

Regulation, Taxation, and Litigation

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Regulation, taxation, and litigation are three policy mechanisms that can be employed to influence individual and corporate behavior to advance societal objectives. These mechanisms often interact with each other and not always in a favorable manner. As I will demonstrate, litigation by government entities may lead to settlements that impose excessive regulations and tax penalties. Notwithstanding the presence of strong regulatory requirements, weak regulatory compliance defenses offer inadequate shields against potential litigation liability. For concreteness I focus on how different social institutions address health and safety risks, but the principles involved apply to many other situations as well.

My discussion takes as the policy objective the promotion of economic efficiency, or the maximization of the net benefits to the citizenry. In many contexts the efficient outcome will emerge from decentralized economic decisions. With respect to health and safety risks, there is substantial evidence that markets play a constructive role, as consumers and workers are often aware of the risks associated with products and jobs and receive either a price cut for dangerous products or a wage premium for risky jobs. The value of these money-risk tradeoffs is on the order of \$9 million per expected death.¹ Even in situations where real risks may be present,

¹ This \$9 million value is based on the median estimate in the literature for the value of statistical life based on labor market studies, which is \$7 million in year 2000 dollars, or \$8.9 million in

markets have much to recommend them by matching people to activities and products which they prefer and which are in line with their personal attitudes toward risk.

State interference with market decisions is typically said to be justified on claims of one of four types of market failure. First, consumers and workers might be thought to underestimate the risk, leading to excessive risk taking behavior. Second, people might act irrationally, for example by placing insufficient weight on the effect of current decisions on their future welfare. Third, there may be informational problems, particularly with respect to informational asymmetries in which the producer knows more about the risk than does the consumer. Finally, there might be third party harms or externalities, such as pollution resulting from industrial activity and auto accident costs inflicted by careless drivers. These externalities would not pose an efficiency problem if the third parties could bargain with the injurer to lead to an efficient level of harm prevention. If the conditions of the Coase Theorem are satisfied,² and there are no barriers to bargaining, then private bargains can reduce externalities such as pollution to an economically efficient level. However, as Coase recognized, there are often important practical barriers to such negotiations.

Forms of State Intervention

Establishing a rationale for intervention does not imply that every form of intervention is warranted, as the modes of intervention have different characteristics. Government regulation

2010 dollars. See W. K. Viscusi and J. Aldy, The Value of a Statistical Life: A Critical Review of Market Estimates Throughout the World, 27 J. Risk & Uncertainty 5 (2003).

² R. Coase, The Problem of Social Cost, 3 J. L. Econ. 1 (1960).

attempts to control behavior or technologies directly, as with the requirement that cars have airbags. Alternatively, state intervention might take the form of financial incentives to alter behavior, such as gasoline taxes designed to reduce gasoline usage. In other respects, regulation and taxation have many similar characteristics. Both policies result from a deliberative governmental process. Legislation to impose taxes is the result of legislative action, and excise taxes are often imposed with advice and input from regulatory agencies. Similarly, government regulations are subject to a formal rulemaking process. Neither regulation nor tax policies involve transfers of monetary payments to compensate injured parties. Both regulation and taxation are designed to foster ex ante prevention of risks. Regulations generally involve broad rules, such as specification standards for permissible risks, and financial mechanisms such as alcoholic beverage taxes likewise are not tailored to the specific characteristics of the affected firm. The design and implementation of regulations are based on the technical expertise of government agencies, and in the case of tax or financial penalty policies, this expertise is augmented by legislative review. The process by which regulatory and tax policies emerge is subject to the influence of competing interest groups. Finally, tax and regulatory policies are enforced by public agencies.

The way in which the civil justice system addresses risk and environmental harms through litigation is quite different from regulation and taxation. Litigation occurs on an ex post basis, after the damage has occurred. The judgment of liability is based on facts of the specific case and not on industry-wide averages or some other aggregative approach used in setting regulatory policies. Unlike governmental intervention that draws on the technical expertise of government agencies, the courts rely on juries which in turn may be informed by experts who testify in these cases. Governmental actions are open to a wide variety of forms of public input

and political influence that do not affect the functioning of the courts, which instead reflect the public through the preferences and possible biases of the jury pool and the judge.

The role of the courts differs from regulation and taxation not only in the determination of liability but also in the compensation for the harms that tort law provides. While compensation to accident victims serves an insurance function for tort victims, this is a very costly form of insurance in terms of the transaction costs associated with litigation and legal fees. Using data on a comprehensive set of tort cases from Texas, Hersch and Viscusi found that for every dollar paid to plaintiffs, there were legal expenses of 75 cents.³ Tort liability is consequently much more costly than social insurance plans such as workers' compensation, for which the administrative costs are much less. In addition, the very high levels of sanctions that may be required to establish incentives for safety may provide too much compensation from an insurance standpoint.⁴ Regulatory and tax policies often have greater leeway in that respect.

The Regulatory Compliance Defense

³ See J. Hersch and W. K. Viscusi, Tort Liability Litigation Costs for Commercial Claims, 9 Am. L. Econ. Rev. 330 (2007).

⁴ This is a well known, long standing limitation of tort liability. See, for example, M. Spence, Consumer Misperceptions, Product Failure, and Producer Liability, 44 Rev. Econ. Stud. 561 (1977). Addressing two different policy objectives—deterrence and insurance—with a single policy instrument of a damages payment will often involve compromising one of the two objectives.

A rational scheme of government regulation would not subject companies and individuals to overlapping and duplicative mechanisms for promoting safety. Thus a principal way in which tort liability and regulation could potentially interact is through regulatory compliance defenses that absolve defendants from the threat of litigation if they comply with government regulations. Regulatory standards are generally higher than the efficient level of safety, given the restrictive legislative mandates of regulatory agencies. Compliance with such regulations should therefore provide evidence that the firm has struck a reasonable balance between cost and risk. As a result, companies in compliance with regulations should not be subject to negligence claims for matters addressed by these regulations, and certainly should not be subject to punitive damages.⁵

A review of Federal regulatory policies indicates why regulatory compliance should function as a safe harbor. U.S. Department of Transportation regulations must meet a test that the benefits of the regulation exceed the costs, which is the standard economic version of a legal negligence test. Regulations from the U.S. Occupational Safety and Health Administration and the U.S. Environmental Protection Agency go even further, usually mandating regulations for which the cost per life saved is well beyond any economic efficiency reference point, such as the value of statistical life. Similarly, in its approval process for drugs, the U.S. Food and Drug Administration (FDA) requires that drugs to be shown be both safe and effective. This approval process is quite thorough, involving a Phase I trial on small groups, a Phase II trial on 200-300 patients with the condition, and Phase III trials on 1,000-3,000 patients with the condition. New information may become available over time, and companies should provide the agencies with pertinent information that might lead them to alter the regulations or the approval status of a

⁵ An American Law Institute group advocated such a defense against punitive damages. See American Law Institute, *Enterprise Responsibility for Personal Injury—Reporters Study* (1991).

drug. However, from the standpoint of economic efficiency, there is no basis for the courts to second guess the expert judgments of regulatory agencies in situations in which agencies have established pertinent regulations.

Compliance with regulatory warning label standards should also provide a safe harbor against litigation. Here the issue is not the appropriate standards of care along a continuum of possible intensity, but rather the form and content of the warning. For warnings, it is highly desirable that firms be able to provide warnings using established, uniform vocabularies. Standardizing the use of human hazard signal words such as “Danger,” and restricting the use of warnings formats such as black box warnings to particular kinds of risk situations, maintain a degree of commonality that enables consumers to interpret the relative risk being conveyed by the message and to distinguish situations in which particular care is warranted. The FDA is perhaps the most prominent example of an agency that can promote such uniformity in that it reviews and approves all warnings for drugs and medical devices.

In contrast, warnings cases that end up in courts are decided by jurors and do not adhere to a standardized warnings vocabulary. A satisfactory warning in one state, before one jury, might be unsatisfactory before another jury, in that or another state. The result will be excessive warnings, as firms try to anticipate the different standards that might be imposed. In addition, juries will be affected by hindsight bias—the kind of Monday morning quarterbacking that leads jurors to think that a one-in-a-million accident was inevitable and foreseen by the defendant. “If only this particular warning had been included on the product, the accident would not have occurred.” Minor hazards are thus elevated to the same level as truly serious risks, leading to a warning label that, by warning of every conceivable accident, becomes so cluttered that it warns

no one. If everything is labeled hazardous, then those exposed to risk will not be able to draw distinctions as to which risks merit attention.⁶

Unfortunately, regulatory compliance defenses have been rejected by the courts. Although there is a legislative provision for regulatory compliance defenses for medical devices, these defenses are not generally accepted and were recently rejected for pharmaceutical products in *Wyeth v. Levine* by the U.S. Supreme Court.⁷ If meaningful regulatory compliance defenses are to emerge, they must be provided through legislatively enacted safe harbors.

State Tobacco Litigation

The linkage between regulation and litigation can also take the form of litigation which generates regulations as part of the settlement. This is most likely to happen when the plaintiff is a governmental entity which views the settlement negotiations as a mechanism for achieving policy outcomes that could not be accomplished by conventional means. To illustrate this phenomenon, this article focuses on the state tobacco litigation against the cigarette industry as a case study of how litigation can result in tax and regulatory outcomes.⁸ It is also noteworthy that state tobacco litigation rejected regulatory compliance safe harbors, in that the U.S. Congress mandated warnings for cigarettes beginning in 1966, and industry compliance with these

⁶ Similarly, if every day at the airport merits a Department of Homeland Security Orange alert, then there will never be a motivation to exercise particular caution.

⁷ *Wyeth, Petitioner v. Diana Levine*, 129 S. Ct. 1187 (2009).

⁸ Much of the discussion below is documented in W. K. Viscusi, *Smoke-Filled Rooms: A Postmortem on the Tobacco Deal* (2002).

warnings has not absolved firms from liability even for failure-to-warn claims. The cigarette experience is of substantial interest in that the stakes involved in the litigation and the ultimate settlement are greater than the outcomes in any previous case. Other cases that might involve similar issues include litigation involving guns and lead paint.⁹

Although cigarettes are associated with substantial health risks, the focus of the state litigation was not on the health losses to the smokers but on the financial costs of smoking to the states. In particular, the cases were based on the gross financial externalities affecting Medicaid, and not on wrongful death or personal injury claims. There were no claims for any losses to individual smokers, whether for their financial costs or nonpecuniary losses such as pain and suffering.

State Attorneys-General began filing these cases in 1995. The basis for the claims was that the cigarette industry was guilty of wrongful conduct in the manufacture and marketing of cigarettes. This conduct in turn allegedly led to smoking behavior that people would not have chosen had they been better informed or had available a different product mix including safer cigarettes. Thus, had it not been for the wrongful conduct, there would have been no financial costs associated with smoking.

At the time the litigation was filed, the prospects for success were not great as the cigarette industry had not made any payout to date in an individual smoker case, where the claims of wrongful conduct were usually similar to the claims made in the state cases. There are many consumer products associated with injuries, such as cars and sports equipment, but

⁹ For a series of such case studies, see W. K. Viscusi (ed.), *Regulation through Litigation* (2002), and D. Kessler (ed.), *Regulation Versus Litigation: Perspectives from Economics and Law* (2011).

manufacturers are not generally liable for the financial costs associated with all product-related injuries.

Not all states filed lawsuits against the tobacco industry. For example, the state of Alabama refused to file a lawsuit based on the premises that the risks of smoking were well known and that therefore these claims lacked a sound basis.¹⁰ Nevertheless, all states including Alabama were involved in the settlement of the litigation in 1998. Four states – Mississippi, Minnesota, Florida, and Texas—settled separately. These were the states where the litigation was most advanced. At the time of the settlement, a tobacco trial for the state’s claims was in progress in Minnesota. The other 46 states settled in a joint arrangement known as the Master Settlement Agreement (MSA).

The MSA imposed regulations and financial penalties that are the equivalent of a tax. The extensive regulatory components imposed a wide variety of limitations on tobacco marketing, and the tax payments and other financial sanctions total about \$250 million over the first 25 years of the MSA, which runs in perpetuity. Thus the MSA can correctly be viewed as a large scale intervention on both the tax and regulatory dimensions.

The process by which the MSA emerged was not unlike other negotiated settlements in that it was the outcome of bargaining between the parties that was not open to the public. The states were represented by their Attorneys-General, although not all of them were actively involved in the negotiations. The lead negotiator for the states was then Attorney-General and

¹⁰ The reasons for this decision are discussed in “Report of the Task Force on Tobacco Litigation Submitted to Governor James and Attorney General Sessions by the Task Force on Tobacco Litigation Chaired by William Pryor, Jr., Deputy Attorney General,” Oct. 2, 1996, reprinted in 27 *Cumb. L. Rev.* 557 (1996-1997).

now Governor of the state of Washington, Christine Gregoire. The other parties to the negotiations consisted of representatives of the major tobacco companies, which were the defendants in these cases. No public interest or consumer group representatives were included in the negotiations, nor were there representatives of other tobacco companies not named in the lawsuits. Once the parties to the negotiations reached a settlement, the Attorneys-General from each state had to sign off on the arrangement. There was no requirement that the state legislatures approve the deal, and in the case of Massachusetts the governor publicly opposed the settlement. Several of the state Attorneys-General were running for office in 1998, and most but not all of them signed on to the agreement before the election.

The MSA as a Tobacco Tax

How the settlement should be structured was a matter of considerable debate. In a typical personal injury case, the settlement usually takes the form of a lump sum damages payment from the defendant to the plaintiff. One might then have expected that, if successful, states might have sought a money payment based on the increased Medicaid costs attributable to smoking. Another frequent form of compensation in personal injury cases is that of structured settlements, in which payments are made over time in a manner that corresponds to the changing financial burdens over time. However, all the damages claimed in the cases were prior financial costs incurred by the states so that there was no comparable rationale for a structured settlement.

The negotiators of the MSA considered two quite different payment options. The first option was that of a lump sum penalty, analogous to a conventional damages award. This, however, was thought unsatisfactory for several reasons. A damages award on the order of \$250

billion would have pushed the tobacco companies to reorganize under bankruptcy law, with the result that, as unsecured creditors, the states would receive less than this amount. Further, since the damages payment would have been a fixed cost, it would not have affected the price of cigarettes. Firms would not have been able to pass the costs on to consumers because they would be undercut by new entrants if they attempted to do so.

The second payment option, adopted by the MSA, was to structure the damages payment in a form equivalent to an excise tax on every pack that is sold in perpetuity. This will not trigger the bankruptcy option, so that ultimately the states will be able to reap a greater financial reward from the settlement. In addition to generating a higher payout to the states than they would obtain under a lump sum damages payment, a tax equivalent per pack will raise the price of cigarettes.¹¹ The effect of this increase will be to discourage smoking because, as with other products, cigarettes have a demand curve that is downward sloping. In terms of policy objectives, the per pack damages payment serves to discourage smoking while the lump sum payment approach does not.

The per pack payment approach clearly was preferable for the defendants. To the extent that there is a reduction in smoking, that decrease in turn would adversely affect cigarette industry profits, but not to the same extent as would a lump sum damages payment. The magnitude of these MSA settlement payments linked to sales is the equivalent of 40 cents per pack. Such a tax increase reflected an 18.4% increase in the price of cigarettes. With a cigarette demand elasticity in the range of -0.4 to -0.7, this price increase led to a 7-13% decrease in cigarette demand.

¹¹ This result is a consequence of the relatively flat supply curves for cigarettes.

These calculations and the lack of a severe effect on company profits assume that all firms are subject to the same penalty. In theory, new entrants not covered by the agreement could enter the industry, undercut existing firms' prices, and gain market share. Since new entrants were not involved in the litigation and had no past wrongful conduct, they should not have been subject to the damages payments, however construed. To avoid placing the defendant firms in an adverse competitive position, the MSA also provided for payments to be made by all companies selling cigarettes, not just those companies that were parties to the original agreement.

The financial structure of the MSA settlement is consequently quite unconventional. Rather than a lump sum damages payment, the settlement is in the form of a tax per pack of 40 cents. Moreover, this tax is not limited to defendant companies, but extends to new entrants or companies marketing new brands of cigarettes. The damages being sought in the cases were for financial costs to the states based on alleged patterns of wrongful conduct. However, the payment requirements are divorced from any past behavior but instead are levied on all firms in the industry, whether or not they caused any previous damages. Thus the MSA in effect included a de facto excise tax arrangement that was made possible by the litigation but that was not directly linked to the harms allegedly caused by the particular companies.

One might view the payment as penalizing risks and financial costs associated with cigarette consumption in the future. Thus, even if there is no damages based rationale linked to wrongful conduct, perhaps the tax can be viewed as a mechanism for recouping financial externalities associated with cigarettes. However, there are three principal problems with this argument--the lack of any link of the tax to any financial externalities, the failure to consider net

financial externalities, and the role of political factors rather than costs in determining the MSA share amounts.

First, the penalty amount is independent of the riskiness of particular cigarettes. Even if companies developed a risk-free cigarette associated with no increase in medical costs, this product would be subject to the same tax per pack. Thus the excise tax structure is not related to any future financial externalities caused by the cigarettes. Moreover, there is clearly no link to previous externalities: companies that did not market cigarettes and are innocent of wrongful conduct are required to pay the fee even if the cigarettes they market are risk free.

Second, if the objective of the tax penalty is to internalize the financial externalities of cigarettes, the tax should encompass all net financial externalities. The state litigation isolated one financial externality, the increased Medicaid costs associated with cigarettes. However, the adverse health consequences of cigarettes have other financial ramifications as well, including a reduction in pension costs, social security costs, and nursing home costs. My calculations of these financial consequences demonstrate that on balance cigarettes do not impose a net financial externality on society. Indeed, there is a net cost reduction of 32 cents per pack due to smoking.¹² Similarly, even excluding the role of state excise taxes, there is no net financial externality to any state. Smoking does impose costs, but these costs consist largely of the internal health losses to smokers and not financial harm to the rest of society.

Third, the MSA payments to the particular states were based on the negotiations among the Attorneys-General, and were not strictly linked to tobacco-related costs. Thus political and strategic considerations determined payouts. The state of Washington fared very well in terms of its MSA share relative to cigarette financial costs, reflecting the influence of the lead Attorney-

¹² W. K. Viscusi, *Smoke-Filled Rooms: A Postmortem on the Tobacco Deal* (2002).

General in the litigation. All the four major tobacco producing states fared poorly in terms of receiving a smaller share of the MSA payments than would be appropriate based on their smoking-related health care costs. A particularly striking example of the role of salient bargaining points is that New York and California, the two largest states, received almost identical shares of the settlement—12.995% and 12.997%. However, California’s share of the smoking health care costs was only 8.551% as compared to New York’s 15.170% share, so that New York was shortchanged and California was substantially overpaid for smoking-related costs.

Because the payments will continue into perpetuity, the MSA payment structure will lead to long-term financial gains for the states. Given the political pressures for balancing budgets in the short term when current officials would be in office rather than the long term when future officials would have to address budgetary shortfalls, there is an incentive to reap the financial gains from the payments sooner rather than later. Several states followed this course by securitizing the proceeds whereby states were able to reap payments now in view of the discounted expected value of the future payment stream. Whether the payments are securitized or not does not influence the incentive effects of the payments.

MSA as Regulation

The MSA included a remarkable number of provisions that were regulatory in character. These restrictions resembled the kinds of policies that one would expect to emerge from either legislation or a formal rulemaking process rather than the private negotiations involved in the MSA. Notably, the regulatory components do not address specific aspects of alleged wrongful

conduct, such as misrepresenting the riskiness of cigarettes, but instead consisted of a list of policy initiatives designed to reduce smoking rates.

The main cluster of regulatory initiatives pertained to cigarette industry marketing and advertising. The MSA banned the targeting of youths in advertising and the use of cartoons in advertising. Since the most well known cartoon character used in advertising, Joe Camel, had already been permanently retired by R. J. Reynolds, this provision was not as influential as it would have been earlier. The MSA also banned the use of free samples, outdoor cigarette advertising, tobacco brand name merchandise, and payments for cigarette product placements in movies and television shows.

Although one can properly treat these measures as anti-smoking initiatives, viewed more generally they can be viewed as advertising restrictions. In effect, the MSA provided a mechanism by which firms could establish a legal arrangement to restrict advertising. Interestingly, such an effort is the paradigmatic example of collusion by firms in an industry to deter new entrants in the market and reap anti-competitive profits.¹³ Although collusion to restrict advertising in an industry is generally profit-enhancing for the firms, such collusion is illegal. The MSA, however, provided a legal mechanism by which the firms could overcome these restrictions.

A potential puzzle is why the Attorneys-General would support an MSA structure that, in effect, fosters the cartelization of the cigarette industry. One possible explanation is that, driven by their myopic anti-tobacco agenda, any measure that decreased the number of cigarette companies or cigarette advertising was viewed as being in the public interest. There was no

¹³ W. K. Viscusi, J. Harrington, and J. Vernon, *Economics of Regulation and Antitrust* (4th ed. 2005).

apparent recognition of the desirable aspects of market competition both with respect to product prices and product characteristics, including cigarette safety.

There is no evidence of changes in market concentration since the MSA. Instead, stability is the norm, as one would expect given the decreased potential role of market competition. In particular, the standard measure of market concentration (the HHI index) has remained stable from 1997-2005.¹⁴ Philip Morris, now known as Altria, has maintained its dominant market position with a market share that appears to be locked in at 49-51% of the market.

The MSA also required the elimination of two industry trade associations, the Tobacco Institute and the Council for Tobacco Research. The Tobacco Institute is perhaps best known for producing the annual compilation of tax and sales information, *The Tax Burden on Tobacco*, which is now privately produced by consultants. As a result of the MSA, joint efforts for lobbying or funded research through these trade associations consequently would need to be replaced by separate company efforts.¹⁵

An even more striking regulatory outcome was the possible use of MSA fees to fund anti-smoking efforts. The potential use of the funds for either anti-smoking policies or smoking-related health care costs fell far short of the avowed purposes of the funds. Before the MSA was finalized, there were common public pronouncements that the funds were needed for anti-tobacco efforts, particularly to discourage youth smoking. However, very little of the funding

¹⁴ W. K. Viscusi and J. Hersch, "Tobacco Regulation through Litigation: The Master Settlement Agreement," in D. Kessler (ed.), *Regulation Versus Litigation: Perspectives from Economics and Law* (2011).

¹⁵ Given the substantial market concentration in the cigarette industry, this change was less drastic than it would have been for an industry consisting of hundreds of small businesses.

was used for that purpose.¹⁶ Many states used the funds to balance their state budgets or to fund public works projects such as road and sidewalk repair.

The MSA settlement may have also altered the political landscape in a way that ultimately led to additional regulation through the enactment of the federal 2009 Family Smoking Prevention and Tobacco Control Act. Before the MSA was reached, there were attempts to end the state cases legislatively. Although this was never enacted, many of the regulatory components of the resolution surfaced in the MSA and in the Family Smoking Prevention and Tobacco Control Act. That act gave the Food and Drug Administration (FDA) authority to regulate cigarettes, banned the use of descriptors such as “light” and “low tar,” and introduced more extensive warnings on cigarettes, including a graphic warnings proposal by the FDA in 2010.¹⁷ After the MSA there have also been cigarette excise tax increases at the local, state, and federal levels, and these too may reflect a shift in the political environment in the post-MSA period.

Effects of the MSA on Litigation

The tobacco industry supported the MSA for two reasons. First, it sought to avoid all adverse competitive effects of the MSA by deterring competition. Second, it sought to reduce

¹⁶ Only 3.5% of the funds from FY2000-FY2005 were allocated to tobacco control. See the U.S. General Accountability Office, Tobacco Settlement: States’ Allocations of Payments from Tobacco Companies from Fiscal Year 2000 through 2005, GAO-07-534T (2007).

¹⁷In 2010 New York City also required the display of graphic cigarette warning posters at points of purchase, but that policy was overturned.

the uncertainty and expenses associated with tobacco litigation. However, this second objective was only realized with respect to state Medicaid cases. Three factors contributed to the continuing wave of tobacco litigation: the release of tobacco industry documents, the anchoring effect of the MSA payment, and the funding of attorneys who also engage in other tobacco-related cases.

The MSA provided for the release and posting of the tobacco industry documents and expert reports from the Minnesota case. While publicly archiving this information may appear to be innocuous, the release of these documents on the Web reduced the discovery costs associated with future litigation. The MSA marked the closure of the state liability claims so that there would not be comparable future claims, but there could potentially be future individual claims and class actions that could utilize this information in subsequent cases. After the conclusion of the MSA, there have been successful individual claims filed against the industry as well as class actions with very large verdicts.

The second way in which the MSA affected subsequent litigation is through the payout of a settlement with a value over 25 years of about \$250 billion. The exact tally varied depending on what components of the costs were counted. This startling settlement amount likely had effects on both the assessment of liability and damages level in future litigation. If the tobacco industry was willing to pay out hundreds of billions in smoking-related cases, one might infer that it was guilty of major transgressions. This settlement was not a secret deal but was a highly publicized event. The payout of such an enormous amount might imply wrongful conduct, which in turn would affect juror attitudes toward assessment of liability in future cases. Whereas the industry had never paid off a claim in any previous tobacco case, that record of unblemished success was tarnished.

In addition, a settlement in the billions established a new anchor for jury awards. In the entire period through 1998 there had only been three punitive damages awards of at least \$1 billion.¹⁸ However, cigarette firms subsequently have lost individual cases with punitive damages awards of \$150 million, \$3 billion, and \$28 billion, as well as class actions with punitive damages awards of \$3.1 billion and \$145 billion. Although these awards have been overturned or reduced, the \$145 billion award in the *Engle* class action case in Florida has generated thousands of *Engle* progeny cases for which the industry thus far has had a mixed record of success.¹⁹

The third way in which the MSA affects subsequent litigation is through the substantial funding of plaintiff attorneys who represented the states in these matters. Rather than staffing the litigation in house, states retained outside attorneys who were retained on a contingency fee basis. Although the amount of these fees is not generally public, for the states for which the amounts are known the fees are quite large. In particular, the fee amounts were \$1.43 billion for Mississippi, \$3.43 billion for Florida, \$3.3 billion for Texas, \$111 million for Missouri, and \$265 million for Ohio. The Chamber of Commerce tally of tobacco case legal fees in the states for which it could obtain information was \$11 billion. Because there was no competitive bidding, these huge payments generated major windfall gains.

¹⁸A. F. Del Rossi and W. K. Viscusi, The Changing Landscape of Blockbuster Punitive Damages Awards, 12 Am. L. Econ. Rev. 116 (2010) provides a listing of all punitive damages awards of at least \$100 million.

¹⁹ *Engle v. Liggett Group, Inc.*, 945 So. 2d 1246 (Fla. Sup.Ct, 2006)

These payments may stimulate additional tort litigation as many plaintiff attorneys will now have the resources to launch other cases. In addition, to the extent that such windfalls establish the prospect for similar gains in tobacco class actions and other large scale cases, the financial incentive to bring such suits will also be enhanced.

The Political Economy of Regulation and Taxation by Litigation

Before examining the process by which the MSA established regulations and tax policies, it is worthwhile to review the operation of the rulemaking process generally. To initiate a rule, the agency must first obtain the approval of the U.S. Office of Management and Budget (OMB), which ensures that the rule is consistent with the agency's legislative mandate. The agency then prepares the proposed rule and an associated regulatory impact analysis that evaluates the economic consequences of the regulation. OMB has 60 days to review the proposal and determine that the rule is consistent with administrative objectives and the agency's legal authority. A key test applied by OMB is whether the benefits of the regulation are shown to exceed the costs. If OMB approval is obtained, the agency issues a notice of proposed rulemaking in the Federal Register, which is followed by a 30 to 90 day public comment period. The agency then prepares the final rule and must obtain OMB approval before publishing the final rule in the Federal Register. Even after the final rule is published, there is the opportunity for both Congressional review before the rule takes effect, and judicial review after the rule goes into effect.

By comparison, the process by which the MSA was devised is cavalier. There was no regulatory impact analysis of the costs and benefits of the regulations, the effect on market

structure, or other usual components of a regulatory impact analysis. There was no requirement that the benefits of the regulation exceed the costs. Nor was there any opportunity for public input. The process by which the MSA was developed was not open to the public or subject to any public comment period and review. The ad hoc nature of the process creates opportunities for inordinate rewards to the deal makers.

The absence of any consumer or public interest representation may have influenced the ultimate structure of the bargain. The damages payment in terms of a financial penalty per pack serves to shift the brunt of the cost of the settlement to an unpopular class of smokers, who were not represented in the bargaining process. Coupling these penalties with requirements that new entrants also pay that fee serves to protect the competitive position of existing firms. Similarly, the advertising restrictions may appear to serve a public policy purpose, but they also amount to a barrier to entry for new firms and comprise a standard textbook case of collusion that firms will find to be desirable in future essays in regulation by litigation.

To the extent that the cigarette litigation experience is replicated by similar uses of litigation to impose regulatory and tax policies, the outcomes that emerge are likely to be far more harmful to society than policies that government agencies promulgate. The use of litigation settlements to impose policy outcomes falls short on two principal dimensions. First, the private interests of the parties involved in the negotiations are not synonymous with the public interest. There will be incentives to maximize private financial gains by shifting costs to parties outside the negotiations and to use the settlements for anti-competitive purposes. Smokers and potential new entrants to the cigarette market were most adversely affected by the structure of the deal. Second, the private negotiation process lacks all the substantive inputs and reviews associated with regulatory and tax policies. The input of agency experts and a wide

array of business and consumer groups potentially make policies much more effective and reflective of the diverse impacts that they have across society. The participation of interest groups in the usual governmental processes is not a flaw in democratic society but is a mechanism by which the preferences of these groups can be expressed.

The use of litigation by government entities to force regulatory and tax type policies is a recent development that should be discouraged. The proper forum for developing regulatory and tax policies remains the established governmental institutions. Failure to work through the requisite political process may appear to be politically expedient for advocates of particular policy interventions, but may lead to policies that are both not well founded and are more in the private interest of the parties to the negotiation than are in the broader societal interest.

While the use of litigation to generate regulation is a practice that should be discouraged, there is good reason to foster the linkage in the opposite direction. Compliance with government regulations for safety and government approved warnings should address concerns about whether the company was negligent or guilty of reckless behavior. For the most part, these regulations specify a level of stringency that goes beyond what is efficient from a benefit-cost standpoint. To the extent that juries nevertheless choose to find companies liable even when they are in compliance with such regulations, it is usually because of some failure of jury rationality such as hindsight bias. In contrast, regulatory agencies can make judgments of the costs and benefits across the entire class of consumers of a product, which is the appropriate vantage point.

Why do these problems of overlap and failure to consider appropriate interactions persist? In part, the courts may suffer from a tort-centric perspective. If the courts represent the sole societal mechanism for addressing inadequacies in safety and warnings, then the role of

other social institutions need not be considered. But given the emergence of substantial government regulations beginning particularly in the 1970s, the legal system should adapt to the presence of other social institutions. As the decision in *Wyeth v. Levine* made clear, however, such a recognition of the proper role of the courts is likely to require legislative action specifying the nature of any regulatory compliance defense.

The developing American system of regulation by litigation will, if left unchecked, weaken our economy and undermine the legitimate role of governmental institutions. The perverse bargains cut between ambitious politicians and industries, which offer the former the political support of trial lawyers and the latter the promise of an anticompetitive market structure, are yet additional symptoms of the American Illness.