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Deregulation and Litigation

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by Stephen J. Friedman

The regulator's attitude toward his professional life is well captured by a story about the enormously successful and prolific Japanese artist Katsushika Hokusai. As he lay dying at the age of 90, after producing over 13,000 prints and drawings, his daughter heard him murmur "Oh, if I could only have just five more years, I could become a really great painter."

So it is with regulators. Engaged in a constant battle with a diverse, innovative and aggressive private sector that is constantly seeking new ways under, over and around the regulatory barriers, the regulator keeps tinkering with the regulatory system, believing in his heart that in only a few years it will be just right. Sometimes, in the heat of battle, the original policy objectives are lost, and the regulatory system takes on a life of its own. At that point, the pendulum begins to swing back toward deregulation. Today, we are somewhere on the arc of that backswing.

What does this trend mean for litigation? It will not do to say simply that less regulation means less enforcement or less litigation; nor, on the other hand, is it necessarily the case that a lower level of enforcement means a transfer of enforcement responsibility to the private bar.

There are four general problems associated with overregulation. The remedies proposed for each evil contain different implications for litigation. Those problem areas are:

- the restrictions on competition and market forces that flow from economic regulation;
- the cost burdens imposed by the new ventures into health and safety regulations of the late 1960s and the 1970s;
- the rigidity and drag on innovation introduced by excessively detailed rules; and
- the general level of government intrusion into the private sector.

Much of the regulatory apparatus that blossomed during the first half of this century and the end of the last grew from concern about excessive market power as a result of a naturally dominant market position. The ICC, FCC, CAB and other agencies fall into that category. As those agencies evolved, they came to see their roles as protecting regulated companies from "excessive competition," and regulation became a force for higher prices, fueling inflation.

The Carter administration began to dismantle much of that economic regulatory structure. In fact, deregulation is probably the most significant accomplishment of that administration in the economic area. The CAB is being eliminated. There has been substantial deregulation in trucking, railroads and communications. In banking, deposit interest rate controls are being phased out, restrictions on functions are being blurred, and barriers to interstate banking are crumbling. The Reagan administration is pressing forward with this effort, spearheaded by its prompt deregulation of oil prices and the struggle to resist the rising tide of protectionism.

Dramatic Example

Economic deregulation will assuredly mean fewer formal administrative proceedings. If an agency is no longer in the business of allocating routes, approving rates or fixing prices, that litigation will drop sharply. There is probably no more dramatic example than the fall off in litigation following the decontrol of oil prices. Immediately before President Reagan took office, there were more than 1,500 people administering the price control system and its related web of allocation rules. To put that total in perspective, throughout most of its life the SEC staff has ranged in size between 1,500 and 2,000.

The reduction in administrative proceedings and related enforcement work will not be supplanted by private sector litigation, since in large measure the substantive rules themselves will disappear. However, antitrust litigation will probably increase as the antitrust immunity conferred by regulatory approval of pricing behavior or mergers begins to fall away.

The second complaint about overregulation is the

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asserted excessive cost burdens it imposes on the productive process. In general, this contention is aimed not at the financial regulatory agencies such as the SEC and the bank regulators, or the economic regulators of market power, but rather against the agencies administering health and safety rules.

Governments have imposed "unproductive" costs in the form of fire and building codes for a long time. But concern for air and water quality and highway safety, and a keener appreciation of the impact of chemical contamination, have escalated these costs.

A double-barreled remedy has been proposed to deal with these mounting costs: greater executive control through the Office of Management and Budget, and a requirement that the agency consider economic burdens when it adopts new regulations. Although the Supreme Court recently decided that the Department of Labor was not required to weigh the costs of OSHA's cotton dust standard against the benefits, *American Textile Mfrs. Inst. v. Donovan*, 101 S. Ct. 2478 (1981), Congress may well require that balancing both for OSHA and for other agencies.

Weighing costs and benefits is easier said than done, since it is often difficult to convert health and safety benefits into monetary terms. That difficulty will produce more litigation instituted by unions and public interest groups, just as has been true with environmental impact statements. Indeed, some current legislation requires analyses much like "inflation impact statements." *See, e.g.*, Regulatory Flexibility Act, 5 U.S.C. §§ 601-612.

The attempt to quantify the impact of regulation has not produced very satisfactory results in agencies such as the SEC. For example, the Regulatory Flexibility Act requires the agencies to consider alternatives if a proposed rule will have a "significant economic impact" on a "substantial number of small entities." 5 U.S.C. § 605. In a mature regulatory system like that administered by the SEC, most rulemaking is incremental, involving only adjustments to the existing requirements. Since the statute does not require a reappraisal of the set of rules being amended, the statutory threshold is seldom met.

The proposed requirement that OMB approve new rules could compromise the status of independent agencies. Agencies would be required to negotiate new rules with the OMB staff, just as a one-house legislative veto requires negotiating with the congressional staff. That approach is outside of the public record; it cannot be tested through judicial review and it substitutes executive branch decisionmaking for that of the agency. This encroachment on independent statutory responsibilities will be the grist for new litigation by labor unions and public interest groups.

The third major element of deregulation is the effort to control excessively detailed and rigid rules. These rules reflect a loss of balance and perspective—a regulatory myopia.

Any regulatory system rests upon a set of values—in the case of the SEC, for example, the worth of disclosure of material facts to the marketplace. The agency's rules simply implement those values. When a regulatory system is young, the eyes of those who deal with it are firmly fixed on the values. As it matures, perfection of the regulatory net becomes an independent goal, and the rules sometimes become divorced from the ultimate values that gave rise to them.

The success of the regulatory system and the aggressiveness, intelligence and innovation of the regulators often generate excessive regulation. Regulators are engaged in a constant battle with the efforts of thousands of market participants to gain a competitive edge by bypassing some of the rules. The smarter and more experienced the regulator, the more escape routes he will identify and try to deal with through prophylactic and sometimes overly rigid rules.

At that point, the agency needs a fresh outlook—a return to basic assumptions and the means to achieve them. It requires self-restraint by the regulators or a restraining hand by an outside agency, such as OMB. It may be necessary to rely on broad statutory or regulatory commands rather than detailed recipes for behavior.

Self-Regulation

It is unclear whether this element of deregulation will produce less litigation. Broad prohibitions can provide as much opportunity for enforcement as detailed rules. Indeed, the SEC Enforcement Division tends to operate most vigorously in the interstices between the detailed rules, acting instead on the basis of standards such as the antifraud rules or the fiduciary provisions of the Investment Company Act. This is so because self-regulation works most effectively when there are detailed rules, and there is thus less need for enforcement action. Moreover, general prohibitions like the antifraud rules provide regulators with the tools to react to efforts to circumvent their rules.

Consider the following tradeoffs between regulations and enforcement in the area of securities regulation.

Before the Foreign Corrupt Practices Act was adopted, the Commission found an adequate legal and practical basis in its disclosure systems to proscribe the bribery of foreign officials. The accounting provisions of the Act now require that issuers maintain an appropriate system of internal accounting controls and accurate books and records. But the enforcement litigation under the Act has been limited in virtually every case to an egregious departure from accepted norms of financial accounting practices, and the charges include general allegations of antifraud violations as well as violations of the accounting provision of the Act.

Even without the Foreign Corrupt Practices Act, the level of SEC enforcement proceedings dealing with conduct now covered by both the antibribery and accounting provisions would not be significantly lower. In short, restraint in rulemaking may not mean less enforcement activity by those agencies, like the SEC, that have general mandates under which they can proceed. Moreover, the antifraud rules provide a basis for private suits.

Another example of these tradeoffs is provided by the amendments to section 17 of the Investment Company Act that were adopted last year in the Small Business In-

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$1 million. One recent verdict amounted to $2.9 million. These results have had a strong impact, of course, upon subsequent settlement offers in other cases.

Districts vary dramatically in the percentage of cases that have been disposed of. Many cases have been tried in Colorado and the Eastern District of Virginia. On the other hand, as of summer 1981, none had been tried in the Southern District of New York. Routine calendar delays and the appointment of a single judge are a major factor in determining how quickly the cases are resolved.

The American legal system has proven in recent years that it can handle in an orderly fashion mass litigation concerning catastrophies. The swine flu litigation is another example of this orderly process. The swine flu litigation can be criticized, however, for the delays in some jurisdictions and the expense—both for the government and individual plaintiffs. Moreover, the government has become an adversary of the citizens it originally acted to protect. No matter who wins the remaining cases, the wisdom of Congress's decision to permit the government to step into the private world of the manufacturers and defend the swine flu suits is certain to be a hotly debated issue the next time scientists warn of an impending, nationwide health hazard.

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vestment Incentive Act, 15 U.S.C. §§ 80a-53-80a-64. Section 17 contains a broad prohibition against transactions involving an investment company and its affiliates. As a practical matter, many such transactions are a necessary part of business life for investment companies carrying on venture capital-like activities. The SEC has power to grant exemptions. In practice, the Commission gave an exemption only after a long and detailed negotiation with the investment company about an "appropriate" set of conditions to the exemption.

The Small Business Investment Incentive Act was designed to ease the regulatory burden on publicly held venture capital companies. Many transactions involving business development companies and affiliates are no longer prohibited so long as the board of directors of the company, including its independent directors, concludes that the transaction is "reasonable and fair" and does "not involve overreaching of [the business development] company or its shareholders or partners on the part of any person concerned." 15 U.S.C. § 80a-56(f)(1). The shift away from a detailed administrative proceeding was clearly intended to "get the government off the backs of investment companies." At the same time, the breadth of those standards and their ambiguity will result in additional litigation on the part of both the SEC and private litigants.

Less Government

Finally, there is an element of deregulation that comes down to nothing more than less government. It recognizes that some aspects of human economic behavior are so ambiguous or multi-purpose that government cannot reach the concededly questionable conduct without unduly restricting legitimate activity. It accepts the fact that we must tolerate some abuse to avoid the evils of overregulation.

Some believe that this will mean reduced enforcement activities. Some have suggested that this step will simply shift the locus of the litigation from the agency to private litigation. But, in some regulatory regimes, private rights of action do not exist. If the agency does not act, there is no action.

The securities law antifraud rules generally authorize private litigation. But SEC enforcement proceedings under the antifraud rules have not replaced private litigation. The two have often proceeded side-by-side. Many Commission enforcement proceedings grow out of its unique access to information—its inspection program and customer complaint collection system. The lack of a Commission follow-up investigation and the attendant publicity may well mean a lower level of class actions and derivative actions.

Federal regulators may draw fewer regulations over the next several years. And the ones they draw may contain broader strokes. Some of these changes will undoubtedly reduce the opportunities for litigation, but it is uncertain whether the net impact of deregulation will be less litigation.

From the Bench

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ily depend in some measure on whether you represent a plaintiff or a defendant. If you represent a defendant the background of the case will already have been covered by the plaintiff and by the opening statements, though you may want at the outset to supply any vital omissions in the background or to correct and refute by your first witness any false or incorrect statements about the background suggested by the witnesses of the plaintiff. If the discrepancies about the background are great, you may wish to start over and have your witness paint an entirely new or different background more in keeping with your theories of the case.

If you represent a plaintiff you start the presentation of evidence laboring under one distinct disadvantage: you have to go first. Remember the old saw that "figures don't lie but liars do figure." While you are questioning your client on direct, your opponent and his lawyer are sitting there listening to everything he says and busily adjusting their tactics and position to capitalize on every advantage revealed. In many situations it is a distinct advantage for your opponent to have to take a position first. Frequently there is nothing you can do about this and in some cases it makes little difference, but there are also many cases in which you should consider completely reversing this advantage by calling the opposite party