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A Taxing Settlement

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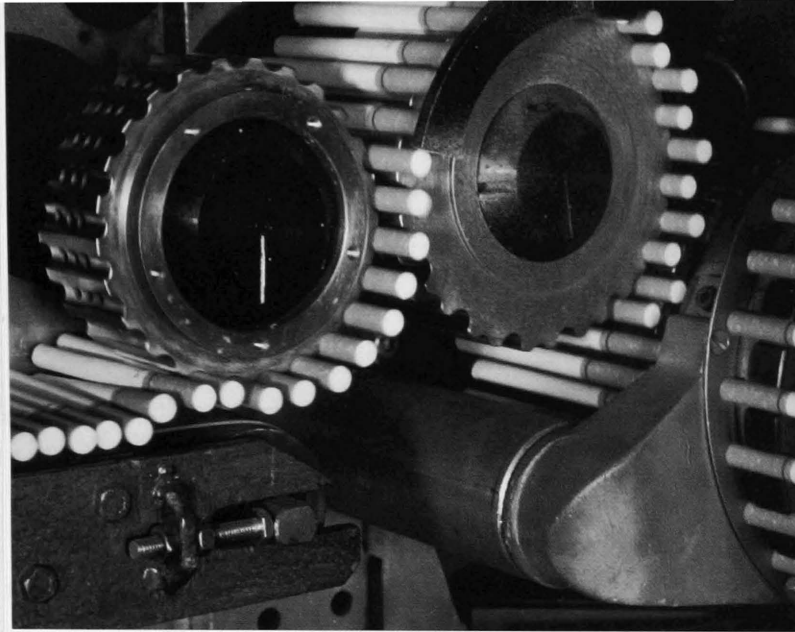
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A Taxing Settlement

The following essay is based on the talk "Government, Citizens, and Injurious Industries: A Case Study of the Tobacco Litigation," delivered by Hanoch Dagan last May to the Detroit Chapter of the International Association of Jewish Lawyers and Jurists, and on the article "Governments, Citizens, and Injurious Industries," by Dagan and James J. White,'62, which appeared in 75.2 New York University Law Review 354-428 (May 2000). The authors hold conflicting views on the underlying issue of this topic: tobacco company product liability. Professor Dagan holds the position that tobacco companies are liable for harm done by their products; Professor White argues that tobacco companies are not liable for harm done by their products.



By Hanoch Dagan
and James J. White

Citizens sue industries for tort injuries. That is familiar. Governments sue the same industries for cost suffered in ameliorating or preventing those injuries. That is unfamiliar. This new pattern of litigation and settlement inherently puts the government in competition with its citizens. It also facilitates the government's fulfillment of its public responsibility. This article deals with these vices and virtues.

The tobacco litigation by the states and the settlement of that litigation (the largest ever) is the most prominent example of this pattern of government suing injurious industries. A similar pattern is developing in the gun industry where more than 20 suits have been brought against the manufacturers. Industries waiting in the wings for this treatment include lead paint makers, and perhaps even brewers, distillers, and producers of fatty foods.

In this article we address some of the questions raised by this recent pattern of litigation and settlement. We assume

throughout that consumers or third parties have actually been harmed by the products at issue, be it cigarettes, guns, etc., and have valid claims against the pertinent industry. We explore the intricate legal questions arising from the triangular relationship among the players in these high-profile cases: governments, citizens, and defendant industries. We have two major purposes: identifying the proper cause of action of governments against industries and setting their appropriate boundaries; and discussing the inherent risks in allowing such claims and pointing to the way they should be addressed.

We begin with the question of the liability of an injurious industry to a government that has incurred preventative and ameliorative costs due to the harms inflicted by that industry on its citizens. The states' litigation against the tobacco industry focused on reimbursement of tobacco-related healthcare costs. Many of the causes of action actually

brought by the states were invalid bases on which to make such claims. The states' complaints did not adequately present their true remedy: subrogation.

Subrogation arises where one person (the subrogee) pays another (the subrogor) to cover a loss or a debt for which a third party is primarily liable. The subrogee then enforces the rights of the subrogor against that third party (the party primarily responsible for the loss) for its own benefit. Subrogation has two forms: contractual (also called conventional) and legal (also called equitable). Our focus is on cases where there are no contractual arrangements (explicit or implicit) respecting subrogation.

Our analysis shows that the states have a valid subrogation claim. To be sure, theirs is a hard case because — unlike core cases of subrogation (such as traditional insurance subrogation) — the interests of the governments and those of the industries are not closely locked-in together: governments, payments are indirect and to some extent discretionary. And yet, like in other subrogation borderline cases, third-party interests should make recovery available: public authorities should be able to respond in an efficient manner to any threat to the public health or safety, without worrying that the provision of services would insulate those who are responsible from these threats from liability and unjustifiably shift the burden of their wrongdoing to the public purse.

The governments' status as subrogees makes their rights derivative of those of the direct victims, due to and to the extent of the unsolicited benefits conferred. As such, the subrogee's rights can be no greater than the rights of the subrogor. Thus, the industry's original liability to injured citizens caps its exposure to subrogation. The governments are also subject to whatever defenses the industry would have had against the injured citizens, most prominently assumption of risk, causation, and statutes of limitations. Moreover, governments are entitled only to the damages attributable to the loss which they have covered (and they carry the burden of proving that these costs were indeed incurred in a way that benefits the injured citizens). Governments are not entitled to damages for pain and suffering, punitive damages, or statutory penalties to which the injured citizens might have been entitled from the industries.

Citizens vs. Governments: Takings

Governments that seek to recover their ameliorative and preventive costs might end up harming citizens who seek remedy for their direct damages. This proposition can be demonstrated by the tobacco settlement. Our analysis of the settlement concludes that some of the *quid pro quo* given by the states to the tobacco manufacturers is actually at the expense of third parties: competitors (and hence future consumers) and injured smokers. In particular, we show that the tobacco settlement secured two things for the tobacco companies: at least momentary safety from bankruptcy and

protection against competition. Regarding the bankruptcy issue, we predict that the settlement has indirectly purchased the allegiance of its beneficiaries, not only [state] attorneys general, but also public employees, contractors, even teachers' unions. All of these beneficiaries now have a reason to support federal legislation, like the McCain Bill, that would cap tobacco companies' liability. Citizens thus help pay for the governments' winnings through reduced opportunities to pursue their private claims against the injurious industries. Indirect evidence for the same phenomenon is the receipt by a government of funds in excess of spent costs and the spending of such funds on causes that have nothing to do with the injured citizens' interests.

These dangers, which are inherent in allowing governments to sue injurious industries for their preventive and ameliorative costs, can, and should be, addressed in the framework of takings law. The takings question regarding a triangular paradigm analogous to ours — where the government's settlement with another sovereign limits a citizens' claim against that sovereign — is unsettled. While the Supreme Court in *Dames & Moore v. Regan* (453 U.S. 654 [1981]) left open as unripe the question of whether such a settlement constituted a taking, Justice Powell noted in concurrence that “[t]he government must pay just



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compensation when it furthers the nation's foreign policy goals by using as 'bargaining chips' claims lawfully held by a relatively few persons and subject to the jurisdiction of our courts." Lower courts have followed this proposition by scrutinizing the constitutionality of such governmental interference.

By exploring the foundations of takings law, we show that a government's interference with its citizens' compensatory claims beyond its role as a legitimate subrogee (via its receipt of more money than it has spent on preventative and ameliorative measures and/or the enactment of caps) justifies compensation. In other words, insofar as the citizen's expected awards are compensatory, and the government spends the money it receives from the industry on programs that do not benefit the injured citizens, the citizen's takings claim should be successful. Governmental interferences with citizens' punitive damages awards present a more complex case. The case of barring punitive damages as part of a government-industry settlement derives complexity from the unsettled nature of punitive damages. We doubt that citizens can claim any entitlement for punitive damages for retribution. But insofar as punitive damages are aimed at deterring the defendant's infringement of the plaintiff's entitlement, thus vindicating the latter's control over the infringed resource, plaintiffs may well have valid takings claims even respecting punitive damage. As long as punitive damages for deterrence will not be disentangled from punitive damages for retribution, these claims would probably remain theoretical. On the other hand, we have no doubt that governmental interference with citizens' compensatory awards should be regarded as a violation of

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their Fifth and Fourteenth Amendment rights. A strict takings doctrine is the only viable protection for citizens from the dangers inherent in governmental interference with their claims against injurious industries.

Public Policy

Such findings have significant impact on the formation and conduct of public policy. There is considerable risk that governmental interference in the resolution of mass tort claims will violate the legal rights of the individual victims. Our case study of the tobacco settlement highlights an additional disadvantage, that such interference is also bad public policy even where it might not violate the legal rights of the individual victims. This is true whether one considers the settlement to be merely an agreed resolution of a tort subrogation claim or a state imposed tax.

We acknowledge that the states are proper subrogees for their ameliorative and preventative costs and we also see no reason why their claim for those costs could not be resolved by agreement with the manufacturers. But the settlement is unlike a garden-variety subrogation recovery; as true subrogees, the states would surely not have won judgments with a value equal to the amount that the tobacco manufacturers have agreed to pay. The states reached such a favorable settlement only by colluding with the tobacco manufacturers to put a disproportionate share of the cost on their citizen smokers.

Our principal quarrel with the settlement as an agreed resolution of a tort claim is that some of the terms — reducing payments by the participating manufacturers if they lose market share to outsiders and inviting the states to enact a tax that deters new market entrants — improperly redistribute costs from the tobacco companies' shareholders to their consumers. If the agreements in the settlement had been reached between private parties, they would have violated federal antitrust laws. Although states' agreements are immune from federal antitrust prosecution, the anticompetitive provisions of the settlement will have exactly the same effect as if private parties had conspired to exclude competitors. If the agreement with the manufacturers hinders the entry of new competitors, the price of cigarettes will be higher than in a freely competitive market.

The higher price has two effects. First, it frees the companies' shareholders from having to internalize the costs of their tort liability; they can pass on the costs to consumers without a loss in market share. Second, it facilitates the inclusion of additional payments in the settlement (e.g. payments for lobbying) without fear that new entrants to the market will undercut the cigarette prices of the participating manufacturers. If demand for cigarettes is relatively inelastic, if price competition among the participating manufacturers is muted, and if outsiders are barred, the cost of any "bribe" to the state governments can be passed through to purchasers without cost to the manufacturers.

The settlement may be even more offensive to public policy if it is considered to be a tax imposed by quasi-judicial function. The payments have many of the attributes of a tax: they are made to the states; continue indefinitely; are only imperfectly related to past tort injuries; and in many states

will go directly into the treasury and be expended in just the same way as conventional tax revenues would be. As a tax, the settlement is undemocratic and regressive.

The first and most powerful objection is that as a tax the settlement violates the democratic principles that are built into the tax laws of every state. If a state were to enact a multi-billion dollar tax equal to the revenues that it will receive under the settlement, it would have to follow elaborate legislative procedures. Typically, these measures would include legislative hearings, debate, and passage by both houses of the state legislature, and signature by the governor. In contrast, a state's adoption of the settlement required only the agreement of a state official such as the attorney general and the adoption of the settlement in a judgment dismissing the state's suit against the manufacturers. The settlement's bypassing of the traditional mechanisms for the passage of new taxes reduces the visibility of the settlement's provisions. No advocate for cigarette consumers has ever had the opportunity to express the arguments that we consider here. No attorney general has had to respond to questions about the settlement's anticompetitive provisions. No anti-tax governor has had to explain why he or she is proposing a huge new tax.

The lack of public participation becomes even more troubling when we consider that in modern America smokers are drawn disproportionately from classes with limited education and low incomes. The tobacco manufacturers' ability to pass on the costs of the settlement means that the costs will be imposed primarily on working-class smokers. This concern would be alleviated if a disproportionately large share of the tax revenues were to go to the working class, particularly to the smokers, but we see no evidence of that happening.

Consider one final consequence of this unusual tax. Every excise tax on a potentially injurious product is, of course, a bargain with the devil, for more sales mean both more tax revenue and more injuries. But the peculiar nature of this tax ties the states even more closely to current members of the tobacco industry than would be true of a conventional tax. Because the tax arises from an agreement between each state and specific tobacco manufacturers, the tax revenues depend upon the continued existence and solvency of the participating manufacturers. If Philip Morris or RJR goes into bankruptcy and liquidates, and its market share is taken over by a new entrant, every state's tax revenues will decline accordingly. Each state will thus have an incentive to keep these particular taxpayers healthy. If our analysis is correct, the states have made covert, implied promises about lobbying and covert, express promises about erecting barriers to new entrants that the states would probably not make to anyone openly, certainly not to specific members of a particular industry.

Because the settlement revenues go to identifiable beneficiaries in most states, persons in every state will shortly

regard these benefits as an entitlement. The incentive of state officials to maintain the revenues will be correspondingly enhanced by the knowledge that particular, local voters depend on this revenue.

We see much that is bad and little that is good from enacting such a tax by a quasi-judicial process. The absence of the legislature from the adoption process stills the public's voice and facilitates collusive bargains. Characterizing the payments as tort recoveries frees public officials from the pain that they would suffer for enacting new taxes, particularly regressive ones. Finally, the exclusion of smokers from the private bargaining table facilitates other parties taking assets that should belong to the excluded players.



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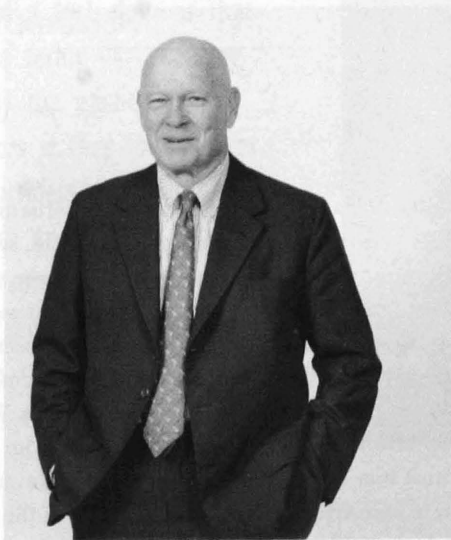
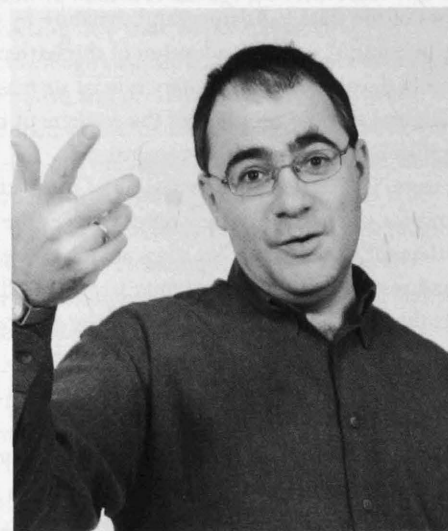
Conclusions

We do not claim that every bargain struck in settlement of a state or federal suit against weapons manufacturers, sellers of fatty foods, brewers, or distillers will have all of the same characteristics as the tobacco settlement. But we believe that when the government asserts a claim that could be asserted by an individual citizen, it will almost always be presented with the same temptation to collusion and conversion. The industry under attack will always want protection from the private suits that may be its only hope for survival. Invariably, therefore, these industries will seek payment out of the resources of the individual plaintiffs. Because these bargains are negotiations for the settlement of suits to which, by hypothesis, the individuals are not parties, the individual plaintiffs will be excluded. But . . . government interference is also beneficial, for it allows governments to pursue their

public responsibilities in preventing and ameliorating injuries to their citizens without fear that the public will bear more than its fair share of the cost. Properly asserted, government legal subrogation claims insure the correct internalization of the true costs of an industry's products.

As we claim throughout, government's legal subrogation claims are both salutary and dangerous. Only a generous approach to subrogation accompanied by a strict takings inquiry can capture the advantages of government involvement without opening the door to abuse.

Hanoch Dagan is an Affiliated Overseas Faculty member of the Law School and a professor at Tel-Aviv University Law School in Israel. Professor Dagan received his LL.M. and J.S.D. from Yale Law School after receiving his LL.B., *summa cum laude*, from Tel Aviv University. He is widely published in both English and Hebrew on private law theory, takings law, distributive justice, and property theory, and he is often invited to give lectures and presentations in his areas of interest. He wrote *Unjust Enrichment: A Study of Private Law and Public Values* (Cambridge University Press) and is editor of *Land Law in Israel: Between Private and Public* (in Hebrew). Some of his more recent articles are: "Mistakes," 79 *Texas Law Review* 1795 (2001); "The Liberal Commons" (with Michael Heller) 110 *Yale Law Journal* 549 (2001); and "Just Compensation, Incentives, and Social Meanings," 99 *Michigan Law Review* 134 (2000). He has taught courses and seminars at the Law School on property law, jurisprudence, American legal theory, property theory, legal realism, and unjust enrichment.



James J. White, '62, the Robert A. Sullivan Professor of Law, is a graduate of Amherst College and the University of Michigan Law School. He practiced privately in Los Angeles and began his academic career at the University of Michigan in 1964. Professor White has written on many aspects of commercial law and has published the most widely recognized treatise on the Uniform Commercial Code, *Handbook of the Law Under the Uniform Commercial Code* (with Summers, 1995, 4th ed.). He is also the author of several casebooks on commercial, bankruptcy, and banking law. Professor White has served as the reporter for the Revision of Article 5 of the Uniform Commercial Code; he is a member of the National Conference of Commissioners on Uniform State Laws (NCCUSL) and has served on several American Law Institute and NCCUSL committees. He received the L. Hart Wright Award for Excellence in Teaching for 2001-02. Among courses he recently has taught are Payment Systems, Secured Transactions, and Negotiation.