Readings

of particular interest

New Economic Reasoning at the High Court

"The Supreme Court, 1983 Term—Foreword: The Court and the Economic System" by Frank H. Easterbrook, in *Harvard Law Review*, vol. 98, no. 1 (1984), pp. 4-60.

Scholars who look at the Supreme Court's treatment of economic matters often carve the field into isolated subjects. They treat administrative law as one issue, antitrust as another, rate regulation as another. The author of the foreword to the *Harvard Law Review*'s annual survey of the Supreme Court's term argues that this is shortsighted. Several general principles cut across many economic cases. The Court's understanding and application of these principles has changed dramatically in the last thirty years, with results that affect its work in every subject area.

"Judges both resolve disputes and create rules," the author notes. Litigation tends to concentrate judges' minds on dispute resolution, on the question of how to divide gains and losses among the parties to a suit. By the time the parties appear in court, it is too late for them to change their past behavior. But the Supreme Court is concerned less with results in particular cases than with prospective rules. "The principles laid down today will influence whether similar parties *will be* in similar situations tomorrow," Easterbrook writes. "Indeed, judges who look at cases merely as occasions for the fair apportionment of gains and losses almost invariably ensure that there will be fewer gains and more losses tomorrow." When the Court distinguishes cleanly between the forward-looking effects of rules and the backward-looking arguments based on fair divisions of the stakes, he says, it substantially improves its decision making. Easterbrook lays out more than 100 cases to illustrate his claim that the Court of thirty (or even ten) years ago was concerned with stakes-division, while the Court today is concerned with the effects of economic rules on future behavior. He concludes that this change in emphasis has affected the Court's treatment of almost all of the economic issues that come before it.

Even if judges look for the probable effects of their rules, there is no guarantee that the results will be satisfactory; their analysis may still be faulty. For many decades, for example, the Court overlooked the elementary difference between marginal and average effects. Thus, an opinion on patent law might reject a particular claim by the patent holder on the ground that the patent would yield a large enough profit in any case. "Enough" meant on average; the Court was unconcerned about the benefits and costs of the particular provision on the margin. As an economic matter, though, average effects may be irrelevant; people adjust their behavior according to the gains and losses on the margin. More recently the Court's analysis in this area has grown more sophisticated. In the video copying ("Betamax") case last term, for example, it repudiated the sort of arguments it used to accept and asked how a marginal change in the copyright holder's ability to collect royalties would affect its incentive to make new movies and put them on the air.

Finally, Easterbrook argues, even sophistication about the difference between margins and averages would be of little avail if the Court had a romantic view of statutes. It is possible to treat statutes as indicators of "problems" or "evils" that the legislature insists must be redressed. The Court's role, in this view, is to find and expunge every instance of the evil, no matter what the cost. This method of statutory construction, prevalent for many years, is built on two premises, the author says: that all laws serve the "public interest" and that the more public interest there is the better. "The statute's reach goes on expanding so long as there are unredressed objectionable results," since there cannot be too much of a good thing. "The judge interprets omissions and vague terms in the statute as evidence of want of time or foresight and fills in these gaps with more in the same vein."

Other judges view economic statutes quite differently, as contracts between contending parties. Some laws have little purpose but to enrich the interest groups that lobbied for them. (Much of the deregulation movement is based on this latter perception.) A judge with this view "implements the bargain as a faithful agent but without enthusiasm; asked to extend the scope of a back-room deal, he refuses unless the proof of the deal's scope is compelling," Easterbrook says.

This latter view has now caught on at the Court. The justices now regularly treat statutes as contracts among interests, asking not whether there is some unredressed problem but what each interest group was or was not promised as a term of the deal. The Court recently adopted such a line of reasoning in the case of *Silkwood* v. *Kerr-McGee Corp.* when it held that Congress did not immunize the nuclear industry from state punitive-damage suits for nuclear contamination, even though there is extensive federal regulation of the nuclear power industry. Easterbrook concludes that the Court now sitting is more astute about economic matters than any group of justices in a long time, and that the increased sophistication in things economic has brought about substantial improvements in the law as it applies to the economic system.

Liability unto the Third and Fourth Generations?

"The Achilles Heel of the Takeover: Nature and Scope of Successor Corporation Products Liability in Asset Acquisitions" by Robert J. Yamin, in *Harvard Journal of Law and Public Policy,* vol. 7 (Winter 1984), pp. 185-259.

When one corporation acquires another, it often does so by buying the assets of the target firm rather than by carrying out an outright merger or consolidation. One important reason is that an arms-length purchaser of assets, unlike the surviving firm in a merger, traditionally need not assume the legal liabilities of the seller. This generally holds true even if the acquirer continues the seller's operations essentially unchanged and even if the seller is dissolved or liquidated after the sale and thus becomes unavailable to satisfy the claims of plaintiffs harmed by its past actions. The advantage of this old and well-established general rule is that it promotes predictability in corporate transactions, free availability and transferability of capital, and mobility in the business and economic world in general. By reducing the uncertainty associated with transfers of property, such as asset purchases, it opens the way for more transfers that put assets to more productive use.

One of the consequences of freeing successor firms from liability, however, is that some injured plaintiffs will not be compensated for their losses. On one reading, this outcome might not be deemed unfair to plaintiffs. After all, it is undisputed that a company can escape yet-unfiled liability claims by liquidating itself. In the case of an asset purchase, the potential defendant receives cash or property equal in value to the assets it sells and thus remains, along with its cash or new property, momentarily available to be sued—although, of course, it is selling its assets precisely because its owners or managers plan to dissolve or liquidate it shortly thereafter. Lawyers for potential plaintiffs, however, object that in an asset purchase, unlike a liquidation, the business itself is continuing, even if under new ownership. If in some sense the liability adheres to the business as a business, and not its now-defunct owners, a rule of successor nonliability allows it to get off scot-free.

Sympathetic judges, swayed by such arguments, have begun awarding damages against successor corporations, but only on behalf of one kind of plaintiff: individuals who have been injured by the defunct corporation or by the products it has manufactured. To achieve this outcome, the courts have created or expanded exceptions to the general rule against successor liability in asset purchases. Robert J. Yamin, a corporate practitioner with the Hartford, Connecticut, law firm of Day, Berry & Howard, describes in this article how the law has been changing in this area and explores the policy implications of those changes. He divides the theories courts have invoked to place liability on successor corporations into four main categories: the "mere continuation" exception to the general rule, the "de facto merger" exception, the "product line" theory, and the "duty to warn" theory.

The "mere continuation" exception originally provided for liability in cases where the legal and economic owners of the successor corporation were essentially the same before and after the asset sale transaction. Some recent courts have begun invoking this exception even in cases where the new owners were clearly quite different from the old, so long as the underlying business continued in operation. The "de facto merger" exception applies in cases where courts find, among other things, that the predecessor firm's stockholders continue to hold a strong equity interest in the successor corporation, usually when the purchaser used its own stock to pay for the assets that it acquired.

The "product line" test, first enunciated in a landmark California Supreme Court case (*Ray* v. *Alad Corporation*, 1977), is more sweeping. It charges the successor with liability so long as there is substantial continuity of the offending product line after the asset sale. The rationale is that the buyer is entitled to enjoy the sweet of whatever "good will" accompanies the seller's product line only if it chokes down the bitter of successor liability as well.

The "duty to warn" theory holds that a successor corporation has an affirmative duty to warn customers, the public, or both that products manufactured by its predecessor may be defective. Unless the successor firm issues such a warning—and in practice it may be difficult if not impossible to discover and publicize all past product flaws—it is exposed to successor liability.

The "product line" and "duty to warn" theories have proved to be the most potent routes to successor liability, Yamin says, although jurisprudentially they are at opposite ends of the spectrum. The product line theory is a highly novel approach, abandoning as it does any pretense of remaining within the corporate law regime in favor of a theory of strict products liability imported from tort law. Courts adopting the "duty to warn" approach, on the other hand, claim only to be applying a mere exception within the general framework of corporate law. Precisely because the "duty to warn" theory can be applied without the appearance of "judicial activism," Yamin says, it may prove to be the most versatile and powerful of all the theories adopted by courts to find successor liability.

Critics have charged that by bending traditional principles to protect consumer plaintiffs, the courts are harming the economic climate and increasing the cost of litigation. Nonetheless, in the author's opinion, the expansion of successor liability is likely to continue. But, he adds, things could be a lot worse for the business community. Not only have even the most plaintiff-oriented courts refused to find successor liability in product liability cases not involving injury to individuals, but they have consistently reaffirmed the general rule freeing successors from all of their predecessors' other debts and liabilities outside the products liability area.

Even the California Supreme Court, in its seemingly radical *Ray* opinion, emphasized that the narrow "special exception" it was creating "imposed no liability upon [the successor corporation] for [its predecessor's] obligations other than certain contractual liabilities that were contractually assumed" and stated that the general rule's "insulation . . . of a corporation acquiring business assets has the undoubted advantage of promoting the free availability and transferability of capital." The author concludes by listing preventive strategies by which purchasers might help avoid successor liability and "ameliorative" strategies by which they might lessen the impact of such liability where that risk cannot be avoided.

Tying the Chains in Knots

"Winners and Losers under the Robinson-Patman Act" by Thomas W. Ross, in *Journal of Law and Economics*, vol. 27, no. 2 (October 1984), pp. 243-271.

The 1936 Robinson-Patman amendments to the Clayton Antitrust Act were born during a period of intense rivalry in the distributive trades. The old wholesaling-retailing order was being threatened by innovative new entrants, including mail-order houses, door-to-door salesmen, and department stores. None was more threatening to the livelihood of the thousands of small independent wholesalers and retailers than the chain store. And in no field had the new chain systems become so powerful as in grocery retailing. From a retail market share near zero before 1890, grocery chains had come to account for about a third of all retail grocery sales by 1929.

Independent retailers and wholesalers did not take this invasion lying down. Warning of an imminent monopoly of retailing, they initiated a spirited public debate on the "chain store problem." Legislators at both the state and federal levels responded to these concerns in a number of ways; among them were special taxes on chains and the federal Robinson-Patman Act.

The Robinson-Patman Act prohibits differences in price that may be injurious to competition. It was directed at the discounts that chains were receiving from their suppliers. These discounts could often be cost-justified, since the chains frequently provided services for which suppliers otherwise would have had to pay middlemen. Though the law does allow for a cost-justification defense, this defense has been a difficult one to prove; indeed, some legal scholars have called it "impossible."

This study, by Thomas W. Ross of the University of Chicago and Carleton University in Ottawa, begins by examining the effects of the law in the 1930s on some of the principal economic actors of the time. Employing the techniques of capital market analysis, Ross assembled portfolios of common stocks in companies operating chain systems and then examined these portfolios for unusual movements attributable to the passage of the act. The results suggest that the law's adoption did substantial damage to the value of the six companies in the grocery-chain portfolio. The effects here were both large (an abnormal, negative return of 58 percent over thirty-one months) and highly significant statistically.

Though there was evidence of some damage to the values of the chains in the variety, department store, and drug fields, it was much less and statistically insignificant. This is consistent with earlier claims that the grocery chains (by far the largest chains in the 1930s) were the chains that benefited most from preferential treatment by suppliers. It is also partly explained by the fact that a large fraction of enforcement activity was directed at the grocery-store industry.

When the act was passed, some thought it might confer benefits on manufacturers of grocery products. By prohibiting them from giving discounts to the big chain buyers, the law could have kept them from engaging in vigorous price competition. Ross studied the effects of the act's passage on the stock value of a group of large grocery manufacturers, however, and found that they may have actually been hurt as well, though once again the effect was statistically insignificant.

The big winners of the period appear to have been the food brokers. These middlemen found protection in a part of the act that prohibited the payment of brokerage fees (or discounts related to brokerage savings) except to true food brokers. Thus, even if a large grocery chain performed all the brokers' functions (as the large chains did), it could not be compensated by the suppliers, even indirectly. This provision led to a sharp reversal in what had been the sagging fortunes of food brokers. The rough estimates provided suggest that the act may have boosted commissions to food brokers by as much as 19 percent in 1939.

The second part of the article analyzes the effects of Federal Trade Commission enforcement of the act to determine whether or not its activity in this area matters. Since the typical punishment on conviction for a Robinson-Patman offense is simply an order to cease and desist, one might justifiably wonder about the law's potency.

Again Ross employed capital market analysis to study these effects. He compiled a sample of fifty-five cases resolved since July 1962 (when the necessary stock price data became available) and assembled three more stock portfolios. The first included firms that consented to cease and desist before any judgment was rendered. The second consisted of firms that fought the charges and lost, thereupon receiving orders to cease and desist. The last portfolio contained firms that fought and won dismissals of the charges.

Firms in all three groups were hurt by the Robinson-Patman proceedings. Probably the most interesting result is that the firms signing consent orders seem to have been hurt the most. In the period from thirty-five days before the order was announced to fifty days after, they lost, on average, almost 10 percent of their market value.

When firms fought and lost, their stock prices fell about 5 percent in the days bracketing the announcement of the full commission's decision. More curious, when firms fought and *won*, their stock still fell and by almost as much (4.5 percent) as if they had lost.

The fact that the firms in the consent portfolio suffered the most might possibly be explained by self-selection, the author suggests. Perhaps the firms in this group were the worst offenders who, certain of losing, surrender quickly. Because their violations were the most serious, the consent order could be expected to bind them most tightly. It is much harder to explain why firms that fought and won were hurt as much as firms that fought and lost.

Reagan's Record Revisited

The Reagan Regulatory Strategy: An Assessment edited by George C. Eads and Michael Fix (Urban Institute Press, 1984), 227 pp.

In its first days, the Reagan administration began a much-publicized program of regulatory relief aimed at restoring productivity and growth to the economy. It created a task force to launch and sustain major reform initiatives, and targeted certain major industries for special relief; it centralized many powers of regulatory review within the Office of Management and Budget; and it called on Congress to amend major regulatory statutes and give back more regulatory authority to the states.

This volume consists of six papers assessing the Reagan effort up to June 1983. Editors George Eads and Michael Fix write that by then the program had run into considerable resistance in both Congress and the courts and seemed to be turning from a political asset to a liability. The policies of the Environmental Protection Agency, the Department of the Interior, and OMB had generated especially heated controveries.

The first paper in the anthology is by Murray Weidenbaum, the first Reagan chairman of the Council of Economic Advisers and also chairman of President-elect Reagan's transition task force on regulatory reform. He notes that the administration has succeeded in cutting regulatory agency budgets and staffs, though some of the cutting might be counterproductive from a deregulatory standpoint. For example, if environmental permit-granting staff are cut but have undiminished statutory duties, the time and cost of regulation could actually increase. On the other hand, he says, not much was done to reform regulatory statutes. And there is an even deeper problem: "The necessary foundation has not been laid in terms of public understanding and support for reducing the burdens of regulation."

In the next paper, Gregory Christainsen and Robert Haveman assess the impact of regulatory relief on productivity during Reagan's first eighteen months. They assume that reductions in regulatory outlays by government and business result in dollar-for-dollar savings in business costs. Accepting (without endorsing) the cost savings claimed by the administration for its deregulatory program, they estimate an average resulting increase in annual productivity of 0.15 to 0.3 percentage points. Using a different methodology, they estimate that regulatory reform raised the growth rate of labor productivity between 1981 and 1982 by 0 to 0.15 percentage points. Unless new cost savings are found on an ongoing basis, however, this marginal improvement will dissipate within a few years. The authors warn that all their numbers should be interpreted with great caution.

One of the industries targeted for special relief was the auto industry, examined by Robert Leone. In April 1982, amid fanfare, the administration announced a package of thirty-four specific regulatory actions to help the auto industry, and provided forecasts of the higher auto sales and employment levels that it believed would result. These goals were not met on schedule, however, and sales figures remained low for some time due to the continuing economic slump. Although it is hard to sort out the various influences, among which were the voluntary Japanese import restraints, Leone believes regulatory relief contributed only modestly to the revival of industry profits.

Another goal of the administration, restoring state and local regulatory authority, had to some extent already been contemplated by existing legislation and was thus easier to implement than some other measures. Michael Fix believes such devolution will have more enduring results than many other Reagan initiatives, but maintains that the administration is not entirely consistent on this issue. It is too ready to preempt the states when that is needed to pursue its other regulatory goals.

Jerry Mashaw and Susan Rose-Ackerman develop a conceptual framework for examining how regulatory power is allocated between the different levels of government in the federal system. Officials at each level seek to garner the credit for dispensing regulatory benefits while shifting the costs of the program to other levels of government. As for industry, its preference will depend on (among other things) how much bargaining power it thinks it can muster at each level of government. Mashaw and Rose-Ackerman assess the arguments deployed by advocates of federal and state authority on such grounds as democratic responsiveness, administrative efficiency, and economies of scale, and conclude that the Reagan administration oversold state decentralization as a solution to regulatory problems.

The final paper, by Christopher Foreman, examines the role of congressional oversight in the regulatory process. He categorizes the various ways Congress can keep a rein on regulatory bureaucracies, arguing, among other things, that the proliferation of committees and subcommittees with overlapping jurisdictions provides a healthy check against the "capture" of committees by the agencies they oversee. Foreman briefly reviews Congress's record, explores proposed new oversight tools, and concludes with policy recommendations.

Newcomers in the Deregulated Skies

Deregulation and the New Airline Entrepreneurs by John R. Meyer and Clinton V. Oster, Jr., with Marni Clippinger, Andrew McKey, Don H. Pickrell, John Strong, and C. Kurt Zorn (The MIT Press, 1984), 240 pp.

At the time the Airline Deregulation Act of 1978 was passed, forty years of regulation had thwarted most forms of entrepreneurship in the airline industry. The 1978 act created new opportunities for the established airlines and, perhaps more significant, also made it possible for entirely new competitors to enter the market. The rebirth of entrepreneurship in the industry took two major forms. First, entirely new jet-equipped carriers like People Express sprang up to offer simple, no-frills service with low fares in short to medium-haul markets, while a number of other carriers that had been previously confined by regulation to intrastate operations, like Southwest Airlines, seized the chance to expand. Second, there was a surge of growth and new entry by commuter airlines operating small propeller-driven aircraft in short-haul low-density markets.

This book, by John R. Meyer of the Kennedy School of Government at Harvard and Clinton V. Oster, Jr., of the School of Public and Environmental Affairs at Indiana University, and their colleagues, examines the demand and cost characteristics of the industry, the business strategies of the new entrepreneurs, and a number of related public policy issues such as the safety record of commuter airlines, the problem of limited airport access, and the federal program of subsidies for small community service. They find that entry by airlines has contributed to three of the main outcomes of deregulation: the broadening of fare and service choices, productivity and cost improvements, and the rationalization of small-community service. A recurring theme is that the new airline entrepreneurs have imposed new competitive pressures on the established carriers far out of proportion to the volume of traffic they carry.

Many reformers had expected deregulation to lead to across-the-board fare cuts, since the unregulated intrastate markets of Texas and California were generally characterized by low fares. But the established carriers at first responded to their new pricing freedoms with targeted discounts rather than general cuts. These discount fares were capacity-controlled (available for only a limited number of seats on each flight) and market-segmented (restrictions kept business travelers from using them). The new entrants countered by offering low fares in a simpler unrestricted format, thus attracting some of the majors' former customers, as well as entirely new travelers.

The intensification of competition between existing airlines would have placed downward pressure on costs to some extent even in the

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By Wright for the Miami News

absence of new entrants, the authors say. The new entrants greatly increased that pressure, however, by streamlining their service offerings and operating with lower cost, often nonunion work forces.

Before deregulation the federal government required many carriers to serve small communities using jets and large turboprops. These aircraft were ill-suited for low densities and short hauls, however, and carriers could fill the planes only by adopting "hedge-hopping" routes whose departure times were often inconvenient. Even this mediocre level of service was usually unprofitable and required large and growing federal subsidies.

The 1978 act changed things in two ways. First, it allowed existing carriers to drop unprofitable routes. Second, it made commuter as well as regular airlines eligible to receive subsidies for service to small communities. As larger airlines pulled out of small markets after deregulation, the commuter lines moved in to fill the gap, cutting costs by using smaller turboprop aircraft. The shift to smaller aircraft has made possible higher service frequencies and more convenient schedules, which in itself has often stimulated traffic. Commuters had been making steady inroads into small community service even before, but deregulation has accelerated the trend: "replacement" services have contributed as much as 25 percent to the post-deregulation growth in travel on commuter airlines.

The success of the commuter lines, the authors say, has apparently helped quell one of the major fears about deregulation. Basic air service to small communities has continued and even expanded. In the authors' view, furthermore, the safety record of the commuters is acceptable; the larger and more experienced commuter carriers, who serve over half of all commuter passengers, have a safety record virtually as good as the jet carriers. Moreover, the cost of this service is down both in absolute terms and to the federal treasury. The authors say the 1978 changes had saved taxpayers a total of more than $20 million by mid-1981 and can eventually be expected to save at least $50 million annually—compared with what would have happened if the small community program had continued as it existed before deregulation.