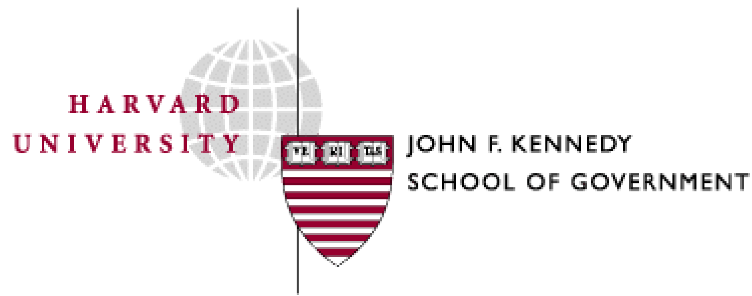


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# Class Actions in the U.S. Experience: An Economist's Perception

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# CLASS ACTIONS IN THE U.S. EXPERIENCE

## Abstract

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This paper, presented at a University of the Piedmont (Italy) conference in January 2007, analyzes several features of the U.S. experience with class action litigation, emphasizing suits alleging antitrust law violations. It observes that despite the trebling of damages under U.S. antitrust law, deterrence has been less than completely successful, as shown by the large number of important price-fixing conspiracies proven in recent years. It argues too that many class action suits are brought with insubstantial evidence of violation. An important motivator is the significant share of settlement damages realized by entrepreurial law firms organizing the class actions. The retention by judges of neutral economic experts can help sort out the evidentiary complexities of class action suits, but the approach is far from a panacea.

CLASS ACTIONS IN THE U.S. EXPERIENCE:
AN ECONOMIST'S PERCEPTION

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June 2007 Revision

My role in this conference, addressing important changes being considered actively in Europe, is akin to what Augustine of Hippo did: confessing and distilling lessons from the sins of my youth. Specifically, how do class action suits work from the perspective of an economist who has participated as an expert witness in several? My focus has been mainly on antitrust suits, but I will recognize the relevance of other types.

## 1. The Rationale of Class Action Litigation

There are two main reasons for laws permitting class action litigation:

(1) To do justice, that is, to compensate a nation's citizens for harm that is done to them by powerful (usually industrial or medical) actors -- e.g., through price fixing, selling defective and dangerous products or services, polluting the environment, polluting the information environment with false and misleading statements, and engaging in unwarranted discrimination -- price or otherwise.

(2) To deter actions that might be illegal, but that might either escape the attention of law enforcement authorities, or be committed because the expectation of penalties administered by government agencies is insufficient, or to solve free-rider problems when no individual has a sufficient incentive to take corrective action that will benefit many fellow citizens.

Let us consider first the second of these explanations. Does deterrence from class action litigation actually work? In principle, the prospect of paying treble damages for violations of U.S. antitrust law ought to be a formidable deterrent. Whether it actually deters is questionable, given the plethora

of large-scale price-fixing conspiracies brought to light in recent years, in both the United States and Europe. Examples include vitamins, carbon electrodes, airline fares, auction house fees, lysine, citric acid, dynamic random access memory chips, and most recently (January 2007, from a European Commission action), in electric power switchgear. (It was a 1950s case in electrical equipment, including switchgear, that precipitated some of largest early damages awards under the U.S. antitrust laws.[1]) Similarly, much litigation against the U.S. cigarette manufacturers by private parties and state attorneys general has led to fines and punitive damages awards measured in the hundreds of millions of dollars, which, given inelastic demand for cigarettes, have been passed on to consumers in the form of greatly elevated prices. Despite the past history of litigation and damages, recent research has suggested that the cigarette makers have knowingly increased average nicotine levels by 10 to 11 percent since 1998, presumably in the expectation of enhancing addiction effects for new smokers.[2]

Why does deterrence appear to be ineffective? There are two plausible reasons: a perceived low probability of being caught and assessed damages; and/or the insufficiency of the damages actually awarded when violation of the law is proven.[3] I find the latter explanation hard to believe, given the fact that class action plaintiffs under the U.S. antitrust laws can claim three times the actual amount of damages proven. Clearly, further analysis of what is happening is needed.

## 2. Is Justice Served?

Closely related to the question of the sufficiency of damages is the question: Is justice served? Are consumers in fact made whole as a result of class action suits? According to the preamble of the Class Action Fairness Act, which was passed by the U.S. Congress in 2005, justice is being served

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1 . See R. A. Smith, "The Incredible Electrical Conspiracy," Fortune, April and May 1961.

2 . See "Study on Nicotine Levels Stirs Calls for New Controls," New York Times, January 19, 2007.

3 . See Lawrence J. White, editor, Private Antitrust Litigation: New Evidence, New Learning (MIT Press: 1988), for conference proceedings that thoroughly explore both the theory and evidence on class action suits under the U.S. antitrust laws.

inadequately:[4]

> (3) Class members often receive little or no benefit from class actions, and are sometimes harmed, such as where --
>
> > (A) Counsel are awarded large fees, while leaving class members with coupons or other awards of little value;
> >
> > (B) Unjustified awards are made to certain plaintiffs at the expense of other class members; and
> >
> > (C) Confusing notices are published that prevent class members from being able to fully understand and effectively exercise their rights.

The coupon remedy is indeed a problem. What they often do is allow a discount on the purchase of another iteration of the same unsatisfactory product. And if I were a clever business manager forced to issue such coupons, I would try to offer a special product priced with such a high margin that I would profit even though I must grant what is purported to be a discount. My own experience is that I have been offered several such coupons and found it troublesome to obtain them and take advantage of them. Only once did I receive monetary damages from a class action settlement, and in that case, the amount was tiny.

The new Class Action Fairness Act attempts to create a process under which the adequacy of damages and the legitimacy of compensation to counsel are carefully considered by the federal courts, at least, in those nationwide cases where the federal courts assume jurisdiction from decentralized state courts.

### 3. Blackmail?

Complementary to the problem of low damages actually accruing to the persons who have suffered from actionable

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4 . Public Law 109-2, 119 Stat. 4 (February 2005). See also the roundtable discussion, "Class Action Fairness Act," The National Law Journal, May 16, 2005, pp. 18-21.

conduct is the incentive for blackmail by entrepreneurial law firms. There are many such firms in the United States whose specialty is bringing class action suits in the expectation that the defendants will settle and pay substantial negotiated fees rather than incurring the costs and risks of protracted litigation. Steven Salop and Lawrence J. White found in an analysis of 1,959 U.S. class action antitrust suits that 88 percent settled without a trial.[5] Only 106 cases, or 5.4 percent of the sample, actually went to trial. For those that went into trial, the average trial length was 11.4 days. For cases that settled without a trial on which information was available, the attorneys initiating the actions realized on average 20.3 percent of the total damages settlements as attorneys' fees.[6] However, the distribution of fees was highly skew. The median attorney's fee in cases ending through settlement was 110 percent of the damages recovered by those named as plaintiffs (by the initiating attorneys) and hence those who were in principle injured.

Acknowledging that I have also participated in class action suits that I considered well-justified, let me illustrate this point with details on three actions that were either poorly based in facts or (I am unable to distinguish) brought for purposes of blackmail.

One was a class action alleging a price-fixing conspiracy by Canadian producers of potash, extensively used as fertilizer by farmers in the United States and elsewhere.[7] The Canadian province of Saskatchewan is the OPEC of world potash production, controlling roughly half of the world's minable potash reserves. The industry in Saskatchewan is tightly oligopolistic; six companies originated nearly all of the province's potash output. The suit was based upon evidence of abrupt and substantial price increases, shown in Figure 1 as occurring during mid-1987. But

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5 . "Private Antitrust Litigaton: An Introduction and Framework," in White, ed., Private Antitrust Litigation, pp. 10-11.

6 . Ibid., p. 14.

7 . Potash Antitrust Litigation, MDL (multi-district litigation) Docket No. 981, U.S. District Court for the District of Minnesota. For more details, see F. M. Scherer, Competition Policy, Domestic and International (Edward Elgar: 2000), pp. 364-367. I was a consultant for Kalium Ltd. and in my preparation visited the world's deepest potash mine.

there was a simple and obvious non-collusive explanation for the price shock. Competing potash producers in the United States had achieved the initiation of an anti-dumping suit against the Canadians, and March of 1987 (second dotted vertical line in Figure 1), the U.S. International Trade Commission ruled that the Canadian producers were likely to be subjected to substantial anti-dumping tariffs on future shipments. In fact, on August 21 (third vertical dotted line), the U.S. International Trade Administration announced preliminary anti-dumping margins, for which a bond had to be posted, averaging 37 percent for all of the Canadian potash producers and 52 percent for the largest seller. Anticipating that decision and hoping to minimize its future tariff liabilities, the leading firm announced a substantial price increase and then, two weeks after the preliminary dumping margin decision, added a further increase of $35 per ton. Other smaller members followed its price lead -- not an actionable offense under U.S. law. A protracted and expensive legal process followed. But the Canadian potash producers refused to settle, and eventually, the suit was voided.

On my next example I must tread carefully, since parts of the litigation are still pending. In the so-called Branded Drug Litigation,[8] a group of law firms filed class action complaints against the leading U.S. pharmaceutical manufacturers, alleging that they conspired to deny discounts to drug retailers even while they were offering large discounts to hospitals and health maintenance organizations. There were several flaws in the class action plaintiffs' claims. For one, they were not able to present direct evidence that the drug manufacturers actually conspired to orchestrate the discount structure. The most that could be proved is that the manufacturers cooperated with drug wholesalers on a computerized rebate system so that customers who had been granted discounts could be reimbursed promptly. The discounts themselves varied widely from case to case. Second, the hospitals and health care maintenance organizations had substantial bargaining power vis a vis the manufacturers, since they could deny a manufacturer's patented drug a place on their formulary of useable drugs unless acceptable discounts

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8 . MDL-997, Master File no 94 C 897 (U.S. Federal Court for the Northern District of Illinois). The case is described at greater length in Chapter 10 of Scherer, Competition Policy, Domestic and International. I submitted testimony on behalf of Pfizer Inc.

were offered. Retailers, on the other hand, had no such bargaining power. They were by law required to dispense a named patented compound if the patient arrived with a valid prescription. Thus, substitution was possible by the health care organizations but not by the retailers. Third, the drug retailers had a long history of advocating resale price maintenance (so-called "fair trade") and shunning price competition among themselves. It was only when the U.S. laws supporting fair trade were abolished during the 1970s that retailers' gross margins declined from roughly 40 percent to the 20 percent value achieved under pressure from the U.S. government and so-called "pharmacy benefit managers" bargaining over the margins they would reimburse.

A third such case accused the leading credit card companies of colluding to set the fees they charge for converting into dollars transactions consummated in non-U.S. currencies.[9] The principal alleged evidence of collusion turned on the participation of company attorneys at meetings whose principal subjects were government regulation of fee disclosures and the arbitration of disputes, and in which, the evidence showed, the magnitudes of conversion fees were mentioned only in passing. Persons present at the meetings denied under oath any attempt to agree on fees. Announcements of fee increases (from a 1 percent base) extended over a period of several years, and by the end of 2004, when the suit was initiated, most Visa card providers were charging 3 percent, one important Visa provider was charging 1 percent, and American Express and Diner's Club were charging 2 percent. The case continues.

## 4. Improving the Litigation Process

The new U.S. Class Action Fairness Act seeks to correct some of the problems I have identified, but it will have little or no impact on cases such as the three I have described above that would be in federal courts rather than state courts. Even when jurisdiction is with federal courts, it is difficult for judges to sift through mounds of complex evidence and eliminate before a full trial is held the cases that are without merit.

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9 . Robert Ross et al. vs. American Express Co. et al., Case No. 04 CV 05723 (WHP) (Southern Distinct of New York). The author submitted evidence on behalf of American Express.

And even when a full trial is held -- i.e., when the accused parties do not succumb to a settlement -- judicial error is possible. One remedy that may place too much trust in the ability of economists is to have the court employ an expert economist as a clerk or expert advisor to the court. The first known instance of an economist serving in that role was not a class action, but a case litigated during the early 1950s by U.S. federal antitrust authorities against the United Shoe Machinery Corporation. In that case, Harvard University economist Carl Kaysen served as advisor to Judge Charles Wyzanski.[10] Since that time economists have served as court-appointed clerks or experts in a handful of class action suits. Such service is no panacea. My own experience in two such cases reveals the difficulties.

For the damages phase of the folding carton litigation, I was retained by Judges Charles Robson and Hubert Will in Chicago to determine the reasonableness of the negotiated damages settlements.[11] (Shortly before, the U.S. Supreme Court had ruled that such consideration was necessary when class action suits were settled by negotiation.) Another economist had been retained by the Court to advise on the liability segment of the litigation. To the best of my knowledge, I received no information on the division of payments between attorneys and the carton users on whose behalf the suit was brought. Damages were computed for individual carton buyers. One thing that struck me was that the Pillsbury Company claimed by far the largest percentage elevation of prices as a result of the remarkably well-documented price-fixing conspiracy. The question was, why? Investigation revealed that Pillsbury, unlike other users of special, pre-printed cartons, had required carton makers to bid on <u>all</u> of the 50 or so cartons it wanted in one annual competition. At the time there were more than 100 vendors of folding cartons, but only the ten or twelve largest companies were party to the price-fixing conspiracy. By consolidating its bidding requirements, Pillsbury made it difficult for smaller, more specialized carton makers to bid, thereby rendering itself especially vulnerable to the relatively

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10 . U.S. v. United Shoe Machinery Corporation 110 F. Supp. 295 (1953). From his experience Kaysen wrote a book, <u>United States v. United Shoe Machinery Corporation</u> (Harvard University Press: 1956).

11 . MDL-250 (U.S. Federal Court for the Northern District of Illinois).

few large carton producers, who comprised the core of the conspiracy. I asked the judges whether a doctrine of contributory negligence was relevant to the assessment of damages. The answer was, no. But I believe there should be such a consideration when a buyer adopts a bidding system that is unusually well-suited for successful conspiracy by sellers.

Although I retain little documentation, I recall a similar issue in the treble damages suits that followed the "great" electrical equipment conspiracy of the 1950s. Many of the product on which the conspiracy turned were sold to electric power producing utilities. At the time, those utilities were regulated, and their profits were established on the basis of a "fair return on fair value" principle -- the larger their asset base, the higher the profit they were allowed to retain. If the allowed rate of return on assets was higher than the cost of capital, as was commonly the case, the regulated firms had an incentive to increase their asset bases beyond the bounds of economic efficiency.[12] It was rumored at the time that at least some of the electric power companies knew about the conspiracy, but since it enhanced their net profits under the regulated profit-setting formula, they did nothing to combat it. Again, a doctrine of contributory negligence would be appropriate to deal with such anomalies.

Similar negligence has been alleged in connection with the collapse of the Enron Corporation, harming many investors who had been misled by Enron's wildly optimistic financial reports. The accounting firm, Arthur Andersen, which had audited Enron's books and approved its financial reports, was held liable in part for the losses to Enron shareholders and had ceased operating as a result of the legal actions brought against it after the collapse. However, an article in the New Yorker magazine by Malcolm Gladwell revealed that a skilled and diligent analyst could see through Enron's accounting methods and realize that it was concealing substantial losses.[13] The indications of concealed trouble included the fact that Enron paid no U.S. income tax for several years, even though its

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12 . On the theory, see F. M. Scherer, Industrial Market Structure and Economic Performance (RandMcNally: 1970), pp. 523-537.

13 . Malcolm Gladwell, "The Formula: Enron, Intelligence, and the Perils of Too Much Information," The New Yorker, January 8, 2007.

financial reports claimed substantial profits, and that its cash flow was negative. Careful investors and the Wall Street analysts who advised them should have been wary, but hardly anyone did the necessary homework. Here too one might argue that damages claims should have been mitigated by the failure of prudent analysis.

In 1991 I participated again as advisor to Judge Will, this time in the Glass Bottles treble damages litigation.[14] With the benefit of previous experience, we established what appeared to be an ideal working arrangement. I was to be compensated half by attorneys for the plaintiffs and half by the defendants. At an intermediate stage of the proceedings, I met separately with counsel for plaintiffs and defendants, asking them to sharpen unclear points in their briefs and expert affidavits and suggesting statistical tests to focus the issues. When the actual trial began, I read the daily testimony transcript and prepared analytic summaries for Judge Will. My analysis confirmed testimonial evidence of a price-fixing conspiracy during the 1960s. An analysis of pricing revealed almost no deviation of actual transaction prices from list prices until roughly 1972, but after that time, transaction prices deviated by increasingly large percentages from list prices, suggesting that the conspiracy (of which there was no testimonial evidence for the 1970s) had indeed broken up. An expert economist witness for the defendants placed considerable stress on the transaction-list price deviations during the 1970s, but when asked on cross examination whether there was <u>ever</u> any price-fixing conspiracy, he denied its existence. Judge Will had planned to have me testify and be cross-examined by both parties after the testimony by plaintiffs and defendants was concluded. However, the proceedings lasted longer than anticipated, the Christmas recess was approaching, and my testimony would have meant that there would be a substantial interval between the completion of evidentiary proceedings and the time when the jurors would deliberate over their decision. Anxious to complete the case before the Christmas recess, Judge Will decided to forego my testimony. Had I testified, I would have credibly contracted the defense witness's testimony alleging no conspiracy ever. However, I would have stated that the conspiracy broke up before the statute of limitations tolled, so

14 . MDL 89C 5251 (U.S. Federal Court for the Northern District of Illinois).

plaintiffs would not be entitled to damages. Disbelieving the defendants' expert, the jury concluded that the conspiracy had continued into the 1980s, when it was not protected by the statute of limitations. As a result, recognizing that an injustice was being done, Judge Will stepped in and brokered a modest damages settlement. We were both left frustrated. Justice had gone astray because of an economist's refusal to concede his client's damages-free guilt.

5. The Pass-on Problem

In 1977, the U.S. Supreme Court rendered an important decision in the Illinois Brick case, stating that only those who had directly purchased goods or services from conspirators to a price-fixing scheme were entitled to recover damages.[15] Awarding damages to "downstream" purchasers -- e.g., consumers who had bought the price-fixed product from a retailer, who in turn bought it from the manufacturer -- was ruled out because of the difficulty of determining how much or how little of the conspiracy-induced price increase middlemen had passed on to ultimate consumers and because letting both middlemen and consumers sue for damages would unduly complicate class action litigation. But although the amount of pass-on depends upon the structure of the intermediate market, the degree of product differentiation, and other variables, it is highly probable that most of the burden of a price-fixing conspiracy falls upon ultimate consumers rather than the middlemen who are immediate purchasers from the conspirators.[16] Thus, justice is denied to the consumers. This problem was corrected in part as many states adopted their own antitrust damages laws without an Illinois Brick pass-on barrier. The asymmetry between state and federal laws encouraged litigation at the decentralized state level, among other things increasing the costs of damages recovery suits. How this practice will be affected by passage of the federal Class Action Fairness Act, which seeks to reduce the amount of state-level litigation, remains to be seen. The implication for this conference is that if European nations

15 . Illinois Brick Co. v. Illinois, 431 U.S. 720 (1977). See also Hanover Shoe Inc. v. United Shoe Machinery Corp., 392 U.S. 481 (1968).

16 . For a solidly-based predictive model, see Michael P. Lynch, "Why Economists Are Wrong to Neglect Retailing and How Steiner's Theory Provides an Explanation of Important Regularities," Antitrust Bulletin, vol. 49 (Winter 2004), pp. 911-940.

develop their own class action procedures, they would be well advised to avoid the Illinois Brick pass-on precedent.

## 6. Conclusion

The U.S. experience with class action litigation reveals many difficulties that impair the working of the wheels of justice. The possibility of bringing class action suits does not appear to have deterred a substantial number of serious law violations, although increasing the damages multiple for serious offenses might have some deterrent effect. Entrepreneurship by specialist class action law firms often leads to opportunistic cases brought more for purposes of settlement blackmail than in the anticipation that a full trial will reveal the truth. Even when a full trial ensues, the decisions are not always in accord with either truth or justice. To be sure, some good is done. But in considering what kinds of class action laws they will enact, our European cousins are well advised to learn from the mistakes of the United States as well as from its positive experience.

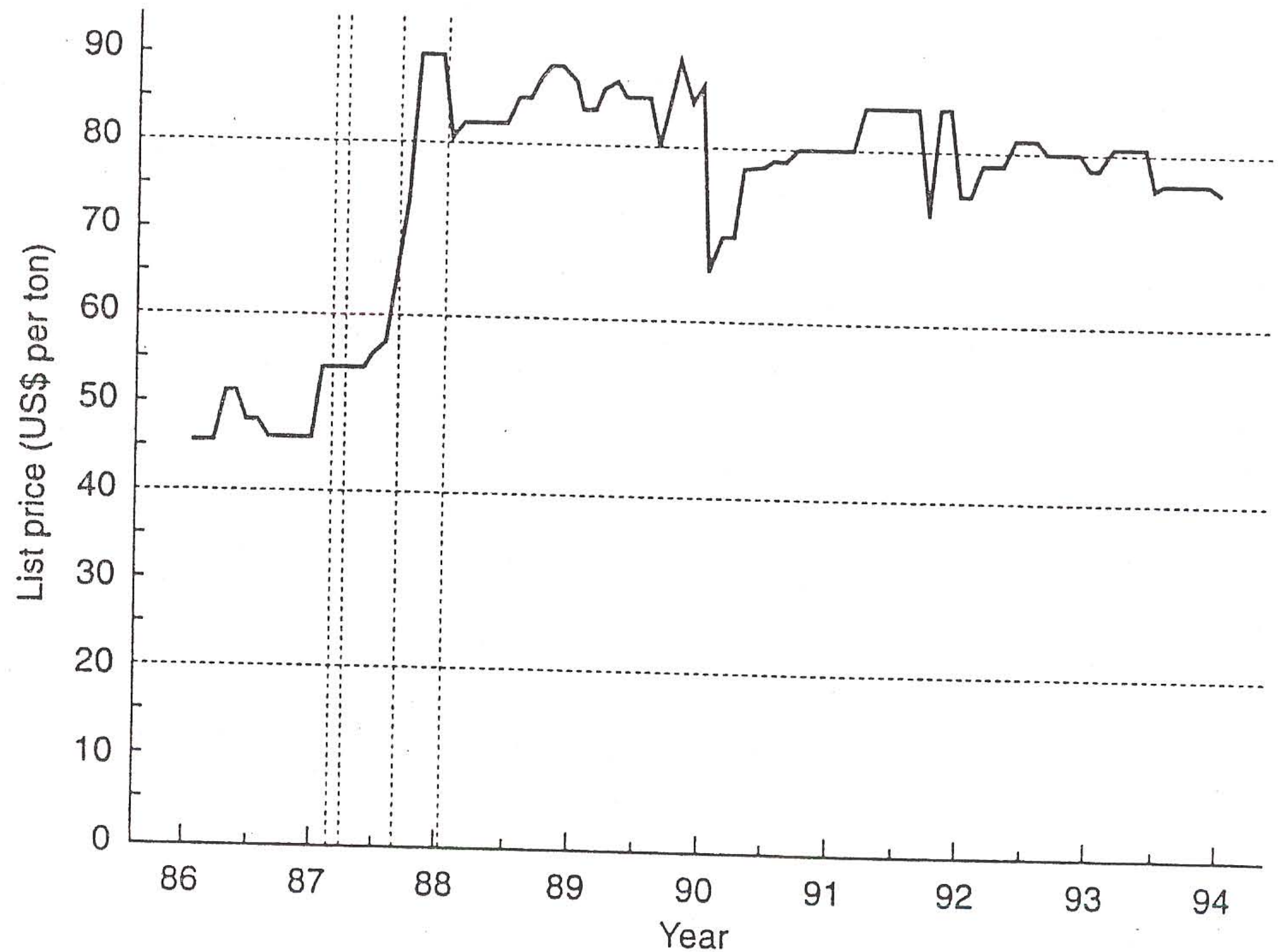


*Figure* **1.** Movement of Saskatchewan potash prices, 1986–93