular business or enterprise"⁸² should not be able to argue that the disparate treatment is justified by a need to exploit its market power. Indeed, it is already the accepted judicial view that an employer cannot establish a BFOQ defense merely by showing that disparate treatment increases its profitability.⁸³

III

THE AUTOMOBILE LENDING LITIGATION

The foregoing sections put forward the economic and doctrinal arguments for the simple idea that anti-competitive practices, even if profitable, should not justify otherwise actionable disparate impacts in the employment context. Much of the discussion has been animated by a hypothetical example of wage-gouging, where an employer paid non-graduates less than graduates, not because they were less productive, but merely because the non-graduates need their jobs more. Because the Supreme Court has expressly limited the ability of

79. See *supra* text accompanying notes 48-50.

80. *Johnson v. Transp. Agency*, 480 U.S. 616, 626-27 (1987) (holding that once a defendant has offered a nondiscriminatory rationale for an employment decision, the burden of proving the decision's invalidity remains with the plaintiff).

81. The BFOQ defense allows employers to consider "religion, sex, or national origin in those certain instances where religion, sex, or national origin is a bona fide occupational qualification reasonably necessary to the normal operation of that particular business or enterprise." The Civil Rights Act of 1964, 42 U.S.C. § 2000e-2(e) (2000). See, e.g., *Healey v. Southwood Psychiatric Hosp.*, 78 F.3d 128 (3d Cir. 1996) (holding that the BFOQ defense allowed a psychiatric hospital to consider gender as part of its employment policies without illegally discriminating).

82. 42 U.S.C. § 2000e-2(e).

83. *Wilson v. Sw. Airlines Co.*, 517 F. Supp. 292, 304 (N.D. Tex. 1981) ("[The] necessity test focuses on the company's ability 'to perform the primary function or service it offers,' not its ability to compete [A] potential loss of profits or possible loss of competitive advantage following a shift to non-discriminatory hiring does not establish business necessity").

plaintiffs to bring disparate impact claims based on the Equal Pay Act,⁸⁴ however, it is not in the wage-gouging realm that our real-world traction is to be found for applying the theory. To date, the most important application of the theory that exploitation of market power should not serve as a justification for policies that have a disparate impact on protected classes can be found not in the employment setting but in recent automobile lending litigation.

The competitive conduct test has played a central role in massive disparate impact litigation that has been brought under the Equal Credit Opportunity Act (“ECOA”) in more than a dozen class action suits against all of the major automotive lenders. While this litigation is important in itself for curtailing some of the most egregious examples of interest-rate-gouging in auto loans, it also affords me the opportunity to set the competitive conduct standard on firmer ground by responding to a formidable set of critics hired to help defend the industry’s price-setting practices.

A. Undisclosed Dealership Markups in Automobile Lending

The emergence of clear evidence of supra-competitive, profit-enhancing policies that disparately impacted African American borrowers in auto lending provides a powerful setting to test intuitions about the need for a competition standard in employment discrimination. The automobile finance industry is large and provides a crucial service in facilitating people’s access to transportation. Mark Cohen reports that nearly 80% of all auto financing is done on site at a dealer and that so-called “captive lenders” have anywhere from 30-50% of this business with the remaining amount distributed over various lenders, including local credit unions as well as major national lenders.⁸⁵ For example, the *Wall Street Journal* recently estimated that 40% of all General Motors automobile sales are financed through the General Motors Acceptance Corporation (“GMAC”).⁸⁶

Although the details vary by dealership and by lender, the industry practice up until the litigation was fairly uniform and tells a damning story. When a car buyer worked with a dealer to arrange financing, the dealer would send the customer’s credit information to a potential lender. The potential lender would then respond with a private message to the dealer that would offer the interest rate at which the lender is willing to lend, called the “buy rate.”⁸⁷

84. *Gunther*, 452 U.S. at 170-71.

85. Mark A. Cohen, *Imperfect Competition in Auto Lending: Subjective Markup, Racial Disparity, and Class Action Litigation* (Working Paper Oct. 2006), available at <http://www.appam.org/conferences/fall/madison2006/sessions/downloads/10393.doc>.

86. Gregory Zuckerman & Mark Whitehouse, *Auto Maker Ponders Selling Stake in Lucrative GMAC Finance Unit*, WALL ST. J., Oct. 18, 2005, at A1, A10. Cohen also estimated that, in 2002, American Honda Credit Corporation financed 38% of all Honda automobile sales. Cohen, *supra* note 85, at 12.

87. *See, e.g.*, Deposition of Kelly, Willis et al. v. America Honda Fin. Corp. (AHFC), No.

But lenders usually encouraged and permitted the dealer to mark up this buy rate if the dealer could induce the borrower to sign a loan agreement with a higher interest rate. The lender of the marked-up loan would often immediately pay the dealer—sometimes thousands of dollars—for passing on the inflated contract.⁸⁸ For example, Nissan’s financial arm, the Nissan Motors Acceptance Corporation (“NMAC”), might tell a dealership that they were willing to lend a buyer money at a 6% interest rate, but that they would pay the dealership \$2800 if the dealership could get the buyer to sign an 11% loan. The buyer would never be told that the dealership was marking up the loan and profiting on the markup. The dealership and the lender would split the expected profits from the markup, with the dealership taking the lion’s share.⁸⁹

Lenders did not allow dealer markups on all of their loans. Some loan programs prohibited (or sharply restricted) dealers from marking up the buy rate. But until the class action lawsuits were filed in 1998, many of the lenders had loan programs that placed no limit on the amount the buy rate could be marked up. Indeed, even after the litigation was filed, many lenders routinely allowed up to a three-percentage-point dealer markup on a subset of their loan programs.⁹⁰ This meant that a 6% buy rate could still be marked up to 9%, which amounts to a 50% increase in the price of borrowing money.

The policy of allowing markups on certain loan programs created two potential sources of inequality. First, the lenders’ decision to selectively ban markups on certain types of loans could induce a disparate racial impact if minority borrowers were less likely to qualify for the no-markup or low-markup loans. Second, the lenders’ decision to grant dealers markup discretion, instead of requiring a standardized across-the-board markup, created the possibility that dealers would disproportionately burden minorities with loans that allowed markup.

Lenders’ policies for setting higher buy rates for borrowers with poorer credit scores also had a disparate impact against African American buyers,

3-02-0490, at 61 (M.D. Tenn. Nov. 8, 2004):

Q. Do your disclosure policies include disclosing the buy rate to the consumer?

A. The buy rate that we—that we have from particular outlet? No.

Q. And do your disclosure policies include disclosing the markup to the consumer?

A. No need to. No.

Q. Do your disclosure policies include disclosing the existence of markup?

A. No need to. No.

88. See Stephen Brobeck, Opinion, *Dealer Finance Reserve Should Be Dumped: Markup Caps Help, But They Don’t End Abuses and Discrimination*, AUTOMOTIVE NEWS, Feb. 21, 2005, at 14; Sarah A. Webster, *Bad Rap or a Bad Buy?: Dealers Defend Financing, But Consumer Groups Seek Changes*, DETROIT FREE PRESS, Dec. 6, 2004, at 1A.

89. A similar system of undisclosed markups has existed in the relationship between home-mortgage lenders and brokers (often with similar disparate impacts on minority borrowers). See HOWELL E. JACKSON & JEREMY BERRY, KICKBACKS OR COMPENSATION: THE CASE OF YIELD SPREAD PREMIUMS 9 (2002), available at http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf.

90. Webster, *supra* note 88, at 1A.

because African American applicants, as an empirical matter, had poorer credit scores on average than white borrowers.⁹¹ But the plaintiffs in this litigation were careful not to challenge the disparate racial impact of the lender's buy rate policies.⁹² The plaintiffs in this litigation challenged only the disparate racial impacts of the markups—markups that were almost completely unrelated to the dealers' or the lenders' costs of doing business.⁹³ The markup component of the APR is much closer to pure economic profit—or at least the markup compensation that exceeds the dealer's cost of arranging the loan. It is highly implausible that the markups could represent payments for the dealers' costs of arranging the loan. This is because, when the lender and dealer negotiated loan arrangement compensation, it was usually on the order of two or three hundred dollars, which is much less than what the markup compensation often turns out to be.⁹⁴

91. Mark A. Cohen, Report on the Racial Impact of AHFC's Finance Charge Markup Policy, Willis et al. v. AHFC, at 39 (June 30, 2004), available at http://www.consumerlaw.org/initiatives/cocounseling/content/AHFC_CohenReportAppendicesA_C.pdf [hereinafter Cohen, AHFC Report].

92. The disparate impact created by tying buy rates to credit scores is potentially justified. People with poorer credit scores are more likely to fail to pay back their loans or fail to pay them back in a timely matter, and thus impose higher costs on lenders. See Avery et al., *Credit Risk, Credit Scoring, and the Performance of Home Mortgages*, 82 FED. RES. BULL. 621, 631-36 (1996). Buy rate policies that allow interest rates to cover lenders' expected costs are presumptively justified—even if they lead to minority borrowers disproportionately paying higher interest rates. But buy rate policies that imposed grossly inflated rates on poorer-credit-score borrowers might still be unjustified. If a poorer credit score imposes a 1% higher cost on a lender, but the lender increases the buy rate by 2%, then this inflated, supra-competitive increment might, according to the theory of this Article, be actionable.

93. Many of the lenders' programs did expose the dealer to a risk of borrower prepayment or nonpayment for the first two or three payments of the loan. See, e.g., Ian Ayres, Expert Report, Claybrooks et al. v. Primus Auto. Fin. Serv., Inc., No. 3-02-0382, at 22 (M.D. Tenn. Sept. 15, 2004) (on file with author) [hereinafter Ayres, Primus Report]. For example, if the borrower paid off the loan or failed to pay on the loan during this period, the dealer might have to pay back to the lender the compensation for arranging the marked up loan. But the industry norm was that the dealers did not bear the risk of paying back the principle if the borrower failed to pay. Testimony from dealers revealed that the three-month risk of a dealership losing its markup compensation did not restrain dealers from setting as high a hidden markup as they thought a borrower would be willing to sign. See, e.g., Ian Ayres, Expert Report, Cason et al. v. NMAC, No. 3-98-0223, at 37 (M.D. Tenn. May 25, 2001) (citing to deposition of Brent Adams) [hereinafter Ayres, NMAC Report].

94. AHFC, for example, as of 2004, typically paid dealers a loan arrangement fee of just \$100 for promotional loans. Declaration of Ian Ayres, Willis et al. v. AHFC, No. 3-02-0490, at 7 (M.D. Tenn. Nov. 3, 2004) [hereinafter Ayres, AHFC Declaration]. In an unrelated example, one particular New York dealer agreed, as part of a settlement with the Attorney General, to fixed-fee compensation for loan arrangement, and estimated the fees would be in this same range. *NY Dealer Sees Spitzer Settlement As A Win*, CAR DEALER INSIDER, April 5, 2004, at 1 (“Metzner [the dealership owner] figures the average fee is about \$225, but will rise to \$300-350 as more lenders come on board and he negotiates higher fees.”).

A prime example of the disparate impact of selective markup caps was the “recent college graduate” programs offered by several lenders, which offered special interest rates that dealers were not allowed to mark up. Just as the employer's high school diploma requirement in *Griggs*

Indeed, the standard industry practice with regard to all advertised “special APR” loans was to prohibit dealerships from marking up the subsidized interest rates. But these below-below market rates—including the 0% specials that were ubiquitous in the wake of 9/11—were usually only available for “well-qualified” borrowers who had superior credit scores. In practice, these special APRs created a “double whammy” that could dramatically increase the disparity in interest rates paid. Imagine that a given lender was willing to lend to Smith at 6% and Jones at 9% (because Smith had a better credit history). After 9/11 and the special APRs for well-qualified borrowers, Smith might walk away from dealership with a 0% loan, shielded from dealer markup, while Jones might walk away with a rate as high as 12%. What started out as a justified 3% difference might become an APR that was twelve percentage points higher. Because minorities disproportionately fail to qualify as “well-qualified borrowers,” they not only lose out on the APR buy-down, they are disproportionately subject to markups that are not related to dealer or lender cost.

The impact of the markup policies of five major automobile lenders—Primus, AHFC, Ford Motor Credit Corporation (FMCC), NMAC, and GMAC—is reported in Table 1.⁹⁵

The table summarizes an analysis of over 3 million car loans including more than 350,000 loans to African American borrowers. On average, African American borrowers paid almost \$400 more in markups than white borrowers in loans from these lenders. The average markup for white borrowers was \$302 while the average markup for African American borrowers was \$695, which was more than twice as high. Across the five lenders, white borrowers had a 31% chance of receiving a loan with a markup, while 53.2% of loans to African American borrowers were marked up.⁹⁶

induced a disparate racial impact, the (recent) college diploma requirement at times caused a disparate racial impact in markup loans as African American borrowers were less likely to qualify for this favorable program. See for example Ayres, NMAC Report, *supra* note 93, at 19 n.24 (“Whites were 19 percent more likely than African-Americans to borrow under defendant’s recent college graduate program”—but noting that this program only produced a small amount of the overall racial disparity).

95. This data is taken from Mark Cohen’s expert report in the Primus Automotive Financial Services (“Primus”) litigation. Mark A. Cohen, Expert Report on the Racial Impact of Primus’ Finance Charge Markup Policy, Claybrooks et al. v. Primus Auto. Fin. Serv., Inc., (Sept. 20, 2004), available at www.consumerlaw.org/initiatives/cocounseling/content/Primus_Cohen.pdf [hereinafter Cohen, Primus Report]. Primus is a wholly-owned subsidiary of Ford Motor Corporation and services many non-Ford brands such as Mazda, Volvo and Jaguar. I have also worked as an expert in litigation involving the following lenders AHFC, FMCC, NMAC, GMAC, DaimlerChrysler Financial Company (“DFC”), Among the financial institutions were AmSouth Bank Corp (“AmSouth”), WFS Financial Inc. (“WFS”), BankOne, Bank of America, and U.S. Bank.

96. The fact that the median white borrower paid no markup is itself strong evidence of the disparate impact of lender programs that selectively banned dealer markup. The median white borrower paid zero markup not because whites were disproportionately adept at bargaining. Most

Table 1

	Primus Jan.-01 Jun.-05	AHFC Jun.-99 Mar.-03	FMCC Jan.-94 Apr.-03	NMAC Mar.-93 Sept.-00	GMAC Jan.-99 Apr.-03	Weighted Average
Total Sample Size Analyzed	219,278	383,652	855,989	310,718	151,191 3	3281550
African American Sample	35,797	44,321	99,347	59,044	127,983	366492
Whites in Sample	183,481	339,331	756,642	251,674	1,383,93 9	29150670
Percent of Costumers Who Are African Americans	16.3 %	11.6 %	11.6 %	19.0 %	8.5 %	11.2 %
Average Amount of Financed-African Americans	\$17,655. 00	19,333.0 0	\$19,383. 00	\$16,749. 00	\$20,443. 00	19500.66
Average Amount of Financed-Whites	\$18,408. 00	17,656.0 0	\$20,563. 00	\$15,922. 00	\$21,530. 00	20085.22
% with Markup-African Americans	61.8 %	43.3 %	48.5 %	71.8 %	53.4 %	53.2 %
% with Markup-Whites	41.1 %	22.2 %	30.9 %	46.7 %	28.2 %	30.8 %
Additional Percentage of African Americans w/ Markup	20.7 %	21.2 %	17.6 %	25.1 %	25.2 %	22.4 %
Relative Odds Ratio % -African Americans	232	268	210	289	292	
Relative Odds Ratio % -Whites	43	37	47.6	34	34	
Average Markup-African Americans	\$862	557	684	970	656	695.23
Average Markup-Whites	\$475	227	337	462	244	302.35
Additional Markup Paid By African Americans	\$387	330	347	508	412	392.88
Ratio of African Americans to White Markup	1.81	2.45	2.03	2.10	2.69	2.4
#Standard Deviations-Incidents of markup- (Actual to Expected)	66.2	91.5	104.1	99	178.8	134.0

The distributions of markups were highly skewed to the right. For example, over half of white borrowers paid no markup at all. But 10% of GMAC borrowers paid more than a \$1000 markup and the top decile of NMAC customers paid a markup of more than a \$1600.⁹⁷ The top 10% of GMAC borrowers produced more than 63% of the GMAC total markup profits, while a mere 5% of GMAC borrowers produced 42% of the total markup profits.⁹⁸ The

whites were unaware that APRs were negotiable. Rather the higher proportion of no markup loans can be attributed to a higher proportion of whites qualifying for no-markup loan products. See Mark A. Cohen, Report on the Racial Impact of GMAC's Finance Charge Markup Policy, Coleman et al. v. GMAC 55 tpls. 20A & 20B, 56 tpls. 21A & 21B, 57 tpls. 22A & 22B (Aug. 29, 2003), available at <http://www.consumerlaw.org/initiatives/cocounseling/GMAC/CohenReport.pdf> [hereinafter Cohen, GMAC Report].

97. Cohen, GMAC Report, *supra* note 96, at 58 tbl. 23A. Honda Finance charged 10% of its borrowers more than a \$1000 markup. Mark A. Cohen, Report on the Racial Impact of AHFC's Finance Charge Markup Policy, Willis et al. v. AHFC 55 tbl. 16A (June 30, 2004), available at http://www.consumerlaw.org/initiatives/cocounseling/content/AHFC_CohenReportAppendicesA_C.pdf [hereinafter Cohen, AHFC Report]. Primus charged 10% of its borrowers more than a \$1700 markup. Cohen, Primus Report, *supra* note 95, at 35 tbl. 14.

98. Cohen, GMAC Report, *supra* note 96, at 28 tbl. 8. The story was much the same at the other lenders: The 5% of GMAC borrowers paying the highest markup paid 42% of the total markup profits. *Id.* at 3. Similarly, in FMCC, 25% of FMCC borrowers produced 53.1% of the total markup profit. Mark A. Cohen, Preliminary Report on the Racial Impact of FMCC's Finance Charge Markup Policy, Jones et al. v. FMCC 36 tbl. 8 (Jan. 9, 2004), available at

disparate racial impacts were even more pronounced with regard to borrowers in this right-hand tail of the markup distributions; the most profitable borrowers were disproportionately African American. For example, while African American borrowers represented only 8.5% of the overall GMAC sample of loans, they represented 21.7% of borrowers in the top decile of markup profitability.⁹⁹ Conversely, African Americans were only 8.5% of GMAC borrowers, but they paid 19.9% of the markup profits.¹⁰⁰

The racial disparities tended to grow even larger further down the tail. For example, in the fifteen states for which the data was coded by race, the top 500 Primus borrowers, who each paid more than a \$4000 markup, were disproportionately black: while African Americans were only 16.3% of the Primus borrowers, they represented 30.2% of these 500 most-profitable markups.¹⁰¹ The racial disparity was even more extreme for the top 100 GMAC borrowers in Alabama, who each paid more than a \$5000 markup: African Americans were only 13.9% of Alabama GMAC borrowers, but represented 62 of these 100 most-profitable markups.¹⁰²

It is not plausible that markup disparities of this magnitude are driven by the costs of doing business with certain types of customers. When loan programs prohibit markups, lender compensation to dealers for loan arrangement is on the order of \$200 to \$400. But the data consistently revealed a substantial number of loans with markups above \$1000 and even \$1500. And the highest markups in the data were often on the order of \$3000 or \$4000. Four thousand dollars cannot be described as compensation for the cost of doing business plus a fair profit margin. These supra-competitive markups effectively demonstrated price-gouging by the lenders and dealers.

The term “price-gouging” has been legally defined. A number of states

http://www.consumerlaw.org/initiatives/cocounseling/content/FMCC_Cohen.pdf [hereinafter Cohen, FMCC Report]. Ten percent of Honda borrowers produced more than 65% of the total markup profits (a mere 5% of Honda Finance borrowers produced 41% of the total markup profits). Cohen, AHFC Report, *supra* note 91, at 29 tbl. 6. At Primus, 10% of borrowers produced more than 45% of the total markup profits (a mere 5% of Primus borrowers produced 26.7% of the total markup profits). Cohen, Primus Report, *supra* note 95, at 22 tbl. 6.

99. Cohen, GMAC Report, *supra* note 96, at 28 tbl. 8. Again, the same story was seen elsewhere: while black borrowers were only 11.6% of the overall Honda sample of loans, they represented 26.5% of borrowers in the top decile of markup profitability. Cohen, AHFC Report, *supra* note 91, at 29 tbl. 6. While black borrowers were only 16.3% of the overall Primus sample of loans, they represent 30.2% of borrowers in this top decile of markup profitability. Cohen, Primus Report, *supra* note 95, at 22 tbl. 6. Or analyzed alternatively, African Americans are only 16.3% of Primus borrowers, but they pay 26.1% of the markup profits. *Id.*

100. Cohen, GMAC Report, *supra* note 96, at 28 tbl. 8.

101. Cohen, Primus Report, *supra* note 95, app. D. Similarly, the top 500 Honda borrowers (from the fifteen race-coded states), who each paid more than a \$3600 markup, were disproportionately black: African Americans are only 11.47% of the Honda Finance borrowers in the fifteen states but they represented 36.4% of these 500 most-profitable markups. Cohen, AHFC Report, *supra* note 91, app. D.

102. Cohen, GMAC Report, *supra* note 96, app. D.

expressly prohibit price-gouging in the aftermath of a natural disaster. For example, a Tennessee statute makes it unlawful:

to charge any other person a price for any consumer food item; repair or construction services; emergency supplies; medical supplies; building materials; gasoline; transportation, freight, and storage services; or housing, that is grossly in excess of the price generally charged for the same or similar goods or services in the usual course of business immediately prior to the events giving rise to the state of emergency.¹⁰³

Similarly, the New York price-gouging statute prohibits “grossly excessive” or “unconscionably excessive” prices.¹⁰⁴ The statute fills out the meaning of the excessive price standard:

[P]rima facie proof that a violation of this section has occurred shall include evidence that (i) the amount charged represents a gross disparity between the price of the goods or services which were the subject of the transaction and their value measured by the price at which such consumer goods or services were sold or offered for sale by the defendant in the usual course of business immediately prior to the onset of the abnormal disruption of the market or (ii) the amount charged grossly exceeded the price at which the same or similar goods or services were readily obtainable by other consumers in the trade area. A defendant may rebut a prima facie case with evidence that additional costs not within the control of the defendant were imposed on the defendant for the goods or services.

These statutes make it clear that the term “price-gouging” is more than a free-form pejorative conclusion that the price charged is too high.

The markups observed in automobile lending would clearly violate the gouging element of these price-gouging statutes. The amounts charged “grossly exceed the price at which [similar] services were readily obtainable by other customers in the trade area.” Indeed, the analogy holds water in both directions. The types of pricing prohibited by the price-gouging states are not the types that are “consistent with business necessity.” In real-world settings, it may at times be difficult to distinguish policies that allow a business to cover its cost and earn a reasonable economic return from those that allow a business to earn supra-competitive profits. However, the facts of the automotive lending cases did not present a hard case. The markups paid were not just supra-competitive, they were “grossly in excess of the price generally charged.”¹⁰⁵

The price-gouging statutes have traditionally only regulated pricing during emergencies or natural disasters.¹⁰⁶ But the evidence from automotive lending

103. Tenn. Code Ann. § 47-18-5103 (2001).

104. N.Y. Gen. Bus. Law § 396-r (3)(b) (2006).

105. Tenn. Code Ann. § 47-18-5103 (2001).

106. Richard Givens defended the traditional limited scope of the statute:

shows that price-gouging can persist over longer periods when consumers have limited information and sellers act to keep buyers uninformed. This Article has not suggested making price-gouging illegal in all cases, but it does suggest that price-gouging that disparately impacts minorities should be at least as problematic as advantage-taking in the shadow of natural disasters.¹⁰⁷

Thus, the markup litigation provides a persuasive example for our intuitions about the central thesis of this Article that exploiting market power should not justify profitable policies that cause disparate racial impacts. We are confronted with a set of lender policies that clearly produced a pronounced disparate racial impact; at NMAC, for example, the median markup for white borrowers was \$0, while the median markup for black borrowers was over \$750.¹⁰⁸ In addition, the lender policies were a but-for cause of that disparity because there would be no racial disparity if Nissan dealer compensation was placed at a fixed amount. The lender policies were also clearly profitable beyond a competitive level. In exchange for engaging in a paper transaction (typically demanding only a minimal amount of time), where the dealer usually bore no risk of repaying the principal, dealerships often reaped thousands of dollars in profits. This is not the increased profitability of a policy that ensures that costs are covered, but rather the increased profitability of prices that far exceeded cost.

This litigation forces us to ask whether policies that increase profits via supra-competitive pricing are a defense to a prima facie showing of disparate impact. In my capacity as an expert witness, I was convinced that no court would accept the profitability of these markups as a defense to what the data laid so bare: a profound disparate impact. Indeed, I felt that just forcing the

The ability of the market to ration supplies through higher prices and encourage additional output because of the profit offered works only over a sufficient period of time and cannot avoid cutoff of supply to many when a spike-like price rise occurs for a temporary period, giving a windfall to holders of supply where encouragement of output cannot take effect within that time span. Over a longer period, antitrust rather than antigouging law becomes the protective legal principle most likely to turn out to work and to be useful. Price controls which continue in effect for an appreciable period cause shortages to develop rather than be overcome, and lead to the necessity for rationing supplies, with debilitating results that increase with time.

Practice Commentaries, N.Y. Gen. Bus. Law § 396-r (McKinney 2004).

107. Price-gouging after a natural disaster, while inequitable, can actually enhance allocative efficiency. When the demand for batteries is greater than the supply, then charging higher prices may do a better job than a lottery or first-come, first-serve allocations in helping to assure that the batteries are not used for playing Gameboy. See Daniel Kahneman, Jack L. Knetsch & Richard Thaler, *Fairness as a Constraint on Profit Seeking: Entitlements in the Market*, 76 AM. ECON. REV. 728, 735 (1986) (acknowledging that certain perceived inequitable practices may be economically efficient). Price-gouging to a subset of auto loan borrowers would do absolutely nothing to enhance allocative efficiency, however.

108. Mark A. Cohen, Supplemental Report on Racial Impact of NMAC's Finance Charge Markup Policy, Cason et al. v. NMAC 60 Tbl. 22 (Aug. 28, 2001) (on file with author) [hereinafter Cohen, NMAC Report].

defendant attorneys or experts to utter the words “price-gouging,” even if only to deny it, would go a long way toward convincing a court to accept the central thesis of this Article.¹⁰⁹

But of course my voice was not the only one heard in this litigation. The defendant lenders retained the services of three extraordinarily capable academics—in turn Richard Epstein, James Heckman and George Priest—to rebut the idea that policies that produce supra-competitive profits do not justify what would otherwise be an actionable disparate impact. These experts put forward a number of arguments for why liability was not appropriate given the facts of this case.¹¹⁰ Many of their opinions challenged whether plaintiffs had even established a prima facie case of disparate impact.¹¹¹ A rehashing of that statistical and data-driven debate is not my aim in this Article. Instead, in the remainder of this section, I will focus on how these experts responded to the justification theory propounded in this Article.

B. Richard Epstein—“Competition Drives Out Unearned Rents”

University of Chicago law professor and titan of the law-and-economics movement, Richard Epstein was hired by NMAC to rebut my price-gouging argument in the first class-action automobile lending suit.¹¹² Epstein’s central argument was to deny the premise of price-gouging. His elegant and simple syllogism went as follows: (1) the credit market is very competitive; (2) competition drives out supra-competitive pricing; (3) therefore, the interest-rate pricing must be competitive. As Epstein testified in his deposition:

[Ayres and Cohen’s] argument was that the markup was an unearned increment by dealers. I knew that that had to be a preposterous statement of economic reality. Nobody gets a free lunch for that long, not on hundreds of thousands of transactions every day. And by your account, the dealers have done absolutely nothing to earn that money. That cannot be. . .

109. My reasoning parallels the attempt of Alan Dershowitz in representing Klaus Von Bulow to lure the prosecution on appeal into “taking the bait” and rearguing the question of guilt. ALAN DERSHOWITZ, *REVERSAL OF FORTUNE* (1986).

110. For example, defendants in various cases argued that: (1) Defendants were not “lenders,” but merely repurchased loans that had been initiated by dealers. *See* Expert Report of Richard A. Epstein, *Cason et al. v. NMAC*, No. 3-98-0223, (M.D. Tenn. July 12, 2001) [hereinafter Epstein, NMAC Report]. (2) Defendants were justified in allowing markups, because if they didn’t allow dealers to price-gouge, dealers would have directed the business to another lender that allowed price-gouging. Expert Report of George L. Priest, *Willis et al. v. AHFC*, No. 3-02-0490, (M.D. Tenn. Oct. 2, 2004) [hereinafter Priest, Primus Report]. (3) Defendants were justified in selective markup caps because they had a legitimate motive to try to sell cars. Epstein, NMAC Report *supra*.

111. For example, as discussed below, George Priest argued evidence of disparate impact with regard to markups was not sufficient to prove that plaintiffs suffered a disparate impact with regard to the net impact of the transaction. *See* Priest, Primus Report, *supra* note 110.

112. *Cason et al. v. NMAC*, No. 3-98-0223, 212 F.R.D. 518 (M.D. Tenn. 2002).

Competition drives out unearned rents, and that's the only thing that one needs to know to figure out why [Ayres's] report is wrong.¹¹³

In his deposition, Epstein's a priori faith in the power of competition to eliminate all supra-competitive pricing bordered on the non-falsifiable:

Q: So one basis of your opinion is your assumption that market forces work efficiently [?] and this market is particularly efficient, so this discrimination could not possibly exist. You agree and one of your assumptions in your report is that the markup charges are related to the work performed by the dealer?

A. Uhm-hhm.

Q. And so if those two assumptions were proven to be false, then would you be prepared to withdraw the opinion in your report?

A. Again, I mean, proven to be false—what I would do is—no, I would ask the following question because I simply do not believe that unearned increments exist in this form.¹¹⁴

By arguing that supra-competitive pricing is just not possible, Epstein was able to avoid confronting whether such pricing would be justified.¹¹⁵

For Epstein, the great dispersion in markups was driven by differences in dealers' loan arrangement costs. Even though Nobel Prize-winning economist and founder of the Chicago School George Stigler long ago understood that the price dispersion in new car prices could not plausibly be attributable to differences in cost,¹¹⁶ Epstein supported the notion of purely cost-based pricing. Even stark evidence to the contrary, for example that the median NMAC markup for whites was \$0 while 10% of NMAC borrowers paid more than a \$1600 markup, did not change Professor Epstein's position on the role of

113. Deposition of Richard A. Epstein, *Cason et al. v. NMAC*, No. 3-98-0223, (M.D. Tenn. July 30, 2001) [hereinafter Epstein, NMAC deposition], at 86.

114. *Id.* at 136-37. Professor Epstein's indifference to the factual record can also be seen in this telling moment of his deposition:

Q. Let me ask you, do you recall—

A. I can't even recall reading the depositions or doing anything with them.

Id. at 52.

115. While not a direct assault on my theory of justification, Professor Epstein did argue that my theory of disparate impact would essentially render superfluous disparate treatment liability: "[Ayres'] version of the world is essentially one in which there's no percentage whatsoever for using a disparate treatment case anywhere, ever, because you will always do better as a plaintiff by using a disparate impact case." Epstein, NMAC Deposition, *supra* note 113, at 83. But this criticism clearly misses the mark. The theory of disparate impact justification suggested both in this Article and in my expert testimony would still allow defendants to avoid liability for policies that help them cover their costs of doing business. Cost-based statistical discrimination on the basis of race might therefore be justified under a disparate impact theory but would not be justified under disparate treatment analysis.

116. Stigler, in considering whether the dispersion observed in new car pricing could be attributed to cost-based differences, concluded: "it would be metaphysical, and fruitless, to assert that all dispersion is due to heterogeneity." GEORGE J. STIGLER, *THE ORGANIZATION OF INDUSTRY* 172 (1968).

competition.

Indeed, Epstein in his expert report suggested that there was a sharp dichotomy between the pricing of loans for two different types of borrowers:

As a general matter, credit markets are divided into two kinds of transactions: those in which there are no (or tiny) risks of nonpayment, and those in which there is a large but uncertain risk of nonpayment. A treasury bill is the prime example of a riskless form of security, whose interest rate represents only a fee that the borrower pays the lender for the use of the money over time. No private borrower has quite the credit of the United States government, but many purchasers of cars (homes, and other consumer goods) have never defaulted on any loan or credit transaction and thus present a well-nigh riskless position. Dealing in these markets is a straight interest calculation that involves little business acumen, for everyone will set about the same rate for the transactions. Matters are far more complicated for high-risk credit transactions where the risk of nonpayment, late payment, or partial payment is paramount. In these cases, the negotiated interest must be sufficient to compensate for the additional risk . . . ¹¹⁷

Epstein reasoned that it was these additional difficulties of arranging loans for high-risk borrowers that justified the high dealer compensation.

But Epstein did not confront the evidence that even borrowers with good credit scores exhibited substantial disparities in markups. Cohen found that the average markups for black borrowers placed by NMAC in the best credit tier were \$361 dollars higher than the average markup for whites placed in the same credit tier. The average markup for black borrowers in Tier 1 was \$660, versus the \$299 markup for white borrowers in Tier 1.¹¹⁸ Epstein's own report opines that for these "well-nigh riskless" borrowers "[d]ealing in these markets is a straight interest calculation that involves little business acumen for

117. Epstein, NMAC Report, *supra* note 110, at 19-20.

118. Cohen, NMAC Report, *supra* note 108, at tbl. 20. The persistence of racial disparity across credit tiers was found for other lenders as well. For example, Cohen's analysis of GMAC borrowers found substantial disparities within each credit tier for every year analyzed:

Average Markup by Race and Year by Credit Tier

Year	Credit Tier = S			Credit Tier = A			Credit Tier = B		
	Black	White	Diff.	Black	White	Diff.	Black	White	Diff.
1999	\$384	\$127	\$257	\$682	\$244	\$438	\$867	\$446	\$421
2000	\$367	\$111	\$256	\$597	\$210	\$387	\$883	\$407	\$476
2001	\$321	\$92	\$229	\$498	\$158	\$340	\$790	\$354	\$436
2002	\$308	\$106	\$202	\$503	\$195	\$308	\$765	\$387	\$378
2003	\$283	\$100	\$183	\$459	\$194	\$265	\$645	\$373	\$272
Overall	\$323	\$102	\$221	\$523	\$191	\$332	\$786	\$384	\$402

Cohen, *supra* note 85, at tbl. 4.

everyone will set about the same rate for the transactions.”¹¹⁹ Epstein’s theory suggests that these borrowers would receive uniform and small markups. But the data are starkly at odds with his faith in market competition. Plainly, on Epstein’s own logic, cost could not have been driving disparities as wide as these. Something else was at work.

In February of 2003, the NMAC litigation was settled and NMAC agreed to three core remedies.¹²⁰ First, NMAC agreed to limit its markup to 3 percentage points “above NMAC’s buy rates for each credit tier,”¹²¹ 2 percent for longer-term finance agreements, and 2 percent for used vehicles.¹²² Second, it agreed over the course of five years to offer 625,000 African American and Hispanic borrowers pre-approved no-markup loans.¹²³ Finally, NMAC agreed to engage in substantially enhanced programs of disclosure and consumer education.¹²⁴

*C. James Heckman -
All Profits Are Justified*

In the next case to reach the deposition and expert report stage, GMAC retained the services of one of the great econometricians in the world, Nobel Prize-winning economist James Heckman. Heckman’s report in the GMAC litigation concentrated on responding to the business justification argument at the center of this Article.¹²⁵

119. Epstein, NMAC Report, *supra* note 110.

120. Settlement Agreement, Cason et al. v. NMAC, No. 3-98-0223 (M.D. Tenn. Feb. 18, 2003), available at http://www.consumerlaw.org/initiatives/cocounseling/content/settlement_agreement.PDF.

121. *Id.* at 15.

122. *Id.* at 16.

123. *Id.* at 24. See also *infra* note 127 (commenting on the implications of race-dependent affirmative lending).

124. The outline of the settlement agreement explains, “NMAC will contribute \$1 million over the next five years to three national consumer financial education programs.” NMAC also promised to “mail an educational brochure in English and Spanish to existing customers annually for five years.” And NMAC agreed to “provide written disclosure on NMAC financing contracts forms that a customer’s annual percentage rate may be negotiable with the dealer.” Outline of Settlement Agreement, Cason et al. v. NMAC, <http://www.consumerlaw.org/initiatives/cocounseling/content/outline.pdf>.

In contrast to the \$63 million benefits accruing to African American borrowers directly (through no-markup loans and markup caps) and indirectly through NMAC’s financing of consumer education), the plaintiffs’ attorneys were paid \$6 million. Overall, in the settled cases Cohen estimates that legal fees have averaged less than 5% of minority benefits. See Mark A. Cohen, Declaration on Valuation of Settlement, Cason et al. v. NMAC [hereinafter Cohen, NMAC Declaration on Valuation of Settlement].

125. James J. Heckman, Expert Report, Coleman et al. v. GMAC, No. 3-98-0211 (M.D. Tenn. Dec. 15, 2003) (on file with author) [hereinafter Heckman, GMAC Report]. One might thus have expected Heckman to respond to the central econometric claim in my report, as well as the actual econometrics performed by plaintiffs’ expert Mark Cohen. In my report, I opined that in disparate impact cases, it was important to intentionally exclude from regression analysis controls

How did Heckman's report critique the idea that policies which have a disparate impact are less justified if they extract supra-competitive profits than if they allow sellers to cover their costs? Heckman, like Epstein, tried to avoid the question, by denying the possibility of supra-competitive pricing.¹²⁶ But unlike Epstein, Heckman did not say that the higher markups track the higher costs of loan arrangement for some customers. He instead argued that the higher markup profits represented returns on entrepreneurial effort.¹²⁷ This section will show that Heckman's theory ultimately represents an unfalsifiable conviction that firms "need to maximize profits to survive."¹²⁸

Heckman's theory that all profits, no matter how high, are justifiable returns to entrepreneurial effort is expressly Schumpeterian. Heckman states in his report:

Those who innovate make what Schumpeter called an entrepreneurial profit. The entrepreneurial activity is distinct from the investment activity which often bears the risk of the entrepreneur's projects. Hence the entrepreneurial profit is distinct from and in addition to any normal return to capital.¹²⁹

This theory leaves no possibility for market failure or supra-competitive profit because the additional revenue merely compensates entrepreneurs for their innovation. Heckman concludes: "[The] extra profits are not an illegitimate 'market failure' as Professor Ayres claims. Quite the opposite, they

for variables that did not provide a plausible business justification. Ian Ayres, Expert Report, *Coleman et al. v. GMAC*, No. 3-98-0211, at 8 (M.D. Tenn. Aug. 29, 2003) (on file with author) [hereinafter Ayres, GMAC Report]. Even though econometricians are used to worrying about the problem of omitted variable bias, I showed that in disparate impact cases the problem of "included variable bias" was more important. Ayres, GMAC Report *supra*, at 7-8. For example, in the original disparate impact case, *Griggs*, 401 U.S. at 424, it would be inappropriate to control for possession of a high school diploma in a regression trying to predict whether African Americans were less likely to be hired or promoted, because the goal in disparate impact cases is to determine whether nonracial factors unjustifiably caused employment disparities. See Ian Ayres, *Three Tests for Measuring Unjustified Disparate Impacts in Organ Transplantation The Problem of "Included Variable" Bias*, 48 PERSPECTIVES IN BIOLOGY & MED., at S68-S70 (2005). To test for unjustified disparate impacts, it is important not to control for any factors that do not provide a plausible business justification. In a disparate treatment case, on the other hand, controlling for whether an applicant had a high school diploma would be appropriate, because the goal is to see whether there was a racial disparity in employment after controlling for all plausible non-race factors. See *id.*

Heckman should have responded directly to this analysis. In fact, he had recently commented on a conference article of mine applying just this idea of included variable bias to the issue of disparate racial impacts in medicine. Robert Bornholz & James J. Heckman, *Measuring Disparate Impacts and Extending Disparate Impact Doctrine to Organ Transplantation* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 10946 2004), available at <http://www.nber.org/papers/w10946>. But only a few pages of his report in the GMAC case concerned the included variable bias theory. See Heckman, GMAC Report, *supra* (only 3 of the 54 pages).

126. Heckman, GMAC Report *supra* note 125, at 18.

127. *Id.* at 17-18.

128. *Id.* at 2.

129. *Id.* at 17. See generally JOSEPH ALOIS SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY (1947).

are the engine that drives economic development and growth.”¹³⁰ Under this theory, market failure is simply not possible. Heckman does not have to consider whether price-gouging would be legally unjustifiable because there seems to be no such thing as price-gouging, in this view.

To Heckman, the Schumpeterian theory of profits as a driving force for innovation in the economy did not seem misplaced in justifying dealership loan markups. He explained:

Acts of entrepreneurship do not need to be spectacular. A willingness to finance the sale of a product to someone who could not otherwise afford it, or in a locality that was not previously being served, are forms of innovation. Under accepted economic theory, these would entitle even as mundane an economic actor as a vehicle dealer to an entrepreneurial profit.¹³¹

While Heckman casts the dealer-entrepreneurs in a positive light as finding new ways to finance “someone who could not otherwise afford it,” on the ground his report is trying to justify GMAC’s policy of allowing \$5000 dealership markups on hundreds of loans.¹³² The true innovation lies not in new products or in servicing a new niche of clients, but instead in devising new ways to extract higher and higher markups from the unwary.

At core, Heckman argues that if firms fail to extract as large a profit as is legally possible, they may not expect to survive in the Schumpeterian world of dynamic competition.¹³³ Heckman seems to believe that Microsoft would put its corporate existence at risk if it dropped the \$299 price of Windows XP Professional by a single dollar. The reader may think that I have overstated Heckman’s view. It may seem that he could not have argued that it is a business necessity for firms with market power to maximize profits to supra-competitive levels. But Heckman argued:

Professor Ayres contends “Exacting supra-competitive revenues from a class of consumers—not because they impose higher costs on the seller but merely because the seller has the power to do so—is not consistent with business necessity.” But adopting practices to make the greatest profit subject to obeying the law is a business necessity.¹³⁴

For a Schumpeterian, there is no such thing as market power because dynamic competition in Heckman’s words “annihilates” permanent surplus value.¹³⁵

130. Heckman, GMAC Report, *supra* note 125, at 17. *See also id.* at 18 (“The presence of profits is not evidence of market failure, as claimed by Professor Ayres. The expectation of profits to be made provides the incentive to enter existing markets and to create entirely new markets by inventing entirely new ways to meet basic demands.”).

131. *Id.* at 18.

132. *Id.* at 17.

133. *Id.*

134. *Id.* at 18.

135. *Id.* at 17 (“The competitive mechanism tolerates no permanent surplus values, but annihilates them . . .”).

Heckman concluded: “[I]f ‘legitimate’ has any meaning in economics, the foregoing discussion shows that increasing revenues and profits is legitimate, indeed is the most legitimate activity of any business in a free market.”¹³⁶

The Schumpeterian competitive mechanism might be reasonably accurate in the long run. But, the Keynesian retort that “in the long run we are all dead” is reason enough to be concerned about short run anti-competitive deviations. The difference between Heckman and myself is not the difference between dynamic and static analysis of competition; at core, the difference is Heckman’s unconditional faith in corporate efficiency versus my empirically contingent views about the efficiency or non-efficiency of particular sellers. Heckman dismisses my analysis as a “polemic” and biased: “Professor Ayres presents, in the guise of economics, what is really his own normative system.”¹³⁷

But if we follow Heckman’s argument to its logical end, much of antitrust and consumer protection law must fail, as there should be a profitability defense to all business conduct. There is circularity in Heckman’s claim that maximizing profits “subject to obeying the law is a business necessity.”¹³⁸ If the law proscribes price-gouging that has a disparate impact against minorities, then according to Heckman’s own analysis it is no longer a business necessity. In such a world, lenders who refrained from price-gouging would not be put at a Schumpeterian disadvantage by earning less profits because by assumption the law would prohibit price-gouging by all lenders in the industry.¹³⁹

Unlike Epstein or Priest, Heckman rose to the bait and openly embraced the wage-gouging hypothetical discussed above in Section I as being consistent with business necessity:

Ayres then gives an example . . . “Consider . . . an employer who institutes a policy of paying employees who are the primary care

136. *Id.* at 18.

137. *Id.* at 15. *See also id.* at 3 (“[Ayres] phrases his methodology in economic terms. However his methodology depends on assumptions which fly in the face of fundamental principles of economics as a science as well as the principles on which free markets are founded.”).

138. *Id.* at 18.

139. Heckman also claims that to forego a dollar of profit is economically equivalent to incurring a dollar of cost and therefore that no “valid economic distinction can be drawn between reducing cost and increasing revenue . . .” *Id.* at 2. Heckman opines: “If there is an opportunity to earn revenue and the business fails to obtain it, economists refer to that as an ‘opportunity cost.’ Foregoing revenue is an opportunity cost. In the context of negotiation, if a buyer is willing to pay ten thousand dollars and the seller agrees to accept nine thousand dollars, that thousand dollars is an opportunity cost. Thus Professor Ayres’ distinction between revenue and cost is untenable.” *Id.* at 18. But many areas of the law distinguish between costs and opportunity costs. *See, e.g.*, Fred S. McChesney, *Tortious Interference with Contract versus “Efficient” Breach: Theory and Empirical Evidence*, 28 J. LEGAL STUDIES 131 (1999) (in which the difference between monetary costs and opportunity costs is central to the author’s model of the tort law’s intersection with efficient breach theory).

givers of school children a substantially lower salary.” The example is clever and polemical. Who could possibly justify such a heartless employer’s practice? [Ayres] goes on: “the employer should not be able to justify paying caregivers less solely because these employees have fewer employment alternatives (say, because of a lower ability to move to other cities). . . .”¹⁴⁰

Heckman understands that the wage-gouging in this example is analogous to the price-gouging of the dealers, but he sees nothing wrong with paying equally productive workers less than they would earn in a competitive market: “Differential search costs of individual persons can produce a result where an identically productive individual gets a lower wage. Workers (male or female) who search less typically get lower wages. Some low wage jobs provide amenities like a location convenient for the employee’s other activities such as caregiving.”¹⁴¹ These sentences are carefully descriptive of economic equilibrium, and in the absence of legal intervention might be true. But Heckman was implicitly arguing that it is legitimate for employers to pay employees less just because they are less able to search for alternative employment. Implicitly he was arguing that it is a business necessity to wage-gouge whenever possible. For Heckman, firms that do not extract the maximum surplus allowed by the law from their employees and customers will not survive.

But this theory is surely not true in the short run and would be even weaker in a world where all competitors are restrained from extracting supra-competitive profits that produce disparate impacts. It would be one thing for Heckman to argue that dynamic competition will eventually give rise to a Google-like competitor. But it is quite another to worry about a competitive disadvantage when all other firms in the industry are similarly constrained. Heckman’s strong-form Schumpeterian views are not generally accepted in the economics profession and they do not resonate with a reasonable interpretation of “job related for the position in question and consistent with business necessity.”¹⁴²

Heckman has not universally embraced the idea that Schumpeterian dynamic competition will cure all market imperfections, however. For example, in a recent interview with the Federal Reserve Bank of Minneapolis, Heckman spoke about the implications of his finding that Title VII had a definite impact

140. Heckman, GMAC Report, *supra* note 125, at 31. Heckman goes on to suggest that in this example I am imputing to the employer “an intention of disparate treatment of women caregivers.” *Id.* But this misses the mark. The example imputes to the employer only an intention to increase its profits by lowering the wage paid to equally productive but less mobile workers. Of course, an intention to wage gouge the vulnerable might result in a disparate impact on a protected class.

141. *Id.*

142. 42 U.S.C.A. § 2000e-2(k)(1)(A)(i) (1994). See *supra* note 7 and accompanying text.

on hiring in the Southern textile industry:

And to be honest, I found that some of my colleagues at Chicago were very hostile to this finding, and some remain so. Some want to believe that markets by themselves will solve problems like racial disparity. Markets do many useful things, but they did not solve the problem of race. Not in America. That's probably heresy to admit it as a Chicago economist, but I became convinced that a doctrinaire notion that markets would solve the problem of discrimination is false.¹⁴³

This characterization not only contradicts his Chicago colleague Epstein, but seems to be in tension with his testimony in this litigation.¹⁴⁴

A court was never able to consider Heckman's views, because in February of 2004 the GMAC litigation settled.¹⁴⁵ The GMAC settlement paralleled the basic structure of the NMAC settlement, but the terms were even more favorable to the plaintiffs' class.¹⁴⁶

*D. George Priest -
Disparate Treatment and Disparate Impact Are the Same*

The most recent defendants, including Honda, Primus, and Ford, have turned to my friend and colleague, George Priest, as an expert witness. Priest's testimony in the Primus litigation is particularly important, because the Primus case was the first suit to go to trial.

Unlike his predecessors, Priest did not argue that there was no evidence of supra-competitive pricing, he leveled another objection altogether:

There may be—in these top 100 examples here in Tennessee, there may be individual examples of exploitation of consumers in one way or another. I'm not saying that that doesn't occur. It's just exploitation by the dealer. The suit should be brought against the dealer . . .¹⁴⁷

So while Epstein argued that price-gouging was impossible, and Heckman argued that price-gouging was a business necessity, Priest instead argued that "exploitation" might have taken place but that it was not the lender's fault. Priest never needed to grapple with the question of whether profiting from anti-competitive behavior was a business justification, because he limited his

143. Interview with James J. Heckman, *The Region* (June 2005), <http://www.minneapolisfed.org/pubs/region/05-06/heckman.cfm> (emphasis added).

144. *Id.*

145. See Settlement Agreement, *Coleman et al. v. GMAC*, No. 3-98-0211 (M.D. Tenn. Feb. 10, 2004), available at <http://www.consumerlaw.org/initiatives/cocounseling/content/GMACSettlementAgrmt.pdf> (Feb. 10, 2004) [hereinafter GMAC Settlement Agreement].

146. For example GMAC agreed to a general markup cap of 2.5% (with a 2% cap for loans with a maturity of more than 3 years). *Id.* at 11.

147. Testimony of George L. Priest, *Borlay et al. v. Primus Auto. Fin. Serv.*, No. 3-02-0382, (M.D. Tenn. March 10, 2005) [hereinafter Priest, Primus Testimony] at XVII: 55.

testimony so as not to offer a business justification opinion.¹⁴⁸

Instead, Priest argued that plaintiffs failed to establish a prima facie case of discrimination. His argument had two main components. First, he claimed that plaintiffs had failed to prove a disparate racial impact because they had not considered whether other aspects of the transaction explained the disproportionate treatment that African American borrowers experienced on their loan markups.¹⁴⁹ For example, Priest argued that lower car prices or higher trade-in prices might have offset the higher markups.¹⁵⁰ Without providing evidence that African American borrowers were in fact paying lower car prices or higher trade-in prices, he argued that these offset effects were a theoretical possibility and that plaintiffs had failed to establish a prima facie case by presenting sufficient evidence to refute this possibility.¹⁵¹

Priest's argument disregarded *Teal*, which held that an employer was liable for a disparate impact violation if any part of its selection process has a disparate impact, even if the final result of the hiring process is racially balanced.¹⁵² In effect, *Teal* rejected what has come to be known as the "bottom line defense."¹⁵³

Even if a bottom line defense was available as a matter of law in these types of ECOA claims, it was bizarre for Priest to argue that Cohen's empirical evidence did not create a rebuttable prima facie case of racial disparity. Cohen found substantial and statistically significant racial differences in the markup

148.

Q. Are you giving a legal opinion here today with respect to the business justification legal defense in the case?

A. No, I'm not.

Id. at 192.

149. Deposition of George L. Priest, Willis et al. v. AHFC, No. 3-02-0490, at 81 (M.D. Tenn. Nov. 8, 2004) [hereinafter Priest, AHFC Deposition].

150. *Id.* at 97.

151. Priest, Primus Report, *supra* note 110. Contrary to Priest's suggestion of financing-profit-as-offset, in a study of an individual Atlanta car dealership that I performed as part of my book, *Pervasive Prejudice?*, I found that there was a positive correlation between vehicle profitability and financing profitability. See generally IAN AYRES, PERVERSIVE PREJUDICE? 19-44 (2001). Cohen found a similar positive correlation in analyzing Honda data. Cohen, AHFC Report, *supra* note 97, at 77.

152. 457 U.S. at 442.

153. *Id.* As the *Teal* Court defined the term, the "bottom line" theory of defense is that "an employer's acts of racial discrimination in promotions—effected by an examination having disparate impact—would not render the employer liable for the racial discrimination suffered by employees barred from promotion if the 'bottom line' result of the promotional process was an appropriate racial balance." *Id.* In *Teal*, the Court rejected the "bottom line" defense, holding that it "does not preclude respondent employees from establishing a prima facie case, nor does it provide petitioner employer with a defense to such a case." *Id.* As a normative matter, I am not a great fan of *Teal*'s argument. See Ayres & Siegelman, *supra* note 6, at 1517 (criticizing the perverse effect of *Teal*'s "no bottom line defense" holding as punishing firms for success in hiring minorities). But its application to ECOA may be particularly appropriate if one concludes that Congress did not intend for disparate treatment on non-credit terms to operate as a defense to racial disparities found in credit terms. 15 U.S.C. § 1691 (2000).

profits.¹⁵⁴ The mere theoretical possibility that dealers, from time to time, might match high vehicle profits with low markup profits offers no rebuttal to the empirical evidence that they did not do so as a rule.¹⁵⁵ Certainly, no Primus policy required dealers who marked up a loan higher to take a lower profit on the vehicle or trade-in portion of the transaction.

It would be one thing for Priest to have argued that Primus deserved an opportunity to show that the disparate racial impacts were counter-acted by aspects of the transactions that were disparately favorable to blacks. Primus almost certainly had better access to this information than the plaintiffs, who were never given discovery information about these other aspects of the transactions. But it is quite another thing for Priest to argue that evidence of substantial racial markup disparities did not create a prima facie case. Even if *Teal* is ignored, the showing of a disparate impact with regard to markup profits should be sufficient, until empirically rebutted, to make out a prima facie case.

Priest's second core argument was that plaintiffs failed to prove a prima facie case because they did not compare the markups received by "similarly situated" white customers. Here, the central flaw in Priest's reasoning was to ignore the difference between disparate treatment and disparate impact claims. He expressly divorced his analysis from the elements of the case:

Q. The fact that this case was brought under a disparate impact theory was irrelevant to your report?

A. It yeah I—it's irrelevant to the economic analysis, yes. Again, it can't be totally irrelevant because I have to place the analysis in a context but it doesn't—the economics don't change according to the legal—the nature of the legal claim.

154. Cohen, *supra* note 85, at 9-18.

155. This possibility that dealers might accept lower profits on the "front-end" of the transaction—by accepting a lower car price and vehicle profit—is undercut by the extreme size of some of the markups at stake. As pointed out by plaintiffs' counsel, Clint Watkins, in his cross-examination of Professor Priest, setting vehicle price to fully offset some of the large markups would entail selling the car below cost:

Q. Now, is it really rational to think that a dealer would sell an automobile for, say, \$8,000 below cost because they're going to make \$12,000 on the finance charge? Do you think that's rational?

A. Sure.

Q. So, in other words, a customer can go to a dealer and buy a car \$8,000 below cost. And the next day they can go to their bank and pay it off. And the dealer just lost \$8,000; correct?

A. Well, if they pay it off immediately before the first payment, yes. Just to be precise.

Q. So if it works the way you think, this is a great opportunity for consumers in this country to go to dealerships and let them slam them on the rate, get the car below cost, and the next day go to their bank and pay it off. Aren't dealers simply too savvy to let that happen, Professor?

A. I think it happens all the time, where people use equity credit lines to pay it off or use other forms of assets to pay it off. . . .

Priest, *Primus* Testimony, *supra* note 147, at 63. This theoretical dealership stratagem of selling a car at a price below its cost would be truly risky in a world in which the borrower could turn around and immediately repay the loan.

Q. Would you agree with this statement? In preparing your report, you completely divorced yourself from the issue of disparate impact or disparate treatment?

A. Yes, I tried to perform as clean and thorough an economic analysis as I could.¹⁵⁶

In contrast, I expressly argued in my report and testimony that economic analysis should flow from the elements at issue in a case:

Because disparate treatment and disparate impact theories of discrimination have distinct elements, it is appropriate when testing for disparate treatment and disparate impact to use distinct statistical methods. When econometricians attempt to test for disparate racial treatment, the goal in a regression analysis is to control for all of the non-race variables that might have explained a particular set of decisions. The regression asks in essence whether—after controlling for all potential non-race variables—the race, say, of a loan applicant determined the finance charge markup she would be asked to pay. . .

But tests of disparate impact require a different statistical method. Under a disparate impact theory, it is possible for decision-making policies that are facially race neutral to give rise to liability if they disproportionately burden the plaintiff class. For example, a practice of charging higher finance charge markups to applicants without a high school diploma still makes out a legal claim if this non-race criterion results in a disparate racial impact that has no business justification.¹⁵⁷

Because disparate impact has different elements than disparate treatment, especially in that it does not require proof of intent, it is axiomatic that different statistical tests were required.

But Priest in effect held plaintiffs to a disparate treatment standard. For Priest, if there is no economic evidence of defendant's race-based disparate treatment of similarly situated people, then there is no discrimination. Plaintiffs' statistics, for example, were unpersuasive to Priest as evidence of even dealership discrimination because these statistics failed to control for

156. Deposition of George L. Priest, *Borlay et al. v. Primus Auto. Fin. Serv.*, No. 3-02-0382, (M.D. Tenn. Nov. 2, 2004) [hereinafter Priest, Primus Deposition], at 21-22. *See also*:

Q. What is your understanding as an economist that you need to know as far as the difference between analyzing a claim based on a disparate impact theory and a claim based on a disparate treatment theory?

A. I don't think an economist can comment on that. I don't think there's any economic—there's nothing from economic theory that relates to that distinction.

Priest, Primus Testimony, *supra* note 147, at 70. And:

Q. So have you approached this case as an economist with an assumption that it was irrelevant to your report, the fact that this is a disparate impact case?

A. Generally, it's irrelevant, yes. . . .

Id.

157. Ayres, Primus Report, *supra* note 93, at 5-6.

revenue characteristics.¹⁵⁸ Dealers might have been charging higher markups to borrowers because these borrowers had higher search costs or less access to information, and not because these borrowers were African American, Priest argued. If disparate treatment were being alleged, Priest would have a strong point, but in a disparate impact case, the prima facie question is whether defendant's policies had a disparate impact on a protected class.

Indeed, while Priest did not explicitly take up my wage-gouging hypothetical, his approach would find wage-gouging based on worker immobility unproblematic as a matter of civil rights law. Even though the wage-gouging was assumed to have a disparate impact against women, Priest would not object to the policy because it would not be an example of treating similarly situated workers differently because of their sex. That is, the underlying differences in women's mobility would justify their differential treatment by the employer, who would be basing his wage decisions not on gender but on mobility.

Under the facts of these ECOA cases, the pertinent question is whether the defendants' policies of granting dealerships selective markup discretion forced African Americans to pay disproportionately higher markups. The answer to this question is clearly affirmative if one simply compares the observed markups to those that would have obtained if defendants had imposed a fixed dollar markup as compensation for arranging loans. If Primus instead had a policy of compensating \$500 (or any other fixed dollar markup) on each loan, there would have been no racial disparities in the markups paid.¹⁵⁹ Priest

158. For example, Priest testified:

Q. Would you agree that one of the major differences in opinions held between you and Dr. Ayres is that you disagree that markup is revenue based and that you believe that it is more cost based? Would that be fair, at least to describe one of the primary differences between the two of you?

A. Yes. I think that's fair.

Priest, Primus Testimony, *supra* note 147, at 33.

159. This counterfactual also suggests that the causation requirement should merely be that the defendant's policy was a but-for cause of the disparity, not that the defendant's policy was the sole but-for cause of the disparity. Even if the plaintiffs' unwillingness to educate themselves was also a but-for cause, a defendant whose policy is a cause of the disparity should still be liable. In antitrust, courts never inquire whether anticompetitive harm caused by defendant conduct is somehow excused by consumers' contributory negligence. William M. Landes, *Optimal Sanctions for Antitrust Violations*, 50 U. CHI. L. REV. 652, 674 (1983) ("there should be no defense of contributory negligence"). In *Griggs*, the Supreme Court never suggested that the failure of applicants to earn a high school diploma might have undermined proof that Duke Power's policy caused a disparity. 401 U.S. at 432-33. See Peter Siegleman, *Two-Party Disparate Impact in Employment Discrimination Law* (Working Paper Oct. 28, 2005) (on file with author).

If an individual lender offered dealers a flat-fee compensation, some dealers may try to find other lenders for their customers who would be willing to pay a supra-competitive APR. But as Mark Coben has observed:

[T]here might also be ways to reduce this leakage. For example, bonuses can be offered for dealers that provide more than a certain percentage of their loans to the captive lender. This approach is already used by some captives.

Cohen, *supra* note 85, at 15. See also Ayres, GMAC Report, *supra* note 125 (arguing that

avoided the compelling prima facie evidence of a disparate racial impact by insisting that all economic analysis of discrimination must be an analysis of disparate treatment.¹⁶⁰ Priest's disparate treatment standard would force plaintiffs to control for a seemingly endless array of non-race factors that might have caused dealers to charge higher markups.

E. What the Litigation has Wrought

The Primus claims went to a bench trial in March 2005 before Judge Aleta Trauger in the Middle District of Tennessee. Shortly after the end of trial, Judge Trauger ruled from the bench: "What I have decided is that the plaintiffs have proved their case and that they will win in my decision,"¹⁶¹ Judge Trauger ordered the parties to attempt to reach a remedy or settlement in the matter, but warned the parties that if they did not reach a settlement, she would structure a remedy.¹⁶² At the time this Article was written, the parties had been unable to reach an agreement and the court had ordered mediation.¹⁶³

Stepping back, there is a strong likelihood that this litigation has reshaped loan pricing throughout the industry.¹⁶⁴ The following table¹⁶⁵ shows some of

lenders can also retard dealer incentive to switch to other lenders by explicitly advertising that their loans will not be marked up).

160. James Heckman similarly conflated the requirements of disparate treatment and disparate impact:

Professor Ayres characterizes his report as a theory of how economists should test for the existence of racial discrimination in automobile credit rate spreads. The main premise of Professor Ayres' theory is that in testing for such a disparity, economists should ignore the impact of all characteristics of the vehicle dealer and the vehicle buyer (except for race) who negotiate the transactions and of all factors that might affect the disparity. Thus Professor Ayres would have the economist ignore all of the factors that govern whether a disparity exists between similarly situated individuals. The only exception Professor Ayres allows is for variables that meet his definition of 'legitimate business need' for either GMAC or the dealer.

Heckman, GMAC Report, *supra* note 125, at 2. Heckman's insistence on comparing "similarly situated" borrowers commits the same error as Priest; it imposes the requirements of disparate treatment on a disparate impact case. As Heckman sees, I would only require a comparison of borrowers who are similarly situated with regard to plausible business justifications. The plaintiffs in *Griggs* without high school diplomas were not similarly situated with the promoted applicants who held high school diplomas—and according to Priest and Heckman, should be excluded from the analysis. But the applicants with and without diplomas were similarly situated for the purposes of a disparate impact test because the Supreme Court found that conditioning employment on a high school diploma was not a valid business justification.

161. Excerpt of Proceedings Volume A, *Borlay v. Primus Auto. Fin.*, No. 3:02-0382 (M.D. Tenn. Mar. 16, 2005), available at <http://www.tnmd.uscourts.gov/borlay.pdf>.

162. *Id.* See order to negotiate remedy, available at <http://www.tnmd.uscourts.gov/borlay.pdf>.

163. Joint Status Report, *Borlay v. Primus Auto. Fin.*, No. 3-02-0382 (M.D. Tenn. May 27, 2005), available at <http://www.tnmd.uscourts.gov/borlay20050527.pdf>.

164. Mark Cohen has similarly analyzed the impact of the litigation on the lending market. Cohen, *supra* note 85.

165. The Table is taken from Cohen, *supra* note 85, tbl. 9.

the major events in the litigation:

Table 2

TIME LINE	MARKUP CAPS
Pre-Litigation	No CAPS at GMAC, FMCC, PRIMUS, Bank One NNMAC had 3% to 5% cap AHFC 2% to 3.5% cap
GMAC and NMAC Litigation Filed -February 1998	
Uncertain date – post Feb. 1998	PRIMUS institutes cap from 2% to 5%
NMAC Report May 17, 2001	
August 15, 2001	GMAC introduces first rate cap = 4%
August 2002	GMAC lowers cap to 3%
November 1, 2002	FMCC introduces first rate cap = 3%
NMAC Settlement February 18, 2003	NMAC agreed to cap of 2% to 2.5%
March 1, 2003	PRIMUS lowers top cap from 5% to 3% (2%)
GMAC Settlement February 10, 2004	GMAC agreed to cap of 2% to 2.5 %
Post-GMAC Settlement	PRIMUS lowers top cap to 2.5%
Note: Other lenders had markup caps and many of them changed the caps with similar patterns to those shown here.	

Before the class action suit was filed, many of the lenders (including Ford Motor Credit and GMAC) placed no limits on the amount by which dealerships could mark up some of their loans. But since 2001, a series of lenders have adopted successively lower markup caps.¹⁶⁶ Professor Heckman attributes some of these industry movements to the impact of the litigation and in fact the ideas at the heart of this Article:

[Ayres'] advocacy has been influential in public debate and has been persuasive enough to induce defendants to settle some large cases. [H]is doctrines are likely to transform distribution practices of the automobile industry.¹⁶⁷

The import of the litigation is also evident in the type of policy changes that have occurred. Instead of across the board caps, many lenders have recently begun imposing smaller caps on extended term loans or loans over a certain dollar amount, which disproportionately burden minority borrowers.¹⁶⁸ Most

166. See, e.g., Opinion: *California Sounds Strict Warning on Finance Reserve*, AUTOMOTIVE NEWS, July 28, 2003.

167. Bornholz & Heckman, *supra* note 125, at 3.

168. See, e.g., TRUSTMARK RATE SHEET (May 1, 2004) (setting 1% markup on certain loans between 67 and 72 months). See also *Nowadays, F&I Should Mean Fair and Impartial*, AUTOMOTIVE NEWS, Jan. 12, 2004, at 12 (“Most responsible banks and finance companies are capping the finance reserve at three percentage points.”); *Cut To the Quick: Rate caps have little*

captive finance companies, banks, and other reputable finance sources have imposed reasonable limits of 3% on the finance reserve.¹⁶⁹ The industry publication, *Automotive News*, recently opined:

Disclosure isn't required by federal regulations. But if the dealership discloses its share of the deal - which at 3 points or less is a reasonable fee for service - there's no moral problem. It's just business. If the customer knows what's going on, everything is fine. . .

As always, honesty is the only policy.¹⁷⁰

Indeed, some participants now see an almost inevitable movement toward flat-fee compensation.¹⁷¹

Mark Cohen has estimated that the settlements to date may benefit more than 1.4 million African American car financiers, in an amount of more than 800 million dollars.¹⁷² Minority consumers benefit not only from the reduced caps, but also from defendants' promises to offer "pre-approval, no markup loans" to African Americans and Hispanics.¹⁷³ These "no markup" loans represent a kind of racial set-aside that is unusual in disparate impact settlements. Normally if a defendant's race-neutral policy has an unjustified disparate racial impact, the defendant substitutes another race-neutral policy.¹⁷⁴

effect on loan profits already clipped by sharp competition among lenders, AUTOMOTIVE NEWS, Dec. 1, 2003, at 40.

169. *Cut to the Quick*, *supra* note 168, at 40.

170. *See* Opinion: *California Sounds*, *supra* note 166.

171. Press Release, The Rikess Group & Dixon Hughes, Dealers Say Automotive Retail Lenders have Strong Case for Eliminating Interest Rate Mark-ups on Customer Financing, (Oct. 11, 2004), available at <http://www.rikessgroup.com/pdf/2004Oct-TRGDHPress%20Release.pdf> (stating that "dealers predict that replacing interest rate markups with flat fee financing will yield a great many benefits for their customers, business operations, and the industry").

172. Telephone conversation between Ian Ayres and Mark Cohen (Nov. 13, 2005) (discussing estimates that Cohen prepared in connection with final settlement of GMAC, AHFC, NMAC, Chrysler, Bank One, U.S. Bank and Bank of America litigation). This estimate probably represents a maximum potential benefit—as some minorities may not take advantage of the no markup loans or dealers may substitute toward less constrained lenders (although the latter strategy is constrained by the industry-wide cap reductions).

173. The details of the promise are described by the *Wall St. Journal*:

Under such arrangements, auto lenders try to identify the race of potential applicants using ZIP codes or various databases that contain the details of previous loans they have issued. Once the race is established, the lender can send an offer of credit to the potential applicant. The offer discloses the annual percentage rate that the applicant qualifies for, which can't then be marked up at a dealership.

Lee Hawkins, Jr., *Honda, Three Banks Settle Loan-Bias Lawsuits*, WALL ST. J., Jan. 27, 2005, at D2.

174. *Bradley v. Pizzaco of Nebraska*, 7 F.3d 795,799 (8th Cir. 1993), is one of the few cases in which a court ordered a race-contingent remedy. The claim was that the defendant employer's no-beard policy had an unjustified disparate impact against African American employees who disproportionately "suffered from pseudofolliculitis barbae ('PFB'), a skin condition affecting approximately fifty percent of African American males." *Id.* at 796. But instead of enjoining the policy with regard to any employee who suffered from PFB, the opinion only required the employer to make an "exception to its no-beard policy for African American males who suffer from PFB." *Id.* at 799. *See* Jolls, *supra* note 2, at 658.

Thus, for example, if an employment exam was proscribed for having an unjustified disparate impact, a settlement would normally require substitution of an alternative race-neutral exam, not a special exam for minority applicants. But under the guise of “affirmative lending” regulation,¹⁷⁵ the litigants agreed to minority “no markup” set-asides.¹⁷⁶ This innovation made it a lot easier for the parties to reach agreement. The class representatives and their attorneys could assure that minority borrowers would have greater access to no markup loans, but defendants would retain an (albeit reduced) ability to extract supra-competitive profits from white borrowers.

But the markup caps contained in the class settlements have also benefited consumers outside the plaintiff class. The reduced caps have saved white borrowers a bundle.¹⁷⁷ Civil rights remedies are sometime seen as a zero-sum game. That is, if a court orders defendants to hire more minorities or women, it will often be at the expense of whites or men. But in this context, the plaintiff class of African Americans has saved white borrowers hundreds of millions of dollars in loan markups.¹⁷⁸ Many people have been critical of the disparate impact cause of action.¹⁷⁹ But the automobile litigation is one area where it has succeeded greatly, both in ending a racially discriminatory policy and in protecting all consumers from a predatory lending practice.

CONCLUSION

On one level, the subject of this Article is an important but narrow question of disparate impact law—defining the appropriate contours of the business justification defense. I have suggested that anti-competitive conduct by a defendant should not provide a business justification defense in disparate impact litigation, even if the conduct increases the defendant’s profits. Policies that increase a firm’s profits by assuring that the firm covers its costs are presumptively justified, but policies that increase a firm’s profits above the competitive level do not justify disparate racial impacts. Wage-gouging is simply not a business necessity.

On another level, this Article aims to establish a firmer footing for disparate impact theories that do more than reveal hidden disparate treatment.¹⁸⁰ Under the conception of hidden disparate treatment, any showing

175. Race-dependent “affirmative lending” programs are explicitly countenanced as potential means to remedy “discrimination”: A lender may be permitted to establish a “special purpose credit program” in which “all program participants may be required to share one or more common characteristics (for example, race . . .).” ECOA Reg. 12 C.F.R. § 202.8(b)(2).

176. See Hawkins, *supra* note 173, at D2.

177. See Cohen, Primus Report, *supra* note 95, at 45 (noting that under a markup cap, average charge for whites went down from \$513 to \$311).

178. *Id.*

179. See Michael Selmi, *Was the Disparate Impact Theory a Mistake?*, 53 UCLA L. REV. 701 (2006).

180. Some courts have adopted the tactic as well. See, e.g., Okruhlik v. Univ. of Ark., 255

that a policy was motivated by profit and not prejudice should be sufficient to avoid liability. Even a price-gouging motive would seem sufficient to absolve a decision-maker of the wrong of intentional discrimination and hence undermine the basis of any disparate impact suit. This Article has challenged that conception. Not all increases in profitability are equal.¹⁸¹ Or, in the words of Priest and Heckman, not all profits are “similarly situated.”¹⁸² A policy that moves a firm from a sub-competitive level toward the competitive level of profits deserves more leeway than a policy that extracts huge, anti-competitive profits from consumers or workers.

At times, advocates of stronger civil rights enforcement have argued, reasonably, that firms should be forced to accept some modest reduction in profits to reduce the disparate impact of their policies. But their mistake has been in tacitly accepting that policies that generate bigger profits are presumptively more justified. Distinguishing pro-competitive increments to profits (those that let firms cover their costs) from anti-competitive increments to profits (those that let firms raise the price above their costs) challenges this unconditional deference to the normative reasonableness of profitability. Through this lens we can now see that a policy that generates bigger anti-competitive profits is presumptively less justified. A defendant who comes into court and says it needs to maintain a policy because the policy permits the firm to gouge its employees’ wages is making a less compelling argument than a defendant who says it needs to maintain a policy because the policy keeps the firm from losing money.

Civil rights advocates have been reluctant to attack this profitability issue head on. In attacking particular policies, plaintiffs’ attorneys have at times relied on strained arguments that challenged corporate policies as being simply irrational or irrelevant by arguing that certain policies have either no impact or a negative impact on a firm’s profits. But the idea that firms adopt policies that

F.3d 615, 625-26 (8th Cir. 2001); *In re Employment Discrimination Litig. Against Ala., et al.*, 198 F.3d 1305, 1316-17 (11th Cir. 1999).

181. This broader conception of disparate impact resonates with that adopted by Justices Blackmun and Stevens in a pair of decisions. See *Wards Cove*, 490 U.S. at 669-70 (Stevens, J., dissenting); *Watson v. Fort Worth Bank & Trust*, 487 U.S. 977, 1001-04 (1988) (Blackmun, J., concurring in part and concurring in the judgment). They objected that non-shifting disparate impact burdens (which were later displaced by the shifting burdens of the Civil Rights Act of 1991) were inconsistent with the independent wrong of disparate racial impacts:

In their view, business necessity was an affirmative defense to be proved by defendants after plaintiffs had successfully established the legal injury of disparate impact. Once a disparate impact had been shown, an employer might be excused from liability on a showing of legitimate motive, but no showing at all about the employer's motive was necessary for liability to be imposed.

Richard A. Primus, *Equal Protection and Disparate Impact: Round Three*, 117 HARV. L. REV. 493, 522 (2003).

182. Heckman, GMAC Report, *supra* note 125, at 2. See discussion *supra* text accompanying notes 155-156.

systematically hurt their profits is often implausible to those of us with an economist's mindset. It tends to lead back toward the idea of conscious disparate treatment driving policies that sacrifice profits in favor of discriminatory preferences. The unwillingness of plaintiffs' attorneys to challenge profitable policies that produce disparate impact thus reinforces the idea that disparate impact liability was meant to merely supplement disparate treatment liability.¹⁸³

Finally, this Article is an invitation to think more about competition and consumer protection law from a civil rights perspective. Inequality and anti-competitiveness often go hand in hand. The ECOA litigation against the major automotive lenders is a vivid case in point. But it is part of a far greater "the poor pay more" phenomenon. It is not a coincidence that antitrust and civil rights share a common concern—discrimination. Price discrimination and disparate-impact discrimination are often related. It is not a misuse of disparate impact law to restrict anti-competitive conduct that has a disparate impact. And it would not be a misuse of competition or consumer protection law to restrict disparate impacts that are caused by anti-competitive conduct.¹⁸⁴

183. Richard Primus has argued against the idea that "disparate impact doctrine is merely an evidentiary dragnet designed to catch elandestine intentional discriminators":

[A]dopting that idea would erase the theory of *Griggs*, which . . . spoke explicitly about a concern with self-perpetuating racial hierarchies, hierarchies that could persist even in the absence of new discriminatory acts. As a matter of descriptive interpretation, it is problematic to interpret a doctrine in a way that so thoroughly ignores the fullest (and founding) judicial statement of that doctrine. As a matter of policy, and on the understanding (which I endorse) that the *Griggs* rationale is normatively desirable, it is problematic to choose an interpretation of Title VII that is wholly about present deliberate discrimination, given that history and de facto segregation remain relevant to the conditions of racial hierarchy in the workplace. To be sure, an honest assessment of the doctrine might require such a reading if Congress had endorsed *Wards Cove* in 1991. But the 1991 Act is a rejection of the Court's *Wards Cove* direction.

See Primus, *supra* note 181, at 523 (discussing different plausible goals underlying disparate impact cause of action). Policies might also be misguided because of unconscious bias or other cognitive distortions. See Linda Hamilton Krieger, *The Content of Our Categories: A Cognitive Bias Approach to Discrimination and Equal Employment Opportunity*, 47 STAN. L. REV. 1161 (1995); Charles Lawrence III, *The Id, the Ego, and Equal Protection: Reckoning with Unconscious Racism*, 39 STAN. L. REV. 317 (1987); Amy Wax, *Discrimination as Accident*, 74 IND. L.J. 1129 (1999). But the resistance of corporations to such litigation suggests that profits are often at stake.

184. The intentionally fluid phrase "unfair or deceptive" in the FTC and baby FTC Acts, see, e.g., 15 U.S.C. §45(a)(1) (2000); N.Y. Gen. Bus. Law §§ 349 et seq. (McKinney 2002); Cal. Bus. & Prof. Code §§ 17200 et seq., (or even the common-law standards for contractual "bad faith" and "unconscionability") might evolve to encompass disproportionate profit-taking from minorities. For example, consider Connecticut's contretemps with Acme Rentacar. See Ian Ayres & Barry Nalebuff, *Connecticut's Speeder-Friendly Crackdown*, N.Y. TIMES, Aug. 31, 2001, at A19. There, the State of Connecticut went after Acme for charging a \$150 penalty for driving more than 80 miles per hour. The State challenged the policy on consumer protection grounds—

arguing that it was an unfair and deceptive practice to profit from a liquidated damages provision. *Am. Car Rental, Inc. v. Comm'r of Consumer Prot.*, 273 Conn. 296 (2005). But this Article suggests that the State might have alternatively challenged the unfairness of the practice as disproportionately extracting rents from minority customers. Of course, the disparate impact would have to be proved, but I recall that several of the people who were originally reported to be victims of the practice were African American. *See, e.g., James Turner v. Am. Car Rental, Inc.*, 92 Conn. App. 123 (2005); <http://www.popularmechanics.com/science/research/1161417.html?page=2>; <http://www.cbc.ca/consumers/market/files/cars/gps/index.html>. I would not be surprised to learn that there are a variety of backend fees that are disproportionately borne by minority customers.