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MEMORANDUM

TO: Commission

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SUBJECT: Policy Review Session on Civil Penalties

The attached briefing book was prepared for the Commission's Policy Review Session on civil penalties as a consumer protection remedy scheduled for July 6, 1982. This book was prepared by a group of attorneys and economists co-ordinated by Mallory Duncan, under the overall leadership of Fred McChesney (BCP Associate Director for Policy and Evaluation). It is intended generally to structure Commission discussion and review of the role and determinants of civil penalties in our consumer protection mission, and presents specific questions for the Commission's consideration.

Attachment

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I. Introduction

A. Overview Consumer Protection of Civil Penalty Remedies

When violations of the Federal Trade Commission Act[1] occur, the Commission faces the challenge of using its remedial authority to deter future violations without chilling legitimate business activities. The purpose of this session is to identify for Commission review policy decisions involving consumer protection civil penalty remedies, with the aim of increasing the effectiveness of these tools. The two broad areas for review at this consumer protection remedies policy session are: (1) civil penalties generally and (2) strategic use of Section 205 civil penalties. This section briefly introduces these areas.

(1) Civil Penalties. The FTC can seek in Federal court civil penalties from firms that violate trade regulation rules or final cease-and-desist or litigated orders. A primary goal is to deter industry from violating rules and orders ("general deterrence"). A second goal is to deter the respondent company from committing the illegal act again ("specific deterrence"). Significant costs may be associated with either overdeterrence or underdeterrence. A policy issue for Commission consideration is whether any of the approaches presented are likely to provide valuable guidance in determining the appropriate level of a civil penalty in a specific case.

(2) Section 205 Civil Penalties. Section 205 of the Magnuson-Moss Warranty-FTC Improvement Act[2] gives the FTC the authority to seek civil penalties (up to $10,000 per violation or, for continuing violations, per day) for engaging in acts or practices determined by the FTC to be unfair or deceptive in proceedings to which the defendants were not parties. Provided that the government can show that the defendant had actual knowledge of the unlawfulness of its acts or practices, Section 205 authorizes assessment of civil penalties for a firm's first violation of FTC law. Prior to enactment of the Magnuson-Moss Act, firms were allowed "two bites at the apple" before becoming

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[1] Or other statutes (e.g., Truth in Lending Act) that the FTC enforces.

[2] Section 5(m)(1)(B) of the FTC Act, 15 U.S.C. § 45(m)(1)(B).

liable for civil penalties. There continue to be numerous unresolved legal questions related to Section 205. Key policy questions for the Commission are: Should the Commission formulate a litigation strategy, with the goal of shaping favorable law? Should Section 205 be used more to serve as industry-wide deterrence?

On the following page is a diagram (Figure 1) which depicts the various routes through which civil penalty actions and the Commission's other Consumer Protection remedies (injunctions and consumer redress) can be applied.[3] The next section provides a legal overview of a few factors to be considered in selecting a remedy. It is followed by a section on the key economic factors in achieving efficient deterrence.

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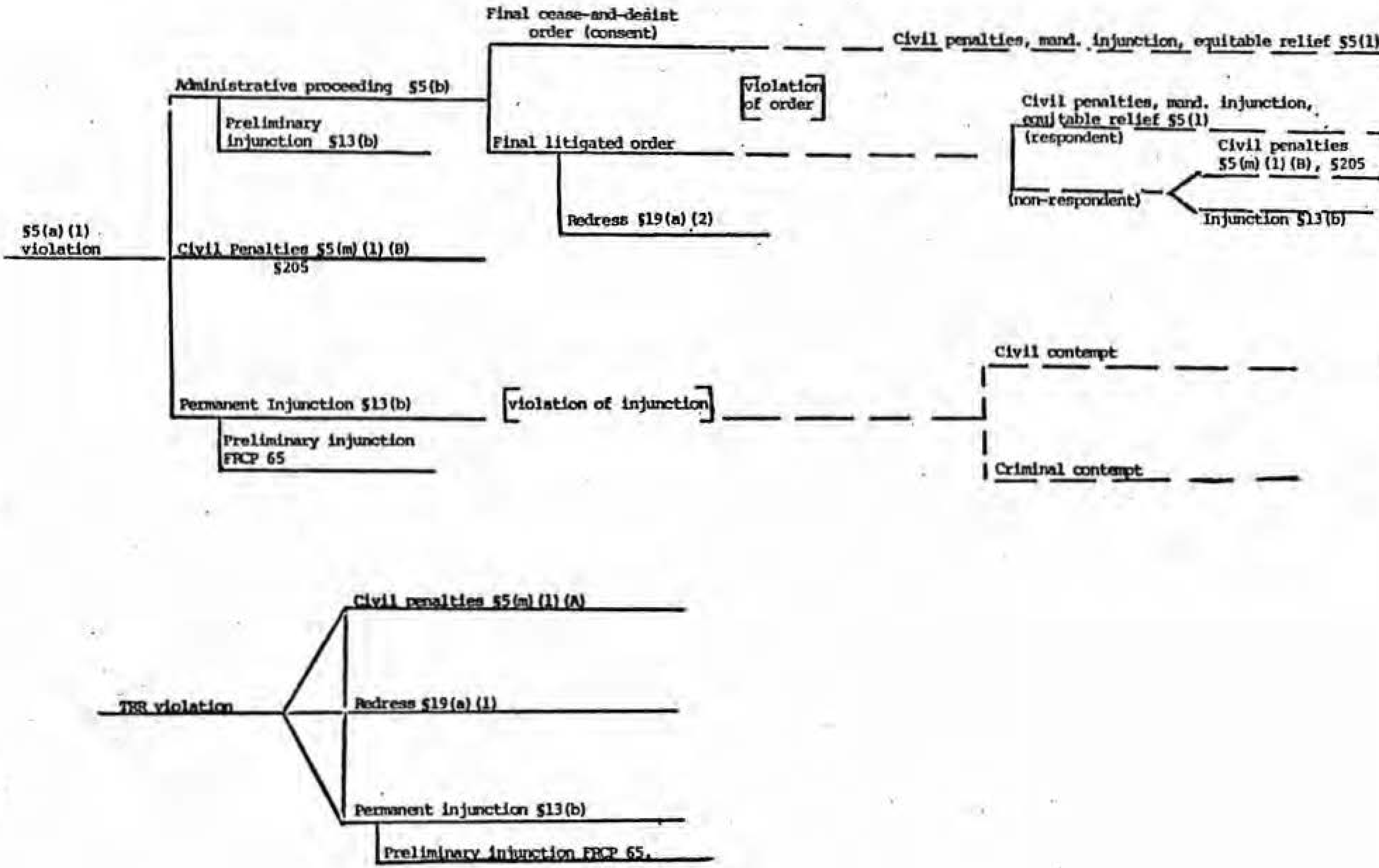
[3] Injunctions and consumer redress will be the subject of an upcoming policy review session.

FIGURE: 1

CONSUMER PROTECTION REMEDIES



B. <u>General Legal Considerations</u>

In determining which remedies to pursue in any law enforcement action, an initial assessment must be made regarding 1) what remedies are statutorily available for the violation, 2) what standards must be met in seeking each remedy, and 3) the procedure by which he remedy will be enforced. Some of these key legal considerations are highlighted below:

* Civil penalty actions for violations of a trade regulation rule require proof that the alleged violations were "with actual knowledge or knowledge fairly implied on the basis of objective circumstances" that the practices are unfair or deceptive and prohibited by the rule. In Section 205 civil penalty actions, the standard is narrower "actual knowledge"). No knowledge standard at all is required for Section 5(l) civil penalty actions for violations of orders by respondents under order. A Section 19(a)(2) redress action against a respondent subject to a final Commission order requires proof that the violation was "one which a reasonable man would have known under the circumstances was dishonest or fraudulent." In a Section 19(a)(1) suit for redress for violation of a trade regulation rule, this standard need not be met.

* All civil penalty actions must be referred to the Department of Justice, which has 45 days in which to determine whether to bring the case or to refer it back to the Commission to bring itself.

* The legislative history of Section 13(b) indicates that only routine fraud cases are appropriate for permanent injunctions. Because in other cases it would be the courts and not the FTC that would be determining whether a particular act or practice is unfair or deceptive within the FTC Act, permanent injunctions are not sought because the FTC has felt "novel" issues should be considered first by the agency.

* Section 19 actions for redress have a statute of limitations of three years prior to the filing of the administrative complaint, and must be filed within one year after the final order.

* Ancillary relief (<u>e.g.</u>, some type of redress) <u>may</u> be obtained in a permanent injunctive action and in civil penalty actions under the court's equitable power.

* The burden of proof in enforcement actions is: 1) "preponderance of the evidence" for enforcement of rules and orders in any civil penalty action; 2) "clear and convincing evidence" in a civil contempt action to enforce an injunction; 3) "beyond a reasonable doubt" in a criminal contempt action to enforce an injunction.

C. General Economic Considerations

In choosing a remedy, and in determining the appropriate level of civil penalties (or redress), the FTC's primary goal is to achieve industry-wide deterrence of violations. Some of the key economic factors include:

* Effective deterrence is achieved when the total cost of the penalty anticipated by the firm exceeds the firm's total net gains anticipated from violating Section 5.

* It is often too costly for the Commission to identify every violation in every program area. Thus, achieving effective deterrence requires multiplying the measured gains of the respondent (typically, an estimate of the respondent's gains over a limited time period) by a factor that reflects the likelihood of detection.

* Deterrence is affected by the total cost to the firm of a Commission action. Besides the direct cost of the penalty, other costs may include the respondent's unavoidable litigation cost, the cost to the respondent of administering the remedy and the seller's reputation loss. Thus, in fixing the magnitude of the penalty, estimates of reasonable values of these other costs should be considered.

* In fixing the magnitude of remedies for achieving appropriate deterrence, an estimate of respondent's gains is a more critical consideration than is consumer or competitor injury. In contrast, consumer and competitor injury are critical in allocating scarce FTC resources to case selection and litigation.

* Deterrence should be in keeping with promoting economic efficiency. This can be accomplished if legitimate productive activities are undeterred while inefficient activities are deterred. Furthermore, included in the analysis of the efficiency of any deterrence program must be the costs imposed by the program.

D. Guide to Briefing Materials

The remainder of this memorandum is organized as follows:

II. Civil Penalties

III. Strategic Use of § 205 Civil Penalties

In each of these areas, the key legal or economic factors are described briefly and are followed by a presentation of the key issues for Commission decision-making.

Due to time and space constraints, the memorandum does not fully address issues relating to the interaction between all of the Commission's consumer protection remedies. For example, we do not discuss issues such as the appropriate mix between injunctions and civil penalties in an individual case and the litigation strategies that involve using the prospect of one remedy (e.g., high civil penalties) to negotiate favorable settlements of another type remedy (e.g., consumer redress). These and other overlapping issues may be worthy of separate treatment at a later date.

II. Civil Penalties

A. Introduction

1. Difficulties in Assessing Civil Penalties.

Civil penalties assessed for violations of Commission consumer protection rules and orders[4] (through consent decrees, or pursuant to court decisions) have ranged from a few hundred dollars to over a million dollars. To an extent this divergence is understandable since there is considerable variation in the goals served by penalties and in the seriousness of violations. The Commission may on occasion wish to use civil penalties to "send a message" to particular segments of the market, or to emphasize or downplay certain enforcement areas. Penalties reached through consent negotiations may differ substantially from penalties for similar acts or practices following litigation. Thus, some variation in the size of the fines is to be expected.

On the other hand, significant variations in the size of civil penalties suggests the need for a general theory of assessing civil penalties in order to give guidance to both staff and industry. While a single "cookbook" approach may be impossible, and the assessment of civil penalties may remain more art than science, this chapter offers some options for Commission consideration.

2. Goals.

It is generally accepted that a primary goal of civil penalties is to deter violations of Commission rules and orders. However, it is not possible for the Commission to prosecute every rule or order violation. Consequently, the signals it sends to industry when assessing penalties are an important enforcement tool. In a sense, the Commission's civil penalty decisions act as a form of industry guidance.

The penalties assessed by the Commission must serve other goals as well. The Commission may wish to minimize intrusion into competitive markets, or it may use civil penalties to convey the seriousness with which it views particular

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[4] Civil penalties are assessed pursuant to § 5(m)(1)(A) and 5(l) of the FTC Act. § 5(m)(1)(B) provides for comparable civil penalties for § 205 violations.

violations. In each instance it may wish the chosen penalty to be high enough to discourage the respondent from committing the illegal act again. Yet, it may also wish its penalties to be consistent or fair, both in appearance and in fact.[5] To the extent that these goals conflict, it may be necessary to make trade-offs between them.

3. Problems in Achieving Deterrence.

Naturally, before the Commission can expect to achieve deterrence, it must ensure that firms are aware of and understand the law. In the case of civil penalty actions based on orders against respondent firms, this is generally not a problem. Firms are presumably aware of their prior violative conduct. Where civil penalties are to be based on rules or Section 205 synopses, greater care may be necessary to clarify precisely what conduct is prohibited. From an economic perspective, firms behave more conservatively (that is, they probably divert some efforts away from competitive activities and towards legal protection) when they perceive the risk of otherwise unintentionally violating the law to be high. This suggests that in the early stages of a new rule or synopsis enforcement, greater emphasis should be placed on educational efforts than on penalty assessments. Once industry is aware of the law, more significant penalties for violations become appropriate. The discussion in the remainder of this chapter assumes that the Commission is beyond this initial educational period.[6]

Just as the law should be clearly understood, so, ideally, should be the method by which the Commission determines civil

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5 Fairness is difficult to define. Fairness encompasses notions of treating equals alike and unequals disparately. A high but rarely imposed penalty may be a very effective deterrent. Initially, it might seem fair that all violators risk incurring it. However, if the enforcement policy is haphazard, it may, after the fact, "appear" unfair to impose so great a burden on the few individuals unlucky enough to be caught. And, if the penalty is sufficiently great, it may also seem inappropriately punitive in view of the conduct involved and thus unfair "in fact."

6 In practice, of course, some industry guidance, whether to reach new entrants or to renew contacts with established firms, will always be a part of the Commission's efforts. For a discussion of this and related issues, see appendix B.

penalty assessments. In order to achieve deterrence, it is not necessary for an industry to know exactly the penalties the Commission will assess in specific cases. It may be sufficient that the industry recognizes the process by which the Commission decides that its penalties are high enough to achieve deterrence in a particular instance. However, in choosing a civil penalty policy, there is a tension between simplicity and specificity. The more specific the Commission's policy, the more large and small firms can be exactly deterred, thereby avoiding both underdeterrence and overdeterrence.[7] On the other hand, greater specificity often comes at the cost of increased complexity.

Finally, even allowing for some complexity, establishing a civil penalty policy that will neither overdeter nor underdeter is difficult. Because firms do not face identical environments and because the Commission will always have limited information about industry, it will be impossible always to achieve exact deterrence.

B. Approaches to Assessing Civil Penalties.

To a large extent, deciding which of the many conflicting goals to emphasize determines which approach to assessing civil penalties should be taken. The remainder of this chapter sets out four basic approaches. Respectively they emphasize deterrence; historical consistency; severity of conduct; and flexibility. The first of these is the most comprehensive and accordingly is discussed in somewhat greater detail in an appendix (A) to this briefing book. In order to clarify tne issues involved, the approaches are first discussed independently of any overlap among them. However, as is noted at the end of the discussion of each approach, each can be modified to serve some goals of the others as well.

It should also be noted that the choice of an approach may be influenced by the point at which it will be used. There is a cost to gathering information. Consent agreements may sometimes

[7] Underdeterrence occurs when a company looks at a history of Commission judgments and says: "Well the Commission generally only assesses a thirty thousand dollar penalty for violating this rule - its worth the risk." Overdeterrence occurs when another company sees the thirty thousand dollar judgments, determines that there is no way it can afford to lose so large an amount, and goes to such lengths to avoid violating the rule that it is unable to compete effectively.

be signed in order to lift from both parties the burdens of additional discovery. The Commission may wish to use a simpler, less precise approach for settlement negotiations, when the amount of information available to staff is typically limited, than it uses when seeking possibly larger penalties through the district courts.

Finally, actions for consumer redress (to be discussed in an upcoming policy review session) may sometimes be preferable to a civil penalty action. Consumer redress can serve some of the same goals as civil penalties, although its primary function is to direct funds to injured consumers rather than to the U.S. Treasury. However, the manner in which redress awards are disbursed, their tax deductability to respondents and the higher legal standard imposed in Section 19 proceedings all suggest that redress is not a perfect substitute for penalties as a means of deterrence.

1. The Deterrence Model.

Currently, the size of previous civil penalty judgments act as guideposts to expected future Commission assessments. However, were the Commission to make it clear that it would set civil penalties at slightly more than whatever amount was necessary to eliminate all benefits a respondent could expect to receive from engaging in unfair or deceptive conduct, firms would have a greater incentive to review the consequences of their conduct rather than the size of previous civil penalty judgments assessed against other firms.

In essence the deterrence model is an approach to civil penalty litigation designed to send three messages to industry:

1) The penalties sought will be high enough to deprive a violator of any actual or anticipated profits[8] from its violation;

2) Reasonable estimates or presumptions may be used to compute penalties when precise data is not readily available; and

3) Violators will be offered an opportunity to rebutt

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[8] As is discuss in the appendices, in most instances this will mean that, in order to remove any incentive for respondents to treat civil penalties as an "expense," the civil penalty will be derived by essentially multiplying respondents' gains by a figure that reflects the likelihood of detection.

these presumptions by offering data justifying a lower civil penalty figure.

a. An Outline of the Deterrence Model-Encouraging Proper Deterrence

Civil penalties should have a general deterrent effect. Paradoxically, this may best be accomplished if the Commission focuses more heavily on the manner in which penalties are assessed against individual respondents, rather than upon maintaining uniformity among its civil penalty judgments. Focusing upon the latter will tend to encourage either underdeterrence or overdeterrence.

The deterrence model assumes that the vast majority of businesses are neither good actors nor bad actors, rather that they seek to be competitive. Under this approach one asks: what economic advantages does a firm realize by violating the Commission's rules and orders? Generally, these advantages consist of the firm's savings in compliance costs and the advantage of being able to compete under more favorable conditions than its competitors. If the Commission were able to prosecute all violators, then setting a civil penalty figure that was just high enough to remove the profits of illegal conduct would be sufficient. However, since only a fraction of the violators can be caught, this penalty figure must be increased sufficiently to discourage firms from taking a chance on avoiding detection.[9]

Two other factors must be considered before the civil penalty is assessed. First, the Commission must ask whether there are aggravating or mitigating factors that should cause the penalty to be raised or lowered.[10] And second, the penalty figure must be compared against the respondent's ability to pay. If the respondent cannot afford the penalty (or if the

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[9] This is the same reason that parking ticket fines are always somewhat higher than the cost of local parking garages. If one were ticketed only occasionally, and the fine were the same as the cost of parking, it would be much cheaper to park illegally. And, just as many drivers would, for the sake of convenience, park illegally if they thought there were little cost to being ticketed, some companies will violate Commission rules or orders if the advantages of doing so are sufficiently great.

[10] Such as the degree of consumer injury.

calculated penalty is larger than the Commission is statutorily authorized to impose) then the penalty generally must be lowered.[11] On the other hand, since the penalty need be no higher than is necessary to deter the specific conduct under investigation, the fact that the respondent has more than sufficient financial assets to pay the penalty, is not a reason to increase it.

b. Practical Considerations

Potentially, this model offers the advantages of being reasonably specific to each violation while being simple enough to be anticipated by industry. It may also seem "fair" in that firms in similar circumstances are treated equally. There are a number of other factors to consider in implementing such an approach. They are discussed in more detail in appendix A. It is sufficient to note here that in many cases the benefits firms receive from violating Commission rules and orders can be estimated. There is no judicial reason why these estimates would have to be more precisely derived than the civil penalty figures the Commission currently generates. However, the fact that they will be developed by a specific process with a particular goal in mind is likely to result in their being more rationally linked to specific violations.

This model can be as refined or as general as resources and demands on the Commission permit.[12] Since the first few cases should probably be developed carefully, in order to determine the advantage enjoyed by firms engaging in violative conduct, the amount of information demanded by staff and the amount of time devoted to analyzing such information will initially be increased.

However, to an extent this difficulty will be alleviated as the Commission develops a pool of working figures or begins to aproximate the model rather than duplicate it precisely. On a long range basis, careful case development and/or studies of industries affected by Commission rules and orders can provide

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11 This does not mean that the Commission must lower the penalty merely to stave off bankruptcy. Ability to pay, however, is one of several statutory factors that must be balanced by the Commission.

12 If desired, the civil penalties derived under this approach can always be modified to accommodate some of the goals favored by the other models.

information as to profitability, sales rates, etc. for various sized firms. On a shorter term, other proxies may be necessary. Where respondents are reluctant to provide essential informaton it may be appropriate for the Commission to make its own best estimate of the advantages enjoyed by the respondent, subject to respondent produced evidence that the Commission derived figures are too high.[13] The Department of Justice Guidelines for sentencing recommendations in felony cases establishes a flat percentage of corporate sales as a base and then adjusts for other factors. The primary aim (in the absence of a negotiated settlement) would be to demonstrate to the district court that the Commission was applying its expertise in a fashion reasonably related to achieving civil penalties that would support its general deterrence goal.

2. Historical Consistency Model.

a. Operation

If the Commission's primary goals were uniformity and/or predictability of civil penalty amounts, an approach that emphasized historical consistency of civil penalties assessments might be desirable. Under such an approach the Commission would review the civil penalties previously awarded for violations of each of its rules. Thus, it would determine the range of civil penalties it had assessed for cooling-off violations; for land sales abuses; and so forth.[14] In addition, staff would need to develop a composite profile of the "average" respondent in previous cases of that type, setting forth its financial status

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[13] Thus in the case of a respondent who failed to provide cooling-off notices, the Commission might announce, as its starting point in calculating the penalty, its intention to remove all profits realized on 10% of the respondent's sales: the degree to which it believed the respondent was competitively advantaged on an annual basis by refusing to comply with the rule. Respondents might be invited to make a showing, during civil penalty proceedings, that their advantages were less than that amount.

[14] A preliminary review suggests that in many program areas, prior assessments will fall within a normal curve. Thus, for example, penalties assessed in the debt collection program area might extend from fifteen to sixty thousand dollars, with the vast majority concentrated between twenty and forty thousand dollars. Specific types of violations would have a similar distribution over a narrower range of figures.

and a synopsis of the circumstances involved in a typical case. Profiles of respondents who drew among the highest and lowest civil penalties would be necessary as well. New cases would be compared against these profiles and the range of penalties assessed in previous violations of the same type. Thus, all other things being equal, if a new land sales matter presented abuses that were more serious than those in two-thirds of the Commission's previous land sales cases but less serious than the remaining third, a civil penalty that was higher than two-thirds of those previously assessed and less than one-third of those previously assessed would be chosen as a starting point. This point would be readjusted after considering aggravating and mitigating factors. The final assessment, however, would not fall outside the range set by previous cases except in extraordinary situations.[15]

b. Practical Considerations

The primary advantage of such an approach is the relative ease with which it could be implemented and used by the Commission. The Commission need not gather any more informaton than is necessary to determine whether the respondent is a significantly better or worse actor than those previously encountered, as well as some information about the respondent's ability to pay.[16] Within limits, this approach assures that no firm will be singled out for particularly harsh or lenient treatment, relative to previous Commission judgments. Finally, it makes it easier for firms to determine the size penalty they are likely to incur for particular violations. This may aid in achieving settlements.

If the Commission is convinced that previous civil penalty awards have been sufficient to deter individual respondents, penalties assessed under this approach should be equally

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15 For purposes of this model it is necessary that civil penalty amounts be stated in constant dollars adjusted for inflation. If they are not, the Commission may in time become locked into a schedule of penalties with diminishing deterrent effect.

16 Issues involved in determining a respondent's ability to pay are discussed at footnote 2 and the accompanying text of appendix A.

effective.[17] However, while this model would maximize consistency of civil penalty amounts, it might do so at the expense of achieving industry-wide deterrence. In order to provide consistency and predictability, the range within which the bulk of the penalties assessed for each type of violation would have to be fairly narrow (possibly a three to one ratio). But as was discussed earlier, unless the ranges chosen were very wide (thus reducing their predictive value) the threat of the penalties would create overcompliance on the part of some firms and would be ineffective as to others. Small businesses might be most injured by such an approach. Lacking the resources to expense for the higher penalty figures, they would be forced to behave overly cautious relative to their larger competitors. The largest competitors would have a further advantage in that they could afford to violate the rules almost with impunity since the maximum civil penalty judgments would never be sufficiently large to remove the profits they gained from violation.[18]

3. Severity of Conduct Model.

a. Operation

Under this closely related variant of the preceeding approach, the Commission would emphasize the "appropriateness" goal and rank violations of each of its various rules, in order of severity of injury, from extremely high to extremely low.[19]

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[17] Of course one drawback to this approach is that it provides no guidance in setting penalties for new rules or for violations of individual orders.

[18] If the Commission were willing to compromise a portion of the consistency goal, this model might be used as a proxy for some elements of the preceeding deterrence model. Future civil penalties, assessed on the basis of the deterrence model, could over-time form the basis for a historical approach to penalties. While this could result in a more broadly spread penalty range within each program area, it would simplify determination of a starting point for considering aggravating or mitigating factors once sufficient experience with the proper assessment in various program areas was developed.

[19] This differs from the preceeding approach in that here the Commission would rank, de novo, the severity of conduct addressed by each of its rules, whereas the preceeding approach essentially codifies existing determinations.

For example, minor delays by debt collection firms in sending notices verifying debts might rank relatively low while other debt collection practices, such as systematically contacting debtors' employers, might rank relatively high. For each of these practices the Commission would establish a range of overlapping penalties (much like criminal statutes) from the mildest to the most severe. The mentioned disclosure violations might carry penalties between three thousand and ten thousand dollars while the more serious debt collection violations might carry penalties between twenty thousand and fifty-five thousand dollars. When presented with new rules (or orders) the Commission would first determine which of its existing rules it was most similar to in terms of general injury and then determine where within the range assigned to that violation it should fall, those involving many mitigating factors falling lower in the range and those with aggravating factors being higher.

b. Practical Considerations

A major advantage to the approach is that it formally recognizes that all violations of Commission rules and orders do not have equally serious consequences. Where injury is minimal, there is little variation in cost of compliance among firms, and the purpose of the rule is primarily informational, the Commission may wish to assess only modest penalties as a means of reminding firms of the desirability of compliance. Major penalties are reserved for violations of the most important rules (and orders).[20]

However, the task of developing a priority ranking of all anticipated rule violations is substantial. Furthermore, such a listing would likely require modification when there were changes in Commission priorities and personnel. Moreover, consumer injury, while an appropriate basis for developing redress amounts or case selection criteria is perhaps less useful as the primary consideration in establishing civil penalty amounts.[21] Finally, this model suffers from the same

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20 To this extent this approach may also act as a proxy for the deterrence model.

21 For example, firms that engage in profitable practices that cause relatively little economic injury to consumers (<u>e.g.</u>, harrassing calls by collection agencies to retrieve large <u>bona fide</u> debts) might receive relatively small fines. And, such (CONTINUED)

predictability/deterrence trade-off that was discussed in the preceeding approach.

4. The Flexible Judicial Model.

Currently the Commission makes civil penalty judgments on the basis of the several statutory, judicial and practical factors.[22] These are balanced against the goal or combination of goals the Commission seeks in each instance: to deter; to guide, or (to the extent redress and civil penalty awards are compatible) to capture payment for consumer injury.

It is impossible to state how these factors are applied in each instance other than to reduce them to a series of "rules of thumb" used in determining civil penalty judgments.[23] This does not mean they are without value. When coupled with prior Commission determinations they may well provide the most versitle means for the Commission to assess and the courts to impose civil penalties.

These factors have been cited favorably by federal courts[24] which appear to have little difficulty in reviewing Commission recommendations in light of them. It is a procedure with which the Commission and staff are familiar allowing them, far more often than not, to arrive at settlement and civil penalty figures that are acceptable (to the extent that any compromise is acceptable) to the parties as well as to the

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21 (FOOTNOTE CONTINUED)

fines may be insufficient to discourage continued violative behavior.

22 The statutory and judicial factors are listed in footnote 1 of appendix A. Practical factors include the strength of the Commission's case and the cost of litigation.

23 For example: The more severe the violation the more severe the civil penalties; good faith, while not a defense to a violation, should reduce the penalty imposed; there is some minimum level below which penalties should not fall in order to preserve the integrity of Commission rules and orders; penalties should not be a mere cost of doing business; and so forth.

24 See, e.g., United States v. Readers Digest Association, 494 F. Supp. 770, 772 (D. Del. 1980), _______ F.2d _______ ( ), cert. den. _____ U.S. _____ (1982).

courts. To the extent that the Commission specifically emphasizes deterrence, consistency, or other goals, this approach may act as a proxy for the other models. Furthermore, the flexibility of this approach facilitates consideration of those hard cases (extremely cautious or bad acting firms) that fall outside the scope of other models.

In view of this it may be that the current approach to civil penalties, uncomfortable as it may be in specific instances, provides as much precision as it is possible to expect from any system that must encompass the myriad of cases confronting the Commission.

C. Questions for Commission Consideration

The Commission may wish to consider the following six questions concerning civil penalties.

1. What is the value of the Commission's attempting to state how it determines the amount of civil penalties assessed for violations?

Development and publication of Commission guidelines for assessing civil penalties could enhance the appearance of fairness by explaining how penalties are derived. In addition, such a statement would enhance the predictability of Commission actions and thus, potentially, their deterrent effect. Furthermore, the process of attempting to develop a well-articulated civil penalty policy statement could increase the actual fairness of Commission decisions by increasing consistency of results. On the other hand, publishing such a statement would greatly reduce the Commission's flexibility in assessing penalties in this necessarily inchoate area. Moreover, such a statement might be subject to substantial manipulation by respondents in litigation: impairing the Commission's effectiveness in court or in obtaining consents.

2. To what extent is the Comission willing to accept over-or-under deterrence to achieve other desired goals in assessing civil penalties?

As is discussed above (and in the appendices), certain goals, such as simplicity or predictability, may be traded-off against optimal deterrence in assessing civil penalties. To what extent should trade-offs be made?

3. Is greater precision in assessing civil penalties sufficiently important to justify devoting increased resources to its attainment?

A more systematic approach to civil penalties that required analyses and collection of data in each program in which civil penalties are used, would mean devoting increased resources to discovery related to civil penalty assessments. The level of resources required may be prohibitive in some cases. Given general resource constraints, does an increase in precision merit devoting more resources?

4. To what extent is fairness achievable and the appearance of fairness desirable?

In a world of perfect information, optimal deterrence is consistent with fairness. However, both fairness and the appearance of fairness may be reduced by the difficulty of consistently applying that criterion. what appears fair prospectively may seem unfair in practice. In addition, to the extent that uniformity of civil penalties is sought to achieve the appearance of fairness, deterrence goals may be compromised.

5. Should different approaches be used to assess civil penalties for purposes of consent agreements as opposed to litigated orders?

In general it may be desirable to reserve more complete analyses and data collection for judicial determinations of civil penalties. Respondents may be willing to settle in order to avoid providing staff with more detailed proprietary information. Currently, settlement figures tend to be arrived at through use of historical experience, informal rankings and an analysis of the strength of the Commission's case. Does consistency demand that the Commission use the same model for setting penalties in judicial determinations as to uses in settlement negotiations?

6. How should a change in assessing civil penalties be introduced?

It may be desirable to identify specific program areas where new methods of assessing civil penalties might first be developed. Among the factors to be considered in choosing an area are: the need for industry guidance; the ease with which any necessary information can be generated; the ease with which the penalties sought in the program area can be shown to be logical to the Justice Department and the courts; and the resource commitment involved. Alternatively, would the simultaneous use of two different methods of assessing civil penalties be fair or explicable to the industries involved?

III. Strategic Use of Section 205 Civil Penalties

A. Introduction

Prior to the enactment of the Magnuson-Moss Warranty-FTC Improvement Act, the Commission was limited in its civil penalty cases to parties that violated a cease and desist order previously issued against them. Section 205 of the Magnuson-Moss Warranty-Federal Trade Commission Improvement Act of 1975[25] gave the FTC the authority to seek civil penalties[26] for violations of determinations made in cases in which the defendants were not parties.

In order to obtain a civil penalty against such offenders ("non-respondents"), the Commission must demonstrate in federal district court that:[27]

1. the particular act or practice was determined to be deceptive or unfair by the Commission in a Section 5(b) (FTCA) proceeding;

2. the Commission issued a cease and desist order in that proceeding with respect to the particular act or practice;

3. the cease and desist order has become final; and

4. the party charged with a violation had actual knowledge that such act or practice is deceptive or unfair and unlawful under FTCA § 5(a).

The Commission has developed procedures for implementing Section 205 whereby a "synopsis" and copies of final orders are mailed (or served) to firms targeted for investigation. The Commission has approved approximately 30 synopses, and has delegated to the Director of the Bureau of Consumer Protection the authority to mail (or serve) them, when there are 50 or fewer mailed at one time.

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[25] Section 5(m)(1)(B) of the Federal Trade Commission Act, 15 U.S.C. § 45(m)(1)(B).

[26] Up to $10,000 per violation or $10,000 per day for continuing violations.

[27] O.M. 11.2.2.1.

After collection of additional information, e.g., through civil investigative demand (C.I.D.) or access letter, and there is reason to believe that they are violating the previously described cases, the staff decides whether to recommend seeking civil penalties against the firm(s) in question. If the Commission decides to seek civil penalties, the Department of Justice is given 45 days in which to determine whether to take the case. If Justice declines, the Commission itself may file suit in Federal District Court.

B. Policy Questions

The language of the Act and the lack of Section 205 case law have left several questions yet to be interpreted by the courts. The issues in this section primarily deal with the strategic use of Section 205.

1. How does the Commisison want Section 205 to be developed in case law?[28]

Discussion: There are several legal issues which have not received court interpretation. While pending cases may help to resolve some of them, it would be helpful if the Commission articulated its views on how it would like to see relevant Section 205 legal issues developed through case law. Such articulation will help shape future case selection and development by the staff. These issues are legally complex; it may be difficult to make definitive decisions without a more fully developed legal analyses that would be beyond the scope of this briefing book. Nevertheless, the Commission may wish to decide which of the following areas most warrant immediate consideration.

a. Due process/constitutionality: Should the Commission allow outside review of synopses (e.g., through publishing them in the in the Federal Register) in an effort to reduce the risk of a successful challenge on due process grounds by future defendants.

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28 A recent decision of the Ninth Circuit Court of Appeals may threaten the future use of § 205 and a case-by-case approach to enforcement. The Court held that the FTC exceeded its authority by proceeding with adjudication rather than with rulemaking (in finding an auto dealership in violation of the FTCA regarding its repossession and resale practices), and in attaching a "Synopsis of Determination" to the order. The FTC has appealed this decision. Ford Motor Company v. FTC Nos. 79-7647, 79-7654, 673 F.2d 1008 (9th Cir. 1982).

Like other statutes, there is a presumption that the statute is constitutional. However, defendants in two cases[29] have argued that Section 205 is invalid on due process grounds or could be implemented by the Commission in an unfair manner, because a party charged with an unfair or deceptive act or practice does not have an opportunity to participate in the earlier proceeding in which the FTC determines that a particular practice is unlawful.

Despite the fact that Section 205 was codified in 1975, there is only one court decision construing it.[30] A motion to dismiss the Section 205 counts is presently pending in one other case on the ground that the provision is unconstitutional.[31] In responding to the motions, the Department of Justice, with the Commission's endorsement, has interpreted the statute as allowing a measure of review of the Commission's prior determination in the enforcement proceeding. The scope of review would be limited to the Commission's prior interpretation of the scope of "unfair" or "deceptive" within the meaning of Section 5(a)(1) of the Act and not to whether the Commission's findings of fact in the prior case(s) were sustainable. The brief argues that deference should be given to the Commission's interpretation of Section 5, particularly where its decision has been affirmed on appeal. On the other hand, it concedes that in an appropriate case, a Section 205 defendant might defend on the ground that conditions had so changed since the prior adjudication that application of the determination today would

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29 United States v. Braswell, Inc., et. al., No. C81-558A (N.D. Ga., filed March 27, 1981) and United States v. Allied Publishers Service, Inc., et al., No. CV-F-81-046 MDC (E.D. Cal., filed Feb. 5, 1981.

30 United States v. Braswell, Inc., et. al., No. C81-558A (1981-2 Trade Cas.) Paragrapn 64,325 (N.D. Ga. 1981).

31 United States v. Allied Publishers Service, Inc., et al., No. CV-F-81-046 MDC (E.D. Cal., complaint filed Feb. 5, 1981). However, a hearing officer, to whom the court assigned the constitutional issues in that case, has recently affirmed the Commission's position.

be arbitrary and capricious.[32]

Although the statute has been upheld in one case, the Commission should continue to assess the substance of this criticism in its implementaton of the statute.

The Commission's position may be enhanced if it were to provide a mechanism for publishing synopses. The current practice (beginning with the Gold Bullion International Ltd. decision) is for the Commisson to include a Section 205 notice as an attachment to its opinions, where appropriate.[33] The Commission might want to consider publishing these notices for comment in the Federal Register, prior to final Commission approval. The FTC might also publish the package of synopses in the Code of Federal Regulations. Either or both forms of outside review of draft synopses, especially by potential defendants, may reduce the risk of a successful challenge on due process grounds by future defendants. On the other hand, such extensive review could be resource-intensive and time-consuming, and may create practical impediments that would discourage staff from developing and updating synopses.

b. What limits should the Commisison place on "determinations" it will use to define unfair or deceptive practices?

Discussion: The Commission has generally acted upon the supposition that "determinations" that a practice violates the law include (1) opinions of the Commission affirmed on review in the courts of appeals; (2) unappealed decisions of the Commission; and (3) unappealed decisions of administrative law judges that become the decisions of the Commission pursuant to Rule 3.51 of the Commission's Rules of Practice, a procedure which is consistent with the mandates of the Administrative Procedure Act.[34] While recognizing that the Commission may

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32 Cf. Marco Sales Co. v. FTC, 453 F.2d 1 (2d Cir. 1971) (refusing, essentially on that ground, to uphold order against punch boards).

33 Gold Bullion International, Ltd., 92 FTC 196 (Docket 9094, July 25, 1978). The Commission took this step "to help guarantee that others will not violate the Hobby Protection Act", 92 FTC at 227.

34 See discussion on the form of prior Commission

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not be able to make these decisions without further legal analysis, one area warranting discussion is pre-Magnuson-Moss Act determinations.

Is it appropriate to continue to rely on orders that predate the enactment of the Magnuson-Moss Act? One argument made is that because of the present tense of 5(m)(1)(B) ("If the Commission determines [that an act or practice is unlawful]"), pre-Magnuson-Moss Act case law determinatons cannot be used as a basis for civil penalties.[35] Others argue that the legislative history of the Act and common sense support using FTC case law prior to the Magnuson-Moss Act as a basis for Section 205 action.[36] In some case areas (e.g., pyramid schemes and Truth in Lending) case law predates the Magnuson-Moss Act; if only recent determinations can be used, Section 205 would not be a viable litigation alternative.

c. What is "actual knowledge"?

The Commission sends a synopsis and copies of past FTC decisions to firms in order to be able to prove that alleged violators had received explicit recitation of the law.[37] It is not yet known how high a standard of knowledge courts will require. There are several possible definitions of actual

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34 (FOOTNOTE CONTINUED)

proceedings in Bickart, Civil Penalties Under Section 5(m) of the Federal Trade Commission Act, 44 U.Chi. L.R. 775 (1977). (Hereinafter cited as Bickart). That article states that some consent orders might satisfy the "determination" requirement. The Commission has informed the DOJ that it does not intend to use consent orders, where the underlying matters have not been subject to adjudication, as a basis for § 205 actions.

35 Abrams, Section 205 and 206 of the Federal Trade Commission Improvement Act, 44 Antitrust L.J. 523, 527 (1975).

36 "Many obviously illegal practices would be allowed to flourish indefinitely if the Commission were required to reconfirm each of its prior determinations before it could impose liability upon a defendant under Section 5(m)(1)(B)." Bickart, at 772.

37 Of course firms can have knowledge of violations without receiving a synopsis. Nothing in the statute requires the delivery of a synopsis; mailing of a synopsis has been institutionalized in an effort to ensure knowledge.

knowledge. One question is what the alleged violator is required to know, beyond the mere words of a Commission determination. To what extent will knowledge problems multiply as a Commission determination becomes broader, i.e., will a defendant successfully argue that it did not know that its conduct fell within the "determination"? The Commission may wish to request the staff to prepare a detailed options paper on the definition of actual knowledge.[38]

d. How broadly should determinations be defined?

The holdings of most cases can be characterized at numerous levels of generality. Two questions yet to receive court interpretation are whether a determination must be specific to the product involved in the case, and whether the determination must be specific to the representation in the case. The more general the "determination", the greater burden imposed on the Commission to meet the actual knowledge requirement. This is the case since if a synopsis is only vaguely related to the specific respondent's actions, it is more likely that the defendant will argue that he or she was unaware of the unlawfulness of his or her activities, regardless of whether the defendant had unarguably received a synopsis.[39]

2. Does the Commission wish to give guidance to the staff about the type of Section 205 cases to seek?

Discussion: There are two basic models (presently used to varying degrees) to choose from for enforcing (and upholding) Section 205. The first finds a violation and then seeks to find an existing determination that can be used as a basis for civil penalties. The second model turns this approach upside down: a "litigation strategy" model starts with prior determinations (focusing on recent ones) and then seeks to identify violations

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38 The level of knowledge necessary to satisfy the satutory requirement will also affect the ability of the Commission to simplify its synopses. It has been suggested that the Commission might more effectively reach a broader spectrum of the business community if the synopses were written strictly in laymen's language and delivered without the possibly imposing customary package of Commission decisions. However, it is less certain that such a delivery would provide "actual knowledge."

39 An unresolved question is the extent to which we can avoid the "knowledge that they were violating the determination" problem by tailoring the letter sent with the synopses.

that resemble the earlier violations and raise few new legal issues. The sequence for raising selected legal issues is planned in advance under the "litigation strategy" model. While in the first model the primary goal is to assess civil penalties against violators, in the "litigation strategy" model the primary goal is to establish favorable precedent concerning the meaning of Section 205, and the secondary goal is to assess civil penalties. The Commission may wish to give general strategy guidance on questions such as:

a. Should the staff try to avoid cases that raise numerous legal issues (e.g., stretching the reach of a "determination)?

All other things being equal, most working group members prefer fewer issues.

b. Should the Commission hold off on the broad use of Section 205 until it finds some cases that raise fewer issues? Does the Commission prefer to seek to resolve legal uncertainties in the near future, or does it prefer a go-slow approach, to search for a "more perfect" case, perhaps with an increased probability of success?

The fact that "perfect cases" tend to settle does limit the ability to develop case law through the go-slow approach; hence there may be a trade-off between defining Section 205 and effectively enforcing the law, e.g., by bringing less perfect cases, many of which are likely to settle.

c. Should the use of Section 205 be restricted to clear instances of deception, or should it be used for unfairness as well?

Until the validity and reach of Section 205 has been decided in the courts, caution suggests that the Commission may want to initiate such civil penalty suits where the facts and equity are strongly on the side of the Commission. The Commission may want to restrict enforcement to instances where the alleged violations are of established Section 5 standards, preferably hard-core instances of deception, although some types of "unfair" practices that are not also strictly deceptive, such as oppressive debt collection practices, could also be eligible targets.

3. Should Section 205 be used more to serve as industry-wide deterrence, as opposed to being directed primarily at assessing civil penalties for law violations? Should synopses be focused more specifically on the most serious violations?

Discussion: After completion of a pilot project on Section 205, conducted shortly after the enactment of the Magnuson-Moss Warranty-FTC Improvements Act (in 1975), the Commission decided to use Section 205 solely as a tool to force compliance with the law by potential respondents. The Commission initially decided that whenever a synopsis was mailed, a follow-up subpoena should be sent. More recently, there have been exceptions to this policy; for example, the synopsis on unordered mechandise was sent to many firms who did not receive subpoenas. On the other hand, the synopsis on credit advertising under the Truth in Lending Act was sent to 50 companies in two industries (auto dealers, home builders) where widespread abuses were prevalent.[40] Follow-up subpoenas were sent to all of these companies. Most of the companies ceased any violations of the determinations upon receipt of the notice letter. At least 12 did not, and eventually agreed to pay civil penalties of $15,000 to $90,000 a piece. The Commission may want to direct more Section 205 projects toward industry-wide deterrence. Synopses used for this purpose should be understandable and focused on the most important abuses. Instead of a synopsis, the Commission might send just a letter that describes FTC determinations. Such letters to firms could make it clear that, while civil penalties could be assessed for violations, the FTC is sending the materials primarily to inform them of the state of the law. They might also indicate that the firm was not being singled out, but that similar letters were being sent to all companies in a certain segment of the industry. The advantage of using Section 205 in this manner would be to provide a low cost means of educating industry about the law--with a fairly good likelihood of changing the behavior of those firms not in compliance, due to the risk of civil penalties for non-compliance.[41]

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40 In addition, 17 companies had been served previously with synopses in the 1975 § 205 project.

41 This approach would allow more flexibility in investigations; after analyzing information for C.I.D.'s served to a sample of companies, staff could refine the investigational strategy for other C.I.D.'s.

4. <u>Cost-Effectiveness of Section 205 Enforcement: Would an impact evaluation of a Section 205 project (designed before mailing synopses) be worthwhile?</u>

<u>Discussion</u>: There are two principal types of effectiveness to consider: the readily quantifiable dollar figure for civil penalties assessed[42] and the hard to quantify corrective (deterrent) effect that Section 205 mailings have on the recipient (and other members of the industry). There have been 29 cases brought under Section 5(m)(1)(B) with civil penalties totaling $843,000.[43] For comparison purposes, there have been 22 cases for rule violations under Section 5(m)(1)(A) which have resulted in civil penalties of $1,113,000. In addition the Commission has authorized litigation in five cases, three of which have been filed.[44]

In a forthcoming memorandum, the Credit Practices Division will evaluate the deterrent impact of the Credit Advertising Section 205 project. This memorandum should shed light on the feasibility of determining deterrent impact. Factors that influence the level of deterrence achieved include the number of mailings of synopses, the number of investigations (per industry), the number and size of civil penalty settlements, whether an administrative order or a court order is attained, and the publicity each setlement receives. Deterrent impact may vary for different industries.

There is considerable variation in the <u>costs</u> of Section 205 projects.[45] In many cases, very little staff time is expended in achieving civil penalty settlements. The average professional staff workyears for example, in achieving the 12

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[42] Note that a benefit from the FTC's perspective is usually a cost from the company's point of view.

[43] The cases have been premised on different synopses involving Truth-in-Lending, the textile rules, food freezer cases, bait and switch, unordered merchandise and the <u>Ideal</u> order requiring substantiation for toy advertisements.

[44] <u>E.g.</u>, <u>Jim Clark Inc.</u> Civil No. 78A1183 (D. Colo.); <u>Sears Roebuck & Co.</u> and <u>Kellwood Co.</u>, Civil No. 81A303 (D. Colo.).

[45] Another cost that must be considered, in particular for industries not included in 205 projects, is the cost to consumers of non-compliance.

settlements (ranging from $15,000 to $90,000) was roughly one-third of one workyear. Companies that are sent synopses incur some costs, both in seeking legal advice and in changing their practices to comply with the synopses. Companies that are the subject of investigation incur additional costs (even if they are not in violation). These could be fairly low when settlement is reached early. Where litigation is pursued costs for both FTC and respondent will be considerably higher, especially in the near future when threshold legal issues (e.g., the section's constitutionality) are being resolved.

In order to get a better sense of the potential for cost-effective use of Section 205, the Commission may want to consider conducting a study to measure the cost and effectivenessof a future Section 205 project. The first step is to select an appropriate Section 205 project (after the Commission has answered the policy questions posed in this memorandum). Next, the study would be designed (before any synopses would be mailed out). It would attempt to asess both the costs of the project (to the FTC, the industry and consumers) and the benefits (changes in industry practices to comply with synopses, civil penalties assessed; and the deterrent impact on recipients and nonrecipients of synopses).

Following are two brief appendices. They show how one civil penalty model might work in practice (appendix A) and provide an economic overview of the issues inherent in the design of a civil penalty enforcement strategy (appendix B).

APPENDIX A: Civil Penalties - Using the Deterrence Model

Using the Deterrence Model

As was suggested in chapter II, it is not necessary for the Commission to develop civil penalties with rigid precision. It is useful, however, if the Commission has a framework within which the various factors can be considered in assessing a civil penalty. Such a framework would not be used in every, or even in most, assessments. Rather it would detail the steps that the Commission must take, at least implicitly, in arriving at a civil penalty that fulfills a particular goal. The following discussion uses the deterrence model but it addresses issues raised by all four approaches. It is an ideal. In practice, this level of detail would be neither necessary nor desirable. Approximations would be more than sufficient.

1) Avoiding Underdeterrence

One of the maxims of civil penalty assessment is that the penalty must be large enough that the company does not consider it a cost of doing business. What does this mean? If the expense of paying a Commission civil penalty judgment were sufficiently small, a company could establish an expense account against the possibility of being caught. A company might shrewdly guess that it could operate for at least five years before being forced to pay a penalty. If it guessed correctly, at the end of five years it might gladly consent to a typically sized Commission settlement in return for having profited by avoiding the rule during the preceeding years. Businesses will stop expensing if the annual cost of the account is greater than the advantages derived from paying it.

The Commission can accomplish this in one of two ways. The Commission can raise firms' perception of their likelihood of being caught. However, given the Commission's limited resources, stepped up enforcement in one area generally means decreased enforcement elsewhere. Alternatively, it can increase the amount of the civil penalties. Considerations in determining the amount of this increase, are discussed below.

2. Establishing the Range Within Which Penalties Should Fall-The Upper Limit

As a start, the Commission can attempt to determine the upper and lower bounds within which a respondent's penalty should fall. The upper bound is the easier of these two figures to determine.

There are two points the Commission should consider in setting it. Statutory and judicial interpretations have established several factors to be used in determining the size of a civil penalty.[1] Of these, the respondent's ability to pay is one means of establishing an upper boundary on civil penalties. There are a number of figures that might be considered in determining a company's maximum ability to pay.[2]

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[1] Among them are: (1) the defendant's ability to pay; (2) any history of prior such conduct; (3) effect on ability to continue to do business; (4) the good or bad faitn of the defendant; (5) the injury to the public; (6) the desire to eliminate the benefits derived by a violation; and (7) the necessity of vindicating the authority of the Commission. Section 5(m)(1)(C) Federal Trade Commission Act, 15 U.S.C. § 45(m)(1)(A); United States v. Papercraft Corporation, 540 F.2d 131 (3d Cir. 1976); United States v. J.B. Williams Company, Inc., 498 F.2d 414 (2d Cir. 1974); Federal Trade Commission v. Consolidated Foods Corporation, 396 F. Supp. 1353 (S.D.N.Y. 1975), United States v. Swingline, 371 F. Supp. 37 (E.D.N.Y. 19174).

[2] Among the more useful indicators of ability to pay are a firm's liquidity ratios. Average ratios of various sized companies are readily available. A comparison of a respondent's ratios with these averages provides an indication of readily available funds. Another alternative is retained earnings. Cash and marketable securities are also an indication of a firm's ability to satisfy a civil penalty.

While these figures may be of help in analyzing moderate to large firms, they may be less useful for smaller, privately held corporations. In such a case, the amount a firm earmarks for depreciation might be a better indicator. In principle, the depreciation entry on the balance sheet represents the amount the firm has set aside for replacing capital equipment. To the extent that a firm's growth has been competitively benefitted by violations of Commission rules and orders (see discussion in text accompanying footnotes 6 and 7, infra.) looking to depreciation as a source of penalties is not inequitable. Yet another alternative in the case of a very closely held corporation is gross earnings after interest, taxes, and fixed, non-salary, expenses. In addition penalties can be structured so that they are paid out over time.

The important point is that the Commission should not lock staff into any particular figure as an indication of ability to pay. A few indicia, such as depreciation or liquidity ratios, might be preferred. Buy especially when dealing with small "creatively organized" corporations, some flexibility in developing a surrogate for ability to pay will be necessary.

The second figure to consider in establishing an upper bound is the maximum civil penalties the Commission can assess. Although staff has some flexibility in framing violations, since the Commission is limited to a maximum of ten thousand dollars per violation, in some cases if the number of violations alleged is not large the amount that can be collected in civil penalties may be less than the ability to pay. Thus, the upper bound on civil penalties is determined by the maximum amount that the Commission can collect given the number of violations or the company's ability to pay, whichever is lower. However in most cases, were the Commission to seek this amount in civil penalties, it would so far exceed the advantages the firm was likely to gain from engaging in illegal acts or practices that they would be inappropriately punitive.

3. The Range within Which Civil Penalties Should Fall - The Lower Limit

Generally, the lower bound is the critical element. Since the goal is to set the penalty at a level just beyond that which makes it profitable for the firm not to comply with the Commission's rules and orders, each of the advantages to the respondent of noncompliance must be considered. These break down into competitive advantages and in some cases, consumer loss.[3]

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[3] From an economic perspective it is useful to remember that this model seeks to maximize deterrence rather than some other goal such as predictability of civil penalty amount or social welfare. In the latter instance, for example, there may be situations where the Commission might choose to accept less than complete deterrence of violative conduct because the advantages of the firm's activity in the marketplace exceed the harm suffered by consumers and competitors as a consequence of the violation.

If social welfare were the goal the Commission sought to emphasize, it would look to the consumer loss caused by the respondent's conduct rather than the respondent's competitive advantage. Such deterrence has been called "conditional deterrence" since it assumes that it may be desirable to deter less than 100% of potentially unlawful activity. An optimal penalty under this approach will tax to violators the cost of their actions to society. It may be that such an approach is most advatageous when seeking to calculate a combination of redress and penalties. However, the model discussed in the text is simpler to use since it is directed only at civil penalties and assumes that deterrence is the primary goal.

- Competitive Advantages

The minimum advantage that a firm enjoys by not complying with Commission rules or orders is its savings in compliance costs. A company that intentionally failed to print required forms, train its sales force or supervise its operation to insure compliance with a mandatory rule, could realize a substantial savings relative to other complying firms. A measure of the competitive advantage a firm receives from not establishing a compliance unit is the marginal cost of operating a compliance division that it saves.[4]

The difficulty for the Commission is determining what the respondent's marginal compliance costs would have been. As with most of the advantages enjoyed by firms acting illegally, while a precise figure is not available it is possible to obtain a reasonably accurate estimate from various sources.[5]

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[4] The marginal costs are a more accurate measure of a firm's savings than is the total compliance cost. For example, a moderate size mail order firm operating for a year without ever complying with the rule, might save twenty thousand dollars. However, in setting a lower bound for civil penalties, assigning twenty thousand dollars as its compliance cost savings is probably an overstatement. That twenty thousand dollars represents two costs: the cost of establishing a mechanism for carrying out the mail order rule (_e.g._, programming its computer, training its sales force) which may have cost eight thousand dollars, and day-to-day compliance costs (_e.g._, screening advertisements, mailing follow-up notices) which could cost twelve thousand dollars. Since as part of a final order the Commission would undoubtedly require that the respondent establish a compliance program, to assess the full twenty thousand dollars for failing to start the program a year earlier would force the company to pay the start-up costs twice. As long as the Commission and the firms assume that violators will eventually be caught, it is not important that the lower bound reflect the start-up compliance cost, the marginal costs are sufficient.

[5] For example, some consulting firms specialize in helping other businesses develop and administer compliance programs. Their charges for setting up and administering programs are likely to be a (slightly high) indication of a business' compliance costs. Staff discussions with other similar size businesses is another indication of compliance expenses. Since (CONTINUED)

Annual marginal compliance costs are one savings to a noncomplying firm; there are others as well. These might be called "privileged competition." Privileged competition refers to the advantages a firm receives relative to its competitors in consummating sales as a result of noncompliance.[6]

A third closely related class of competitive advantages available to noncomplying firms might be called "unfair profits." From time to time the Commission or Congress has found certain sales and business techniques to be so overburdensome to consumers that they can only be engaged in under rigid conditions or are prohibited altogether. These acts or practices generally place sellers in a particularly advantageous position relative to buyers (and thus might be considered a form of consumer loss). However, because they also provide noncomplying firms with an additional leg-up over their competitors they should be considered a competitive advantage as well.[7] Any additional profits the firm receives by engaging

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[5] (FOOTNOTE CONTINUED)

complaints against noncomplying firms are often lodged with the Commission by their competitors, those competitors are likely to provide the Commission with a breakdown of the expenses they incur in complying with Commission rules.

[6] For example, a door-to-door sales firm that fails to provide its customers with cooling-off notices is in a better position to close a sale quickly than its competitors. Competitors who offer cooling-off protection may discover that three out of every ten buyers take advantage of the opportunity to cancel their sale. The noncomplying firm that "forgets" to provide cooling-off forms may find that only one buyer in ten will take the effort to write his cooling-off notice and mail it to the firm within the appropriate period. The profits on the two additional sales would be the privileged competition advantage of the noncomplying firm.

Similarly, a franchisor who failed to deliver unfavorable disclosure documents would be in a position to close sales more quickly than competitors. Again, to the extent that the franchisor was able to make additional sales, annual profits from those sales represent the advantages of privileged competition.

[7] The door-to-door salesman who falsely tells

(CONTINUED)

in such techniques should be added to its compliance cost savings and privilege competition advantages in determining its total annual competitive advantages.[8]

4. Establishing the Civil Penalty Figure - Likelihood of Detection

The sum of the preceeding advantages on an annualized basis helps establish the lower bound. They represent the amount that a company may be willing to risk each year in order to avoid complying with Commission rules or orders. As long as the firm's expected annual cost of paying a Commission civil penalty is less than this amount, it may be willing to risk prosecution.[9]

In order to establish the proper level of civil penalties the Commission must make some estimate as to how long the firm believes it could operate without being caught. Admittedly in most cases this is likely to be a subjective determination on

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7 (FOOTNOTE CONTINUED)

parents that he has been sent to them by their child's teacher is one example. The debt collection company that calls at all hours of the day and night in order to force the debtor to make payments is another. However, it has been determined that gaining access and trust to concerned parents through false preteneses or repeatedly calling consumers at three o'clock in the morning in order to collect a thirty dollar debt, while effective techniques, are sufficiently beyond the mores of normal business practice as to be unfair or deceptive.

8 Again an estimate of the amount of unfair profits realized by a firm can be obtained by comparing portions of its sales and profit figures with those of complying firms. For example, if the closing rate of the debt collection firm mentioned in the preceeding footnote were sixty percent compared with a fifty percent industry average, profits on that additional ten percent might fairly be considered its competitive advantage.

9 There are other expenses to firms for noncompliance. In some instances the legal fees of defending an action and the loss of goodwill resulting from adverse publicity are costs to the noncomplying firm. However, if the firm knows at the outset that it is willing to settle for a lower civil penalty by consent, then anticipated legal fees can be held in check. Nevertheless, the legal expenses of defending a Commission action can be a major deterrent to small firm noncompliance.

the part of the Commission. It is influenced by the publicity that surrounds the rule, prior statements of the Commission's enforcement intentions, the number of similar actions the Commission has brought in the past, the size of the industry, and the degree of competitiveness within the industry (in a small highly competitive field it is more likely that competitors will notice and report to the Commission significant violations). In most instances it is probably fair to estimate that this figure (the "multiplier") will be between one and ten: that is, firms assume that the Commission could uncover their illegal practices within one to ten years.[10] The annualized lower bound figure must be multiplied by this number in order to determine the minimum civil penalty necessary to specifically deter the respondent from engaging in the violative practice.

5. Reconciling the Civil Penalty with Judicial and Statutory Requirements

The Commission should compare this working civil penalty with the upper bound determined earlier. If the penalty is greater than that upper bound then for the statutory and judicial reasons discussed above the penalty must be reduced to that level. However, in most instances, the civil penalty figure will be well below this upper bound.

A civil penalty figure chosen in this fashion will be high enough to satisfy the specific deterrence goal because it will remove virtually all of the competitive advantages of noncompliance. Consequently the civil penalty should not be increased merely because the firm has the financial ability to pay more. At the same time because this is the minimum civil penalty figure necessary for deterrence it may satisfy the Commission's appropriateness goal by avoiding overdeterrence.[11]

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10 Another way of thinking of this is asking what is the firm's perception of the probability of detection within any one year. If it's virtually certain, the probability would be one hundred percent. If it were one chance in five the probability would be twenty percent. Again in most cases it would probably lie between ten percent and one hundred percent. Dividing the percentage probability of detection into one hundred will give the multiplier discussed in the text. This figure may vary depending upon the industry or type of violation.

11 As with all models, in some situations this model can produce anomalies. In areas where the Commission has chosen not to maintain as high profile, firms may correctly perceive that (CONTINUED)

6. Aggravating and Mitigating Factors

Once a civil penalty figure has been derived there is very little else for the Commission to consider. Aggravating and mitigating factors could revise the civil penalty award upward or downward, respectively.

(a) Aggravating Factors

One factor to consider is whether by violating a rule or order a firm has caused consumer injuries considerably greater than the benefits it received. In many instances where a rule violation causes consumers to suffer an injury there is a close to corresponding benefit to the firm. However, in a few instances the injury suffered by consumers as a result of noncompliance may grossly outweigh the advantages to the firm. A debt collection firm whose on-the-job harassment results in an employee being fired is one example. In instances where such nonreciprocal consumer injuries exist it may be worth-while for the Commission to increase the working civil penalty figure somewhat as a means of insuring that the penalty fully reflects the Commission's aversion to the practice.[12]

Recidivism is another aggravating factor. If the firm continues to violate Commission rules and orders despite the imposition of a civil penalty that effectively denies the firm the advantages of its actions the Commission may wish to increase the civil penalty amount as a means of reinforcing its effect.

(b) Mitigating Factors

With the exception of the two factors just discussed, it is

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11 (FOOTNOTE CONTINUED)

the likelihood of being caught is low. In such circumstances the model would recommend a civil penalty amount that might appear unnecessarily high. In addition, the model may not be useful in cases where firms engaged in "economically irrational", albeit, violative behavior. Of course in such circumstances the Commission could reasonably choose to modify the civil penalty assessments accordingly.

12 In other words, when consumer injury is great, the Commission may prefer to err, if at all, on the side of overdeterrence.

important to remember that the working civil penalty figure is designed to deter a firm that deliberately calculates the advantages to be gained by disobeying a Commission rule or order and does so if they are sufficiently great. Where, for statutory or judicial reasons,[13] the Commission is required to consider mitigating factors, the working civil penalty figure should be reduced accordingly. Thus, the good faith of the respondent or the fact that the violation was technical in nature are factors which should be considered in assessing civil penalty amount.[14]

7. Conclusion

If civil penalties were assessed in accordance with the preceeding steps (or a rough approximation of them) the penalties would remove any incentives for firms to engage in unfair or deceptive conduct. The same factors are already considered by the Commission in assessing penalties, although they are probably not always addressed explicitly, within a framework, and deterrence is de-emphasized in order to achieve other goals. These factors are also addressed in the historical consistency and severity of conduct models, again with less emphasis on deterrence. Whether the Commission should adopt such a framework for assessing civil penalties will turn in large part on whether it wishes to make the goals it is seeking to achive explicit.

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[13] See footnote 1, supra.

[14] By "technical" it is assumed that the violation was an inadvertent misapplication of a complicated rule. In such a case mitigation is appropriate since the violation was not deliberate. If by technical one means that there was a deliberate violation of a minor rule provision, mitigation is probably inappropriate. However, in such a case the advantages enjoyed by the firm as a result of the violation aree likely to be minor and the calculated civil penalty is unlikely to be large.

APPENDIX B: Efficient FTC Law Enforcement

Efficient FTC Law Enforcement

I. Introduction

The major benefit from FTC law enforcement in the area of Consumer Protection is the deterrence of business and consumer behavior that is inefficient. The great majority of transactions in the market produces efficient results.[1] However, there exist some areas where consumers are insufficiently informed, and transactions may be inefficient. It is these areas, for example, areas where deception and fraud arise, that the FTC strives to deter inefficient behavior. Ideally, in the best of all possible worlds all "inefficient behavior" would be deterred.[2]

As discussed above in the text, deterrence can be achieved if all gains accruing from a violation are removed. If every time a business was about to engage in fraud or deception it knew with certainty that any "ill gotten gain" would be taken away either through a civil penalty or redress, the incentive to defraud or deceive would be drastically reduced.

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[1] Behavior may be inefficient for numerous reasons but the primary reason is that it causes more harm than benefit to society. Efficient exchange is usually characterized by both parties to the transaction being made better off. Sometimes, however, because of incomplete knowledge, only one party will be made better off. For example, if a consumer buys beach front property from a developer only to the sand wash away in a freak storm which both parties realized was a remote possibility, the consumer was not made better off by purchasing the house. However, this transaction was efficient because both parties fully realized the consequences of their actions. On the other hand, if the developer secretly knew that the sand was sure to wash away at the first moderate storm, the transaction would have been inefficient because the consumer would not voluntarily entered into the transaction. Similarly, a farmer that sells his fall harvest in the spring on the futures market only to see the price of corn double by September was not made better off by the transaction. Yet the transaction was not inefficient. Therefore, it is important to remember that both parties need not be made better off _ex post_ for a transaction to be efficient.

[2] Obviously there will be times where reasonable people will

We would expect to see little or no fraud and deception in a world where gains were always taken away. However, there are obvious reasons why we do not live in such a world. Namely the enforcement costs would be astronomical. In fact, such an enforcement policy would not be feasible. Ill gotten gains can never be completely removed. Therefore, it is important to look for alternative enforcement policies that still provide sufficient deterrence of inefficient behavior but at a lower cost.

II. Deterrence When Not All Violations Can Be Caught

There is an alternative enforcement strategy designed to achieve efficiency which is almost always used both in law enforcement and in other social settings. The goal of this enforcement strategy is to fine the violators who are caught by more than the ill gotten gains in order to compensate for the fact that all violatons cannot be caught. For example, if someone illegally parks on the street (which is inefficient because the injury due to the traffic delays more than outweighs the benefit to the one driver) then the parking fine is in excess of the 3 dollars that it would have cost to park legally. Instead, the fine is 30 dollars which roughly compensates for the fact that, on average, only one in ten illegally parked cars is ticketed. Similarly, the Commission might want to seek civil penalties or redress in excess of the gain received by a company from a violation.

Often this multiplying of the gains to offset the fact that all violations are not detected may not be within the legal authority of the Commission. For example, a company may violate the mail order rule and save $50,000. The Commission may estimate roughly that it can catch only one in three violations of the mail order rule. Therefore, it would like to fine the company $150,000. This fine would

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[2] (FOOTNOTE 2 CONTINUED)

disagree on what is inefficient and what is not. The art of weighing costs and benefits in deciding whether a three week delay in mailing a toaster causes more harm to the consumer than cost savings to the mail order house will, by its very nature, remain imprecise. Therefore, there will always be many "policy questions" that must be resolved. However, for this entire appendix, it will be assumed that the policy questions have been resolved and that everyone agrees that a two week delay in mailing a toaster is okay, but that an unspecified 60 day delay is not.

produce an effective deterrent.[3] The Commission may have some success at defining a violation so as to set the civil penalty at $150,000.

Alternatively, in some cases having the fine or redress commensurate with consumer injury may in effect act to multiply the gain by the probability of detection. For example, a company may deceptively sell a worthless product for $100 that cost $75 to produce. The gain is $25 ($100 minus the production cost of $75) while the consumer injury is the full $100. Therefore, even if the Commission only pursued one in four such cases, seeking a fine or redress for the amount of consumer injury ($100) would compensate for the fact that only one in four acts of deception were caught. Thus, it is often possible for the Commission to increase fines and redress above the immediate gain.

Since deterrence can be accomplished through large fines and redress that are only extracted infrequently, one may wonder why not go to the limit of Draconian fines whenever possible. That is, why not always seek the largest possible fine or redress available to the Commission? After all by doing so it would appear that all deception and fraud could be eliminated with only a small expenditure of Commission resources.

III. The Cost of Deterrence

A. Residual Violations

There are many arguments for why such an enforcement policy would not be desirable. Most of these arguments have to do with the fact that even the most severe penalty will never prevent all violations and that since violations will occur large fines may impose substantial costs on society. Four reasons why residual violations will always occur will be discussed.

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[3] A fine of $50,000 would cause firms to realize that since they only get caught one in three times that by violating the rule 3 times they would likely come out $100,000 ahead. [$100,000 = Gain of 3 violations ($150,000) minus the one fine ($50,000).]

First, even when substantial fines are expected, random violations of rules, deception and fraud will still exist. No matter how many precautions a mail order house takes to make sure merchandise is delivered in a timely fashion, some orders are bound to get lost in the mail room or the postage meter will break or some circumstance will occur.[4]

Second, even the best intentioned person will sometimes violate the law. A possible $200 parking ticket would not dissuade most people from illegally parking during an emergency, such as parking in front of a hospital when bringing someone to the emergency room. There are usually "mitigating" circumstances involved with many violations. (Sometimes the mitigating circumstances will not be verifiable by the Commission - - a distinction that has important implications when determining appropriate fines and that will be discussed below.) Therefore, there will be situations where complying with rules will be so expensive so as to make it worthwhile for even the most honest company to violate the rule.

Third, some companies and individuals are just "bad actors" and will risk violations even if they must risk substantial fines that would deter most people. Perhaps, these bad actors misperceive the probability of being caught, or think that they can beat the system and get away with the violation. Alternatively, these bad actors may be "judgment proof" and therefore, find that a 5,000 dollar gain is worth risking a 20,000 dollar fine even if they are fairly likely to be caught because they do not have any assets against which the fine can be levied. Therefore, bad actors will commit violations even when the expected fine theoretically exceeds the expected gain.

Fourth, some companies may honestly misunderstand a rule or not realize that the rule applies to their type of business. Therefore even large penalties will not prevent these violations.

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[4] All violations are not equally likely to occur. For example, it is unlikely that someone will accidently sell the Brooklyn Bridge.

In addition, there is always the possibility that mistakes will be made when enforcing the law. Innocent parties may be convicted of violations they did not commit. Therefore, even if expected fines are sufficiently large so as to deter most violations, cases will still be brought.

In light of the above reasons why complete deterrence cannot be accomplished and why cases will always occur, there are several costs associated with trying to deter violations through a policy that levies large fines.

B. The Cost of Deterrence

1. Overdeterrence

First, there is a cost of overdeterrence. Overdeterrence is like too much of a good thing. The deterrence of inefficient behavior is desirable. However, as mentioned above violations will often occur because of "accident" and "mitigating circumstances", and cases will be brought by mistake. There is no violative behavior that needs to be deterred in these situations. If the companies merely paid the fines in these situations nothing would be lost beyond the additional risk that would be imposed upon the businesses. Unfortunately, there are additional effects. Businesses will react to these situations by trying to reduce their potential liability. They will hire attorneys, they will try to reduce the probability of accidental violations, and they will spend resources trying to avoid violations even when it is expensive to do so. For example, the mail order house might hire additional personnel to check the mail room every day to guard against lost packages. Also the mail order house might hire special delivery services in order to ensure speedy delivery. All these activities impose costs on society in excess of any benefit derived from these activities, and hence are inefficient.

There will never be a perfect solution to the problem of overdeterrence, any enforcement policy is bound to overdeter sometimes. Fortunately, there are several ways of reducing overdeterrence. One possibility is allowing fines to be substantially reduced the more there are mitigating circumstances. A mitigating circumstance can be thought of as a situation where efficient behavior might call for violating the rule. Even a well crafted rule cannot be written so as to prohibit only inefficient behavior and leave all efficient behavior untouched. Thus, allowing fines to be reduced the more mitigating the circumstances, is a method of refining the law enforcement process and promoting economic efficiency.

Similarly, while the Commission makes allowances for unintentional violations, it is unlikely that the Commission can always distinguish between accidental violations and deliberate violations. Was the merchandise mailed late because someone innocently forgot to mail it, or was it deliberately mailed late because there was no one in charge who had the responsibility to check on the mail? The more likely that a business is innocent and that the case is a mistake the lower the fine should be. Thus, bad actors should be fined most heavily, since a case against a bad actor is less likely to be a mistake. (However, little can be done to deter those firms that are bad actors as a result of being judgment proof. Injunctions or criminal penalties may be necessary to stop these bad actors.)

2. Risk

Second, there is the cost of risk. Since all violations cannot be deterred and since sometimes cases will be brought against innocent parties there are costs associated with an enforcement policy that levies large fines. An enforcement policy imposes risks on society. These risks are a real cost. Just as an uncertain rainfall and hence and uncertain harvest imposes costs on farmers by making their income less certain, any enforcement policy must impose some risk. An enforcement policy makes the stream of income to businesses less certain and hence less steady. As investors prefer a steady stream of income on their investment, it will be more difficult for businesses which are subjected to potential liability to raise capital. The result is that less capital will be raised and hence fewer goods and services will be produced in these areas. These risks can never be eliminated and hence there is always some cost to achieving deterrence.

There are ways to reduce these costs. An enforcement policy that levies a smaller fine but with higher probability of detection imposes less risk. At the same time, such an enforcement policy uses greater amounts of Commission resources. Also, the more guidance that is given to industry the less the risk that a firm will unknowingly commit a violation.

3. Output Reduction

A third cost imposed because enforcement policies cannot perfectly deter is that of "taxing" the industry. Because cases will be brought and fines must be paid periodically, prices must be higher, to cover these costs. Since prices are higher consumers will purchase fewer of these goods and services. While the fines may go into the Treasury, a system of civil penalties is probably not an effective way to raise revenue. On the other hand, a policy that seeks consumer redress will tax the industry less if consumers anticipate the potential for redress. If consumers anticipate redress they will be willing to pay the higher prices for the goods or services. Therefore, output will not decrease and while prices may be higher consumers are receiving not only the goods or services, but also potential redress. (However, it should also be noted both that at present consumers are unlikely to anticipate redress and that there are other reasons to prefer civil penalties over redress. Chief among them is that redress is often expensive to administer. The upcoming policy review session on redress will address this issue in more detail.)

IV. A Flexible Enforcement Strategy: The Role of Reputation Loss

The need to match expected penalties and expected gains in order to deter law violations, together with the recognition that there is a cost of deterrence suggests the need for a flexible approach to civil penalties and redress. The value of flexibility is even more evident when it is recognized that in addition to the direct means of extracting sellers' gains through civil penalties and monetary redress, gains are penalized indirectly. Litigation costs and reputation loss dissipate sellers gains.

Reputation Costs

Gains can also be dissipated through reputation loss. Firms invest in establishing a reputation through advertising, by building loyal customers, etc. As any capital investment, they expect a return on this investment. The return usually comes in the form of increased repeat purchases and perhaps a small price premium. However, if a FTC case attracts public attention, the firm may lose many customers and hence lose their return on their investment. This loss is a real cost to the company and hence will act to deter deception and fraud. If the Commission is oblivious to these reputation losses in setting fines and redress, it is apt to overdeter.

On the other hand, the Commission may not want to accept consents that are hand tailored by the firm to minimize reputation loss. The reputation mechanism works because if a firm "cheats" its customers, it is penalized. The firm can only be penalized if enough consumers are informed that the firm has "cheated". Commission action may be one such method for information to become public. This would suggest that the

Commission not be as sensitive to reputation loss of "bad actors", as to reputation loss that would arise when violations were more of a technical nature or if there were mitigating circumstances. Thus, firms' reputation and law enforcement policy are interrelated.

V. Conclusions

Finally, in order for a enforcement policy to be effective it must be known to the parties involved. Even though a flexible approach may be needed, it is important for firms to realize that the overriding concern is to remove ill gotten gains and that adjustments will be made for mitigating circumstances and bad actors. Although the rules of the enforcement policy should be predictable, specific aspects of the enforcement strategy must remain uncertain. For example, it is important for motorists to know that illegal parking carries a 30 dollar fine. However, rather than enforcing the parking laws only on Mondays, it would be preferable to scatter 8 hours of enforcement throughout the week. Therefore, while the rule of law should be well understood, the exact criteria for case selection should not be revealed unless the Commission is particularly interested in deterring certain violations and not others. Otherwise, announcing case selection criteria is similar to announcing two different rules of law.