Market Failure and Inequality: An Anti-Competitive Conduct Standard for Assessing When Disparate Impacts are Unjustified

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Abstract

Anti-competitive conduct by a defendant should not provide a business necessity defense in disparate impact litigation – even if the conduct increases the defendant’s profit. This anti-competition standard promotes both equity and efficiency as a policy matter and comports with the statutory requirement that to be justified a challenged practice must be “job related for the position in question and consistent with business necessity.” Civil right advocates, scholars and courts have failed to understand that profits that are the byproduct of market failure are much less justified than those that are a byproduct of competition. Racial disparity and market failure often come hand in hand. By enjoining policies that extract supra-competitive profits disproportionately from racial minorities, disparate impact law can actually help make markets more competitive.

Words: 17k

*Townsend Professor, Yale Law School. ian.ayres@yale.edu  Mitu Gulati, Vicki Schultz and participants at an NYU conference on employment discrimination provided helpful comments. This paper is inspired by the path-breaking work of Mark Kelman – particularly Market Discrimination and Groups, 53 Stan. L. Rev. 833 (2001) and Concepts of Discrimination in "General Ability" Job Testing, 104 Harv. L. Rev. 1157 (1991). While serving as a paid expert witness in Cason v. Nissan Motor Acceptance Corp (2001) 3-98-0223 (M.D. Tenn.) and a number of parallel pieces of litigation, discussed infra in Part III, I offered opinions on the scope of the business justification defense in disparate impact cases that directly relate to the issues discussed in this paper. I’ve particularly profited from my collaboration with Mark Cohen in this litigation.
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INTRODUCTION

Defining the scope of the business justification defense in disparate impact litigation has been “elusive.”¹ Imagine, for example, that an employer’s promotion criteria have been shown to disparately exclude African-American employees from better-paying jobs. What should the standard be for assessing whether the promotion criteria are nonetheless justified?

Civil-rights advocates have tended to answer this question by focusing on the term “business necessity,” suggesting that any policy that is not strictly necessary to prevent a firm’s bankruptcy is not justified.² Opponents, by contrast, have tended to focus on the term “job related” in arguing that any policy that increases a firm’s profitability (even infinitesimally) is justified.³ The conflict over the appropriate scope of the business justification defense was at the heart of the stalemate over the proposed Civil Rights bill which passed both houses of Congress in 1990.⁴ President Bush felt so strongly that the “business necessity” definition created a “quota bill” -- that is, a de facto quota employment requirement -- that he vetoed the original legislation.⁵

Senator Danforth played a lead role in brokering compromise language that ultimately led to the passage of the Civil Rights Act of 1991.⁶ The compromise language in this new

legislation (which was taken word-for-word from the Americans with Disabilities Act), however, did little to resolve the dispute. It defined a defendant’s policy as unjustified if, “the respondent fails to demonstrate that the challenged practice is job related for the position in question and consistent with business necessity . . . .”

Since 1991, some courts have continued to allow a rather broad justification defense. For example, Judge Richard Posner has written that disparate impact liability exists to identify situations in which, “through inertia or insensitivity, companies [are] following policies that gratuitously – needlessly – although not necessarily deliberately, exclud[e] black or female workers from equal employment opportunities.” This gratuitous standard resonates deeply with a profitability definition; an employer who can show it adopted a policy to increase its profits even infinitesimally arguably did not adopt the policy “needlessly.” There is of course a huge difference between Posner’s “needlessly” standard and the “business necessity” definition favored by others. One requires the smallest of reasons, while the other seems to demand the largest of reasons.

But the dispute over the appropriate scope of the defense has masked a deeper consensus about the relevance of profitability. All sides to the debate implicitly agree that policies that produce greater profits are more justifiable. Civil rights advocates and their opponents disagree about how much a policy needs to increase profits in order to provide a defense against disparate impact liability – the left saying a lot, the right saying a little. But both sides agree about the sign of the derivative – more profits means more of a justification.

7 Id. See 42 U.S.C. § 12112(b)(6) (1994).
This paper seeks to contest the view that profitability should necessarily correlate with justifiability. The problem with the received wisdom is that it fails to distinguish between pro- and anti-competitive behavior. Both pro- and anti-competitive policies can increase a firm’s profitability. Indeed, Figure 1 depicts two policies that equally increase a firm’s profitability. Policy A increases the firm’s profit — by the increment $\Delta_A$ — from a sub-competitive position to the competitive level of zero economic profits.\(^{10}\) Policy B increases the firm’s profitability by the same amount — by the increment $\Delta_B$ — but from the competitive level to a supra-competitive level. The thesis of this paper is that supra-competitive increases in profits (such as caused by policy B) should not provide a business justification for policies that have disparate impacts on protected groups. Such policies should be enjoined.

With regard to pro-competitive policies (such as policy A), courts will still need to consider the extent to which firms might need to sacrifice profits in order to mitigate the adverse impacts of their policies. They will need to decide the extent to which the law will make what Mark Kelman has called an “accommodation demand.”\(^{11}\) This paper does not resolve this

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\(^{10}\) The term “economic profits” includes a reasonable return on capital — so a firm earning zero economic profits covers its overhead and is able to pay a reasonable (risk-adjusted) dividend to its shareholders.

important and long-standing accommodation issue. Even defendant policies that are adjudged to be pro-competitive might nevertheless be unjustified if one reads the statute as requiring businesses to sacrifice a reasonable amount of profit to promote participation by protected class members. The competition test, accordingly, is one-sided: it definitively adjudicates that anti-competitive policies are unjustified, but it does not answer whether, or to what extent, pro-competitive policies are justified.

However, this paper’s largest contribution is in noticing that not all increments to profitability deserve equal judicial respect. Civil rights advocates have overlooked the possibility that the enhanced profitability of a policy might stem from an anti-competitive behavior leading to supra-competitive profits. Focusing on the possibility of anti-competitive behavior suggests the opposite legal result. When the policy is anti-competitive, larger increments to profitability make a particular policy less justifiable. Policies which disproportionately hurt protected workers should not be justified by a purpose of extracting supra-competitive profits.

While it strikes many that “profits are profits” and any policy which enhances them is consistent with first principles of a free market, the burden of this paper is to show that not all increments to profitability should be given equal respect at the bar. In a sense, the paper calls for

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This aspect of the paper – pointing out an inappropriate concession of civil rights advocates – parallels an analysis of mine concerning affirmative action. Civil rights advocates have implicitly conceded that affirmative action in procurement – via bidding credits or set-asides – would increase the amount that government needed to spend on procurement. But Peter Cramton and I showed as both a theoretical and an empirical matter that bidding credits and set-asides could save the government money by inducing disfavored firms to bid more aggressively. See Ian Ayres & Peter Cramton, Deficit Reduction through Diversity: How Affirmative Action at the FCC Increased Auction Competition, 48 STAN. L. REV. 761 (1996); see also IAN AYRES, PERVASIVE PREJUDICE? UNCONVENTIONAL EVIDENCE OF RACE AND GENDER DISCRIMINATION (2001). In FCC spectrum auctions, for example, 50% bidding credits increased the government’s revenue by 12% by increasing the price that non-disadvantage firms paid for their licenses. See Ayres & Cramton, at 763.
civil rights to be more informed by an anti-trust sensibility. Viewed through an antitrust lens, supra-competitive profits presumptively reduce social welfare and are suspect. To see this intuition in the disparate impact context, consider the following example: An employer pays high-school graduates an amount equal to their marginal productivity but institutes a new policy of paying non-high-school graduates less. Imagine that the policy has a disparate impact against African Americans – who, in this hypothetical, are less likely to have a high school diploma.\textsuperscript{13}

The employer might justify the pay difference by arguing that non-graduates tend be less productive than high-school graduates. Let’s call this the “productivity” defense.\textsuperscript{14} But in the alternative, the employer might try to justify paying non-graduates less not because the non-graduates are less productive but solely because these employees have fewer employment alternatives than high-school graduates. For example, imagine that non-graduates were less mobile – more tied to their home town\textsuperscript{15} – and hence had fewer alternative jobs where they could work. Let’s call this the “market power” defense, because the lower pay is a function of the employer’s greater market power over the non-graduates.

Note that both these defenses are about profitability. The productivity defense in essence says that the policy enhances the firm’s profitability because the employer will be less profitable if it has to pay non-graduates more than marginal productivity.\textsuperscript{16} A firm that pays less productive workers the same as more productive workers will tend to be unprofitable. But the

\textsuperscript{13} The hypothetical is, of course, inspired by Griggs v. Duke Power Co., 401 U.S. 424, 431-32 (1971), where the employer had a policy of only hiring and promoting high school graduates. But our civil rights laws currently may not allow disparate impact suits with regard to equal pay act violations. See Washington County, Ore. v. Gunther, 452 U.S. 161, 170-71 (1981).

\textsuperscript{14} Alternatively, the employer might justify the lower pay by showing that non-graduates impose higher (training) costs on the employer. But this would be still a defense about their net productivity – net of training costs.

\textsuperscript{15} For example, imagine that the same factors that caused them to leave school earlier (a pressing need to provide care or money for family members) also cause them to need to work close to home.

\textsuperscript{16} Remember in this hypothetical that the high-school graduates are being paid the competitive wage (equal to their marginal productivity).
“market power” defense is also about profitability. Finding a group of workers who will work for a sub-competitive wage is a great way for a firm to increase its profits.

My primary thesis is that courts should reject the market power defense. Anti-competitive conduct – even if profitable – should not justify policies that would otherwise violate civil rights law because they produce racially disparate outcomes. Or more generally, anti-competitive policies should not be recognized as a defense in a disparate impact case.

Even though the exploitation of market power enhances the employers’ profitability, this type of profitability defense should not be legally cognizable. Indeed, anti-competitive policies that more radically increase an employer’s profits become ceteris paribus less justifiable. An employer who is able to more profoundly take advantage of non-graduates by paying them a starvation wage should not be able to point to the enormous profitability of the policy as a mitigating factor in a disparate impact suit. If anything, the opposite should be true. The example depicts a kind of “wage gouging” – a policy of systematically paying non-graduates less than their marginal product. More generally, “price gouging” should not be a business justification for policies that disproportionately burden women or minorities.

Forcing an employer to forego a policy that has a disparate racial impact in favor of a less profitable policy becomes increasingly problematic when in doing so the employer is asked to accept sub-competitive profitability. An employer is prima facie justified in trying to cover its costs – and in the foregoing example, trying to construct a wage policy where worker productivity does not fall short of an employer’s wage bill is accordingly a reasonable concern. But forcing an employer to forego an anti-competitive policy in favor of a less profitable, but more pro-competitive policy is not problematic – even if the employer is asked to forego a substantial, supra-competitive profit. This is the standard demand of both antitrust law and the
common law of unconscionability.

Disparate impact law can complement antitrust and consumer protection law to make markets more competitive and more equitable.\(^{17}\) Civil rights law is often seen to be at odds with a free market.\(^{18}\) But disparate impact law is an example where civil law can stimulate market competition. By raising the cost of anti-competitive conduct (such as price or wage gouging market niches that are disproportionately minority), disparate impact law can increase the relative attractiveness of competitive behavior.\(^{19}\)

This is not a mere marriage of convenience; racial disparity and market failure often go hand in hand.\(^{20}\) The ‘poor pay more” not just because of higher costs of supply but often because sellers prey on consumers’ limited access to information and competitive alternatives.\(^{21}\) The first principles of economic theory might suggest that their disproportionate poverty would tend to protect minorities from the most rapacious excess of capitalism. But study after study has shown – in car negotiations, in predatory lending, in rent-to-own markets and in dozen of other contexts – that sellers are able extract disproportionate profits from poor and

\(^{17}\) Daria Roithmayr is one of the few scholars to analyze how antitrust laws might be used to attack the problem of civil rights. See Daria Roithmayr, Barriers to Entry: A Market Lock-in Model of Discrimination, 86 Va. L. Rev. 727 (2000). See also Edward B. Rock, Antitrust and the Market for Corporate Control, 77 Cal. L. Rev. 1365 (1989) (showing how antitrust analysis could be used to improve markets for corporate control). But this paper focuses instead on how civil rights law can be used to make progress on problems of competition.


\(^{19}\) The potential pro-competitive impact of civil rights law was first seen by John Donohue. John J. Donohue, Is Title VII Efficient? 134 Pa. L. Rev. 1411 (1986). Donohue saw that disparate treatment law by imposing extra costs on employers with discriminatory tastes could hasten their exit from the market and thus dynamically improve market efficiency.

\(^{20}\) Gary Becker long ago emphasized that certain racial disparities were more likely to persist in the absence of competition.

Refusing a defense to anti-competitive policies (which are flying below the radar of antitrust or consumer protection authorities) is a simple way to make progress on two fronts that are inextricably linked.

The remainder of this paper is divided into three parts. Part I elaborates on the relationship between market competition and policies that produce disparate impacts. It shows why limiting the business justification defense to pro-competitive policies promotes both equity and efficiency. Part II argues that this legal limitation is also consistent with both “business necessity” and “job related” conceptions of the defense. Part III then applies the theory to employment and non-employment settings where anti-competitive motives may create unjustified disparate racial impacts. The discussion will pull from my experience as an expert witness in litigation against the nation’s major automobile lenders, in which I explicitly promoted the “price gouging is not a business justification” idea. The paper will present not only my views, but also the responses of three prominent experts for the defendants – Richard Epstein, Nobel Prize-winning economist James Heckman and George Priest.

I. MARKET COMPETITION AND RACIAL DISPARITY

Legally distinguishing between pro- and anti-competitive policies is supported by an economic analysis of market competition. In competitive markets, sellers are driven to price products at their marginal cost and to pay workers their marginal product. Market competition accordingly puts pressure on a firm to pay non-graduates less if this group of employees tends to have lower productivity. If there really is a productivity difference between different types of

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workers, then a firm that pays non-graduates and graduates the same will be at a competitive cost disadvantage relative to competitor firms that pay non-graduates less.

In contrast, market competition does not put pressure on a firm to price gouge or wage gouge (pay a group of workers substantially less than their marginal productivity). Indeed, the opposite is true. Competition from rival employers would tend to undermine the ability of an individual employer to pay non-graduates a wage lower than their marginal productivity.

In the employment context, the core competitive distinction is between policies motivated by an attempt to compensate workers at or above their marginal productivity and those motivated by market power (an attempt to compensate at less than marginal productivity). Competition tends to drive out the latter type of pricing distinctions. Rival employers in a competitive market will tend to bid up sub-competitive wages – driving all wages toward employees’ marginal productivity. But competition will tend to re-enforce pricing distinctions based on marginal productivity. Employers in competitive markets cannot (absent legal intervention) ignore differences in marginal productivity. Pricing distinctions that are a byproduct of market competition provide a stronger business justification. But pricing distinctions that are the byproduct of market failure – and indeed, can only persist in the absence of competition – are not justified. Market competition thus reinforces the tendency of firms to adopt productivity-based wage policies, but undermines the tendency of firms to adopt market power based-wage policies.

A. A Competition Standard

A standard of perfect competition can be used as a benchmark to distinguish policies that are potentially justified from those that are not. The core idea is to imagine the policies that a decisionmaker would adopt if forced to compete with a large number of rival decisionmakers.
Hypothetical perfect competition *drives out* policies based on exploitation of a decisionmaker’s market power, but *drives in* (or reinforces) policies that are based on real differences in cost or productivity. Woe be it to a firm that ignores real difference in cost or productivity. And woe be it to a firm in competition that tries to pay a sub-competitive wage or charge a super-competitive price.

But the discussion of competition up to this point is sure to strike many readers as odd. The free-wheeling market forces that bring buyers and sellers together in marketplace negotiations seem like competition in its purest form. From this perspective, all this talk about supra-competitive pricing seems to be a misnomer, because under this conception, there can be no such thing as a supra-competitive price. The competitive price or the competitive wage is whatever the market can bear.

The problem here is that there are competing ideas of what “competition” means. In one sense, competition is the struggle between a buyer and a seller (or an employer and a worker) to determine how they will split the potential gains from trade between them. To be sure, this is a kind of a competition. But economic analysis and the law itself have long ago rejected this form of competition as a normative benchmark. Monopolists have never been able to protect themselves by arguing that they were only charging what the market could bear or that consumers had consented to pay the contract price.

It initially seems plausible to argue that it is business justified for employers to maximize their profits by paying whatever wage the market will bear. This argument (again, putting aside the important issue of accommodation) makes eminent sense when the market is sufficiently competitive. Competition disciplines employers to set wages so as to at least equal the employee’s marginal product. But when there is a market failure (either in the sense of there not
being alternative employment opportunities or in employees being imperfectly informed about these alternative opportunities), the wage paid may bear no relation to the worker’s expected productivity. When the market fails, the wage that employers can pay will not be the amount that the market can bear, but instead will be determined by what the individual consumer can bear.

Civil rights law should follow the standard antitrust approach and focus on the degree of competition among multiple sellers. Analyzing how multiple sellers would compete for the business of individual buyers produces a “competitive” benchmark for both price and non-price policies against which it is possible to judge real-world decisions. This benchmark is normatively attractive as promoting not only efficiency but also multiple dimensions of equity. Competition among sellers tends to transfer the gains of trade from producers to consumers and workers and reduce inequalities that are not based on productivity or cost of production.

An analysis of competition (and its absence) also explains how anti-competitive policies can have disparate racial impacts. The next two subsections will show that:

(a) both price discrimination (charging different prices/wages to different groups) and more traditional, supra-competitive pricing (charging a single, supra-competitive price or sub-competitive wage) can produce civil right disparities; and,

(b) enjoining these practices can simultaneously promote both efficiency and equity.

To make clear the connection with standard antitrust analysis, the focus here is on anti-competitive conduct regarding product pricing decisions. But Section III will show how the

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23 Traditionally, the antitrust inquiry has been firm-centric instead of consumer- or worker-centric. While it would be theoretically comprehensible to analyze how multiple workers might behave in competing for an individual job, or how multiple consumers would behave in competing for an individual product, the standard normative lens to judge the behavior of firms (qua both sellers and employers) is to ask how multiple firms would compete for the services of employees or the patronage of customers.
same anti-competitive motives can give rise to more traditional disparate impact suits concerning hiring, firing, promotion and terms and conditions of employment.

B. How Price Discrimination Can Cause Disparate Racial Impacts

The term “discrimination” is not just a creature of civil rights law. Antitrust law and economics has long understood that firms with market power may have incentives to “price discriminate” as a means of making supra-competitive profits. For example, an airline with market power on a particular route may try to charge business travelers higher fares than tourists – not because business travelers impose higher costs on the airline but because business travelers have a less elastic demand for air travel and hence are willing to pay more. Employers can also price discriminate in the wages they pay – for example, they might pay non-graduates less than graduates not because the former are less productive but because non-graduates have a less-elastic supply curve and hence are willing to work for less.

Price discrimination is at play whenever a firm makes systematically different rates of profit from different groups of consumers for similar products or different groups of employees for similar services. Policies that implement price discrimination can directly cause disparate impacts if minority racial groups are disproportionately represented in the groups from which the firm is extracting high profits.

Seeing how price discrimination can create disparate racial impacts expands the set of policies that cause unjustified disparate impacts. Scholars, like Judge Posner, would only invalidate policies that “gratuitously” or “needlessly” burden minorities – in the sense that alternative policies could have been employed that were equally profitable. This gratuitous standard suggests a very narrow ground for liability because profit-maximizing firms tend to seek out the policies that are the most profitable. The gratuitous standard would only tend to
smoke out instances of covert animus – where a firm was willing to accept lower profits in order to further a discriminatory motive. But an appreciation of price discrimination suggests that even a profit motive can be unjustified if the profits result from exploiting a failure of market competition. Non-gratuitous, profit-maximizing policies can disproportionately hurt minorities, even when they motivated only by a desire to exploit a lack of competition.

Why are policies that induce supra-competitive profits less justified? The next section will give a doctrinal legal answer. But the policy reason is that price discrimination is inimical to well-accepted notions of both equity and efficiency. The equitable case against price discrimination is straightforward. The idea of extracting different rates of profit from different classes of consumers or employees not because of the costs they impose, but because of differences in their necessitude is inconsistent with basic notions of equality and fair play. In fact, the same equal protection norm undergirds the social concern with both civil rights and antitrust discrimination. The equal protection principle of equity commands treating like people alike – and employers who pay non-graduates less, not because they are less productive, but because they are willing to accept a lower wages violate this principle.

The argument that discriminating polices are inefficient, however, requires slightly more elaboration. As an initial matter, the anti-competition standard for adjudicating business justification is also supported by a straightforward analysis of allocative efficiency. Competitive pricing (including competitive wage setting) promotes economic efficiency – as goods and services tend to flow toward their highest use. When prices are based on cost, consumers will only buy when they value the good or service more than its cost of production. A competition standard for “business justification” would accordingly tend to validate cost-based pricing of products and productivity-based wages for labor – even if these policies induced disparate racial
impacts.

In contrast, supra-competitive pricing (and sub-competitive wages) can retard economic efficiency. Supra-competitive prices can create what economists call “dead-weight losses” in efficiency where consumers who value the product more than its costs are nonetheless deterred from buying because of its inflated price.

![Figure 2: Monopoly Overcharge](image)

As depicted in Figure 2, a non-discriminating monopolist that charges a single price to all consumers causes a group of marginal consumers to stop purchasing (the pink area Z). The inefficiency of supra-competitive pricing comes from the dead-weight loss of people who value the good more than its cost but are nonetheless deterred by supra-competitive pricing from purchasing. A competitive standard for business justification would accordingly tend to exclude this kind of single-price supra-competitive price setting – just as it would exclude employer wage-setting based on non-productivity factors.²⁴

²⁴ The next section will show this tendency more explicitly.
But the impact of price discrimination on allocative efficiency is more complicated. Certain types of price discrimination have the potential for reducing the allocative inefficiency of supra-competitive pricing. Price discrimination holds the potential of reducing the dead-weight loss depicted in Figure 2 by allowing the seller with market power to set different prices for different types of consumers. In theory, if a monopolist could perfectly price discriminate – charging each consumer their actual value for the product – there would be no inefficiency from price discrimination, as the monopolist would sell the efficient amount by lowering the price just enough to attract each consumer.\textsuperscript{25}

In practice, perfect (or first-degree) price discrimination is not feasible. Sellers with market power do not know how much individual consumers are willing to pay and sellers sometimes have opportunities to resell products to higher-valuing buyers. Normally, the best that sellers can implement is what economists call second- or third-degree price discrimination.\textsuperscript{26} The sellers place different types of consumers in different groups and charge the group different prices.

Second- and third-degree price discrimination, however, may not increase market efficiency. Not only will these cruder forms of price discrimination be less efficient than the competitive equilibrium, they may even be less efficient than forcing a seller with market power to set a single price for all consumers. In equilibrium with second-degree or third-degree price differences, the low-price group experiences less dead-weight loss, but the high-price group

\textsuperscript{25} Even if price discrimination were a net improvement in allocative efficiency relative to an inflated single-price (or a deflated single-wage) equilibrium, it should not constitute a business justification under the competition standard. Such price discrimination would still not represent an enhancement in allocative efficiency relative to a competitive single-price equilibrium.

\textsuperscript{26} With second-degree price-discrimination, the seller gives quantity discounts or discounts for charges of different prices for versions of the same product with different qualities. With third-degree price-discrimination the seller separates consumers into different groups (for example, by age or geography) and charges different prices to each group. See Douglas A Ruby, Price Discrimination (2003), at http://www.digitaleconomist.com/pd_4010.html.
experiences greater dead-weight loss, and this latter effect may dominate in efficiency terms. Moreover, the price discrimination tends to be inefficient in a more dynamic sense because it gives firms a bigger incentive to invest in creating market power. Prohibitions of price discrimination, by reducing the incentive to invest in barriers to entry and the like, may produce more competitive equilibria.\footnote{See Richard A. Posner, \textit{The Social Costs of Monopoly and Regulation}, 83 J. POL. ECON. 807 (1975).}

Because of both the efficiency and equity concerns with price discrimination, it is not surprising that there has been a fair amount of legal hostility to this practice – for example in the Robinson-Patman Act’s prohibition of price discrimination.\footnote{15 U.S.C. § 13(a).} But Robinson-Patman’s coverage is incomplete because it only protects wholesale consumers, not retail consumers.\footnote{Id.} Hence many forms of non-racial discriminatory pricing can fly under the radar of our antitrust statutes.

A competition standard would find that second-degree and third-degree price discrimination policies aimed at raising profits above the competitive level do not constitute a valid business justification. The competition standard would not render price discrimination per se illegal; it would only mean that price and wage discrimination policies that disparately burden racial minorities (or other protected classes) would not be saved because they were successful in extracting supra-competitive profits.

\textbf{C. How Simple Monopoly Overcharges Can Cause Disparate Racial Impacts}

Price discrimination is not the only anti-competitive policy that can produce disparate racial impacts. Just charging a super-competitive price (or a sub-competitive wage) can disparately burden minorities. Returning again to Figure 2, we see that monopoly pricing can harm consumers in two different ways. First, it hurts high-value consumers who pay the super-
competitive price – effectively extracting some of the consumer surplus that high value consumers would have received under competition and transferring it via the higher price to the seller. Second, it hurts low-value consumers who refuse to pay the supra-competitive price (but would have purchased at the competitive price). If minorities are disproportionately represented in either of these groups – the purchasing or non-purchasing groups, it may be that supra-competitive pricing cause a disparate racial impact.

For example, if minority consumers have lower ability to pay (and consequently tend to be over-represented in the lower right portion of the demand curve), then supra-competitive pricing will disproportionately exclude minority consumers from the market (relative to what their participation would have been at a competitive price). Supra-competitive pricing increases the seller’s profits but it can have a disparate racial impact. Even one-size-fits-all pricing can thus induce racial disparities.

Or alternatively, minorities may be over-represented in the purchasing group that knuckles under and pays the supra-competitive overcharge. This might happen, for example, at an inner-city grocery store, where a minority consumer might have less access to transportation to alternative stores and is consequently more likely to use the local grocery. The store’s choice to charge higher prices might disparately burden minority consumers. Again, notice the difference between pro- and anti-competitive behavior: an inner city store might charge higher prices either because it has higher costs or because it has more market power over its customers. Both policies would enhance the store’s profits, but only the first would be consistent with a competitive standard.

The possibility that minorities could be burdened by either being disproportionately excluded by a monopoly overcharge or bearing the overcharge itself creates a kind of Catch-22
for the monopolist. Excluding the pathological case where minorities are equally represented in the purchasing and non-purchasing groups, it will always be the case that under-representation in one group will mean over-representation in the other. For example, imagine that minorities would have made up 25% of customers if a competitive price had been charged. Then a showing that minorities are under represented (< 25%) in the purchasing group perforce means that minorities must be overrepresented in the non-purchasing group. The opposite scenario is, of course, also possible. This possible liability for multiple dimensions of disparity raises important Connecticut v. Teal issues.\footnote{457 U.S. 440 (1982). See also Ian Ayres & Peter Siegelman, The Q-Word as Red Herring: Why Disparate Impact Liability Does not Induce Hiring Quotas, 74 TEX. L. REV. 1487 (1996). At least as an analytic matter it would be possible to aggregate the two types of harm to assess whether the monopoly overcharge disproportionately hurt minorities. In economic terms, both the purchasing and non-purchasing consumers are forced to sacrifice some of their consumer surplus and it would be possible to assess whether minority consumers sacrificed a disproportionate amount of the consumer surplus they would have enjoyed if a more competitive price had been offered. But the burdens of exclusion from employment and consumption markets could create distinct burdens on minority communities that might justify the more disaggregated analysis of impacts on the non-purchasing and purchasing groups.} Moreover, minorities are not the only potential plaintiffs who could bring a disparate impact challenge. Non-minorities who are disproportionately burdened might be able to challenge the supra-competitive policy as well.\footnote{Charles A. Sullivan, The World Turned Upside Down?: Disparate Impact Claims by White Males, 98 NW. U. L. REV. 1487 (1996).} Men as well as women could bring a challenge. In theory, it would only be a truly pathological case where an anti-competitive policy would not burden any protected group (or its converse).

But this problem of multiple disparate impact plaintiffs with multiple disparate impact claims is present with regard to any business justification standard – not just the competition standard. A test that does not have a disparate impact against minorities will by definition have a disparate against non-minorities – unless it just so happens that exactly equal percentages of minorities and non-minorities make up each group. In the extreme, any business practice that does not pass a business justification test (whatever that test is) would be subject to challenge,
because in all likelihood, some protected class of workers or consumers would be disproportionately burdened by the practice. But in the real world, courts rarely (read: never) hold businesses liable for practices that disproportionately burden whites and, at times, impose requirements that the burdens be substantial.\[32\] A competition standard is unlikely to render all anti-competitive practices subject to successful challenge under the disparate impact laws. Regardless of whether courts overrule *Teal* or otherwise reign in the multiple plaintiffs problem,\[33\] the argument of this paper is simply that an otherwise objectionable practice (i.e. a prima facie disparate impact) is not rendered less objectionable by a showing that the practice was anti-competitive.

This section has shown how the competitive standard furthers both equity and efficiency. But stepping back, we can now see that this standard is an attempt to make civil right’s law continuous with and complementary to the law of antitrust (which attempts to discourage supra-competitive pricing) and the law of consumer protection (which attempts to discourage unconscionable pricing). While this attempt might at first seem like a category mistake, the convergence is not strained. As emphasized in the introduction, market failure and racial disparity often appear hand in hand. Similarly, minorities are disproportionately the victims of anti-competitive and unconscionable practices. It is therefore natural to build bridges across these connected areas of law.

But harmonization is a two-way street. The foregoing analysis also suggests that antitrust and consumer protection enforcement can be mobilized to make markets less discriminatory. Indeed, enforcement authorities in these related areas might do well to look for market processes

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\[32\] See Sullivan, supra note 30.
that produce racial disparities as a guide to consumer-oriented intervention more generally. And
civil rights’ authorities might do well to look for places of market failure as a likely indicator of
discrimination.  

II. THE STANDARD COMPORTS WITH THE EXISTING PRECEDENT

This competition standard also comports with a careful reading of the Civil Rights Act of 1991 and its judicial interpretations. The Act requires an employer "to demonstrate that the challenged practice is job-related for the position in question and consistent with business necessity." The simplest and strongest reason to reject a business necessity defense for anti-competitive practices is that firms are not forced to act anti-competitively.

It is not consistent with business necessity to price or wage gouge. Competition may force firms to pay paying employees wages commensurate with their productivity (or to charge prices commensurate with their costs), but neither competition nor anything else forces an employer to exploit its market power. Market power may be thrust upon a firm, but a firm is not forced to exercise it in either the wage or product markets. There is a world of difference between enjoining a practice that will leave a firm (or an activity within a firm) unprofitable and enjoining a practice that makes a firm less profitable but still covering its costs.

A. Job Related

Opponents of disparate impact liability tend to focus on the “job related” language

33 I in fact have argued that Teal should be repealed. See Ayres & Siegelman, supra note 28, at 1517; see also Cynthia Estlund, Wrongful Discharge Protections in an At-Will World, 74 TEX. L. REV. 1655 (1996).
34 Labor economists have long noted an analogous strategy among unions to target for organization drives industries that earn supra-competitive profits and hence have more potential for increasing wages. See, e.g., Nancy Rose, Labor Rent Sharing and Regulation: Evidence from the Trucking Industry, 95 J. POL. ECON. 1146, 1163 (1987).
Instead of the “business necessity” language of the defense. But it turns out that even if the “consistent with business necessity” requirement were somehow read out of the statute, the “job related” requirement would by itself exclude as a defense the exploitation of market power. The statute does not speak in terms of “business related” or “profitability related” justifications but restricted the defense to policies that are “job related for the position in question” – that is related to employees’ ability to do the particular job. The phrase “job related” hence can be used to restrict analysis to policies that screen for differences in employee productivity on the job, and would exclude market power differences – which often relate to an employee’s opportunities to perform other jobs rather than the employee’s ability to perform the job at hand.

Returning to our original example, an employer who pays non-graduates less not because they are less productive but only because they have fewer employment alternatives should fail in an attempt to “to demonstrate that the challenged practice is job-related for the position in question.” Far from being related to the job in question, the practice of paying lower pay is instead related to the absence of other jobs being offered.

This reading of the statute also resonates with the Supreme Court’s first attempt to grapple with the contours of the defense. In *Griggs v. Duke Power Co.*, the Supreme Court repeatedly emphasized that to qualify as a defense the practice had to be related to job performance:

> The Act proscribes not only overt discrimination but also practices that are fair in form, but discriminatory in operation. The touchstone is business necessity. If an employment practice which operates to exclude Negroes cannot be shown to be related to job performance, the practice is prohibited.

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36 *Griggs*, 401 U.S. at 432. *See also id.* at 426 (stating that the practice must be “significantly related to successful job performance”); *id.* at 431 (practice must be “related to job performance”).
And:

[G]ood intent or absence of discriminatory intent does not redeem employment procedures or testing mechanisms that operate as 'built-in headwinds' for minority groups and are unrelated to measuring job capability.\(^{37}\)

An employment practice that exploits an employer’s market power is not related to job performance or to measuring job capability. The court concluded that the high school diploma requirement at issue in the case was not “shown to bear a demonstrable relationship to successful performance of the jobs for which it was used.”\(^{38}\) It is fairly clear under Griggs that a policy of refusing to promote workers to higher-paying jobs would be unjustified if it was motivated not by the workers’ ability to perform the job in question but simply as a way to exploit the employer’s market power over un-promoted workers. Even if profitable, the practice would be unjustified because Griggs limited the defense to practices that were related to job performance.

We see a similar analysis in Dothard v. Rawlinson.\(^{39}\) In reviewing a minimum weight requirement which was shown to have a disparate impact against women applicants, the Supreme Court required that to establish a business justification, the defendant must show that the criterion was "essential to effective job performance."\(^{40}\) Indeed, this emphasis on the job performance is central to the established tripartite methods of validating employment tests. Under the EEOC Guidelines, there are three techniques of validation: criterion, content and construct validation.\(^{41}\) Criterion validation requires the employer to establish a statistically significant correlation between successful performance on a selection device and successful performance of the job. Content validation requires the employer to establish that the selection

\(^{37}\) Griggs, 401 U.S. at 432 (emphasis added).

\(^{38}\) Id. at 431. See also id. at 432 (practice must have "a manifest relationship to the employment in question").


\(^{40}\) Id. at 331.
device directly measures important job-related behaviors (such as a typing test for a typist). Construct validation requires the employer to establish that the test measures the more abstract characteristic it claims to measure, and that this characteristic is important to successful performance on the job. The touchstone of all validation is relating the selection criterion to the ability to perform the job in question. It is easy to imagine a test that elicited information not about an applicant’s ability to perform the job but instead about the applicant’s bargaining power. But a test which succeeded in identifying applicants with low market power – even if it dramatically increased the employer’s profits – could not meet the demands of criterion, content or construct validation because it is not related to the ability of applicants to perform the job in question.

B. Legitimate Business Objective

But courts in struggling to define the contours of the business justification defense have not spoken with a single voice. While the Supreme Court’s early disparate impact cases tied the defense to job performance, New York City Transit Authority v. Beazer in its brief analysis of business necessity shifted the emphasis toward whether the practice furthered the employers “legitimate employment goals.” As Linda Lye has observed: “With a deft sleight of pen, the Beazer Court borrowed Dothard’s language on safety and efficiency but shifted the focus away from the narrow requirement of job performance and instead to the more amorphous category of

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42 Indeed, the GAPSFAS form that many students fill out can be seen as just such a “test.” The University says, “You tell us (under penalty of perjury) how much you can pay, and then we’ll tell you how much (net of scholarship) we’ll charge you to attend.” See Aaron Edlin & Ian Ayres, Why Legislating Low Tuitions for State Colleges is a Mistake, FINDLAW’S LEGAL COMMENTARY, Oct. 30, 2003, http://writ.news.findlaw.com/commentary/20031030_ayres.html.
employment goals.”

The embrace of legitimate business objectives as an alternative to job performance could also be seen in lower court options. For example, in *Christensen v. State of Iowa*, a class of female employees at the state university brought a disparate impact action challenging the University's practice of paying less for clerical work than it did for maintenance work of “comparable value to the employer.” The Eight Circuit summarily rejected the plaintiff’s claim:

[Plaintiffs’] theory ignores economic realities. The value of the job to the employer represents but one factor affecting wages. Other factors may include the supply of workers willing to do the job and the ability of the workers to band together to bargain collectively for higher wages. We find nothing in the text and history of Title VII suggesting that Congress intended to abrogate the laws of supply and demand or other economic principles that determine wage rates for various kinds of work. We do not interpret Title VII as requiring an employer to ignore the market in setting wage rates for genuinely different work classifications.

We’ll return to this case when we discuss the Supreme Court’s recent decision in *Smith v. City of Jackson*. But for now, suffice to say that the decision cannot be read as merely judging whether the University’s pay practice was geared to job performance; instead, it embraced as legitimate the objective of matching market-generated wages.

This shift from a “job performance” to a “legitimate business objective” requirement also played out in the struggle to pass what ultimately was became the Civil Rights Act of 1991. Senator Edward M. Kennedy originally introduced a bill that required that “the practice must

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45 563 F.2d 353 (8th Cir. 1977).
47 563 F.2d at 356.
bear a significant relationship to successful performance of the job.’” But the first Bush administration “insisted that it would only sign a bill that permitted employers to use selection practices that served legitimate business objectives, even if these objectives did not concern successful performance of the particular job in question.”

A fair reading of the post 1991 cases suggest that lower courts have continued at times to ask whether an employer’s practice furthers a legitimate business goal – even if the goal is unrelated to the employee’s job performance. For example, in *Fitzpatrick v. City of Atlanta*, the Eleventh Circuit found that a fire department’s interest in worker safety was “an important business goal” and that the department’s “clean shaven” requirement was reasonably necessary to achieve this goal.

There are many ways to read the opinion as consistent with the idea that selection devices must relate to the ability of employees to perform the job. A central contention in the litigation was that oxygen masks might work better on clean-shaven firemen, meaning that bearded employees may not be as effective at putting out fires. But even if we take the emphasis on employee safety as a legitimate business objective that is separate from the employee’s ability to

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51 2 F.3d 1112 (11th Cir. 1993).
52 The idea of non-job-related but legitimate business goal practices is also discussed in Browne, *supra* note ___, at 347-48:

[H]iring procedures may be adopted for legitimate business reasons other than prediction of future job performance. For example, in *Wards Cove* the employers had entered into a hiring-hall agreement with a largely Filipino union local in Seattle. As a result, the positions for which the union supplied employees were held disproportionately by Filipinos. If a black person had challenged the employers’ use of a hiring hall on the ground that a disproportionately small number of blacks were hired for cannery positions, the employers could not possibly defend on the basis of “job performance,” since that would require a showing that employees procured through the hiring hall performed better than potential employees who were excluded because of the hiring-hall agreement. However, the usual reason for an employer's entering into a hiring-hall agreement is not that employees hired under such an agreement will perform better than other employees. Rather, it is to maintain a reliable source of labor.
perform the job, we should see that this objective is radically different that the objective of an employer to exploit its market power over a worker. The first is an objective to protect the employee; the second is an objective to profit by injuring the employee. So even a more expansive reading of business goals would read wage gouging or the exploitation of an employee’s lack of market power as illegitimate.

The most troubling precedent about what might legitimate business objectives is also the most recent. In *Smith v. City of Jackson*, the Supreme Court rejected a disparate impact claim based on age against a city’s plan for raising the wage of its police officers. The policy caused “almost two-thirds (66.2%) of the officers under 40 [to receive] raises of more than 10% while less than half (45.3%) of those over 40” did not receive a raise. Notwithstanding this disparity, the court found the city’s plan justified:

> Thus, the disparate impact is attributable to the City’s decision to give raises based on seniority and position. *Reliance on seniority and rank is unquestionably reasonable given the City’s goal of raising employees’ salaries to match those in surrounding communities.* In sum, we hold that the City’s decision to grant a larger raise to lower echelon employees for the purpose of bringing salaries in line with that of surrounding police forces was a decision based on a "reasonable factor other than age" that responded to the City’s legitimate goal of retaining police officers.

Even though the court was evaluating the plan in terms of the age discrimination act’s specialized RFOA (“reasonable factor other than age”) affirmative defense, the Court’s reasoning harkens back to the Eight Circuit’s analysis in *Christensen v. State of Iowa*: “We find nothing in the text and history of Title VII suggesting that Congress intended to abrogate the

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53 125 S.Ct. at 1546. Bizarrely, the Court ruled that the plaintiffs had “not identified any specific test, requirement, or practice within the pay plan that has an adverse impact on older workers” – even though the very next paragraph described in detail the operation of the city’s algorithm of dividing the five basic police officer positions into “a series of steps and half steps.” *Id* at 1545. The algorithm gave larger percentage wage increases to officers in the lowest steps that were disproportionately under 40. If *City of Jackson* does not constitute a specific practice, one wonders what does.

54 *Id.* at 1546.
laws of supply and demand or other economic principles that determine wage rates for various kinds of work.\textsuperscript{55} The problem here is that following the law of supply and demand might easily allow employers to exploit advantages in market power – in ways that disproportionately hurt women and minorities who are equally productive.

The Supreme Court is wrong to say it is unquestionably reasonable to raise “employees' salaries to match those in surrounding communities.” The problem is that the court has been focusing on the wrong half of the equation. It is indeed reasonable for an employer to pay high wages to those workers who are in high demand. Profit-maximizing firms have strong incentives not to overpay employees and the willingness of other firms to pay a high wage is accordingly strong evidence that the high market wage is deserved. But the problem lies with regard to the low wage employees. An employer who merely matches the market salaries of low wage employees may merely be reflecting these employees’ relative lack of market power. The market wage for these employees may be low – not because they are less productive – but merely because they are more dependent on this particular job.

Indeed, the foregoing example of wage gouging might be hidden within the very \textit{City of Jackson} record which the Supreme Court finds so unproblematic as a matter of law. The police officers who garnered low raises under the system geared to match salaries in other communities might end up with less simply because this type of worker in community after community has low mobility and thus has fewer employers vying for her labor. The wage setting of a monopsonist is not rendered more reasonable merely because another monopsonist charges a similarly low wage.

In a sense, the Supreme Court’s ruling in \textit{City of Jackson} supports the thesis of this paper

\textsuperscript{55} 563 F.2d at 356.
because it seems to be relying on a competition test in determining the reasonableness of an employer’s wage-setting. But relying on a market test without credible evidence of actual competition for low wage employees can reify market failure. When there is not sufficient competition for immobile workers, then “meeting competition” becomes simply another phrase for paying as little as the market will allow. If addressed head on, I predict that courts would be reluctant to accept the exploitation of worker bargaining weakness as a legitimate business justification for paying equally productive workers less.

C. Reasonable Accommodation

Asking employers to ignore workers’ willingness to accept (that is their willingness to supply labor) in setting wages is still jarring. It is a first principle of economics that supply and demand must eventually equilibrate. But we should remember that the competitive process itself tends to force sellers to ignore certain aspects of demand. Competition among sellers forces individual sellers to price their products at their marginal cost – irrespective of the demand conditions. Competition forces the equilibrium price toward sellers’ marginal cost. Milton Friedman pointed out that sellers may not be conscious of their marginal cost pricing strategy.\(^{56}\) It may not be their intention. But Friedman pointed out that competition among sellers causes individual sellers to behave “as if” they were intentionally setting price equal to marginal cost – to behave as if they were ignoring the demand conditions in the market.

The same argument goes for employers in wage-setting. Competition among employers will cause them to ignore the worker’s supply conditions; instead, it will lead them to set the wages equal to the employee’s marginal product. The competition standard suggested in this

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\(^{56}\) See MILTON FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS (1953).
paper is asking employers and manufacturers to ignore just the factors that they would be forced to ignore in a more competitive market.

The law of reasonable accommodation of disability resonates with this duty to ignore. Indeed, it goes even further because it demands that employers not only ignore the supply conditions, but also ignore some of components of marginal cost. Mark Kelman has insightfully shown how the duty of reasonable accommodation is asymmetric with regard to different components of marginal productivity.57 In choosing whether to employ a disabled worker, the duty of reasonable accommodation effectively forces employers to ignore certain differences in the “net” productivity of employees and instead focus on their “gross” productivity. For example, consider an employer that is hiring typists at an annual salary of $30,000. Imagine that the ability to accurately type 60 words per minute is determined to be an “essential function” of the job. Reasonable accommodations would almost certainly mean that an employer would be required to spend up to $2000 a year to rent a special keyboard to accommodate a disability of the employee so that the employee would be able to type 60 words per minute. There is a duty to accommodate out-of-pocket costs. But the asymmetry of the accommodation demand with regard to marginal productivity is that the employer does not need to accommodate any shortfalls in production. Thus, consider the case of an applicant with mild dyslexia who can only type 59 words per minute. Imagine that there is no out-of-pocket accommodation that will improve this applicant’s typing speed. But also imagine that the slower typing only costs the employer $1000 in lost profits. The ADEA requires the employer to hire the applicant who imposes a $2000 out of pocket cost, but does not require the employer to hire the applicant who imposes only a $1000 cost of foregone profits.

Employers thus have to ignore a certain amount of out-of-pocket cost differences that impact employees’ net marginal product. But employers do not have to ignore (that is, employers do not have to accommodate) differences in the gross productivity of their employees. If a disabled employee who has been accommodated with additional training costs still cannot perform all of the “essential functions,” the employer can refuse to hire or can fire that employee.

But, of course, the employer’s largest out-of-pocket cost of employment is the wage that an employer pays. The largest accommodation claim should be on wage differences driven by exploiting differences in market power. Just as an employer has to take on extra out-of-pocket costs with regard to training or accessibility accommodations, employers under the theory of this paper should have to take on the extra cost of paying higher wages to immobile employees who could have been wage-gouged.

Consider again our earlier example of an employer who paid higher wages to high school graduates than non-graduates. Kelman’s reading of the reasonable accommodation suggests that an employer that justifies the policy with a showing of differences in gross productivity stands on the strongest ground. An employer that justifies the policy with a showing of differences in out-of-pocket training costs stands on weaker ground (because even here limited claims of accommodation may be appropriate). But an employer that justifies the policy with a showing that it was exploiting differences in market power would stand on the weakest ground (because price gouging should not justify disparate racial impacts).

The hypothetical competition standard for business justification is thus consonant with the asymmetric demands of our accommodation law. Reasonable accommodation law already forces employers to ignore certain components that impact firm profitability. A prohibition on
wage-gouging (or price gouging) merely asks the employers to ignore certain other components. Indeed, the demands of the competition standard are less far-reaching than the reasonable accommodation demands, because reasonable accommodation demands that employers ignore certain out-of-pocket costs that would drive behavior in a competitive market, while the competition standard just asks employers to ignore information that would be irrelevant in a more competitive environment.

III. THE ECOA AUTOMOBILE LENDING LITIGATION

The foregoing sections put forward the economic and doctrinal argument for the simple idea that anti-competitive practices – even if profitable – should not justify otherwise actionable disparate impacts. But readers may still wonder whether this principle has any traction in real-world cases.

Up to this point, much of our discussion of employment has been animated by an example of “wage-gouging,” where an employer paid non-graduates less – not because they were less productive, but merely because the non-graduates were more necessitous. But because the Supreme Court has expressly limited the ability of plaintiffs to bring disparate impact claims based on the equal pay act,\textsuperscript{58} it is not in the wage-gouging realm that our real-world traction is to be found. It also seems clear that the foregoing theory of employers exploiting market power does not help resolve many hiring and firing rules. That is because while hiring and firing rules may disproportionately exclude minority workers and may be unjustified, they are not unjustified for the reasons explained above, i.e., because they are extracting disproportionate surplus from minority workers. In fact, the refusal of an employer to enter into labor contracts with a group
that is disproportionately made up of minorities produces a lack of privity that as a logical matter precludes the employer from exploiting its market power against this group.⁵⁹

Promotion cases provide a more fertile ground for application of the theory. If an employer sets up a promotion system that fails to promote workers – not because they are less productive than promoted workers, but simply because they are more willing to work at lower wages – then promotion rules can have the same effect as the wage story told above. Indeed, because promotions are routinely accompanied by wage increases, a promotion system that is based on an employer’s relative market power can be an effective tool for implementing wage gouging over time. Our earlier discussion of the Supreme Court’s recent decision in City of Jackson shows just this possibility.⁶⁰ The Court’s crucial error there was its failure to inquire whether the employer was failing to promote and increase the wages of equally qualified employees who merely had fewer opportunities for competitive offers.⁶¹

But the most important application of the theory to date can be found outside of employment. The anti-competitive conduct test has already played a central role in massive disparate impact litigation that has been brought under the Equal Credit Opportunity Act (ECOA) in more than a dozen class action suits against all of the major automotive lenders.

While this litigation is important in itself because it has changed industry practice for the good – curtailing some of the most egregious examples of interest rate-gouging in auto loans – it

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⁵⁹ Of course, as the earlier discussion of “dead-weight loss” showed, anti-competitive policies can disproportionately harm minorities by inducing them not to contract. See supra Section II.B. A policy that disproportionately harmed minorities by refusing to contract them might be actionable if the rationale for the policy was solely to extract a supra-competitive return from other workers. See supra text accompanying notes 48-50.
⁶⁰ See supra text accompanying notes 48-50.
⁶¹ Those of us in academic positions, for example, know that having a spouse with a unique job which they enjoy increases an institution’s market power over you. The spouse’s immobility deters other schools from offering lateral positions, and absent the spur of lateral offers, the dean can pay less. As in Smith, the problem lies not in meeting competition on mobile workers, but in the failure to raise the wage of the equally productive non-mobile
also affords me the opportunity to respond to a formidable set of critics. The industry defendants hired in succession Richard Epstein, James Heckman, and George Priest to defend the reasonableness of the industry’s price-setting practices. By airing and responding to their criticisms, this section further aims to set the anti-competitive conduct standard on a firmer ground.

A. Undisclosed Dealership Markups in Automobile Lending

Auto lending provides a powerful setting to test our intuitions about the foregoing theories because of the emergence of clear evidence of profit-enhancing policies that disproportionately burdened African-American borrowers. The automobile finance industry is large and provides a crucial service in facilitating people’s access to transportation. Mark Cohen reports that nearly 80% of all auto financing is done on site at a dealer and that so-called “captive lenders” have anywhere from 30-50% of this business with the remaining amount distributed over various lenders – including local credit unions as well as major national lenders. For example, the Wall Street Journal recently estimated that 40% of all General Motors automobile sales are financed through GMAC.

Although the details vary by dealership and by lender, the industry practice up until the litigation was fairly uniform and tells a damning story. When a car buyer worked with a dealer to arrange financing, the dealer would send the customer’s credit information to a potential lender. The potential lender would then respond with a private message to the dealer which


would offer a “buy rate” – the interest rate at which the lender is willing to lend. But lenders usually allowed the dealer to mark up this buy rate if the dealer could induce the borrower to sign a loan agreement with a higher interest rate. A dealership that marked up the loan would often be immediately paid by the lender – sometimes thousands of dollars – for passing on the inflated contract. For example, Nissan’s financial arm (the Nissan Motors Acceptance Corporation, or “NMAC”) might tell a dealership that they were willing to lend me money at a 6% interest rate, but that they would pay the dealership $2800 if the dealership could get me to sign an 11% loan. The borrower/buyer would never be told that the dealership was marking up the loan (and profiting on the markup). The dealership and the lender would split the expected profits from the markup, with the dealership taking the lion’s share thereof.

Lenders did not allow dealer markups on all of their loans. Some loan programs prohibited (or sharply restricted) dealers from marking up the buy rate. But until the class action lawsuits were filed in 1998, many of the lenders had loan programs which placed no limit on the amount the buy rate could be marked up. Indeed, even after the litigation was filed, many of the lenders routinely allowed up to a 3 percentage point dealer markup on a subset of their loan programs. This meant that a 6% buy rate could still be marked up to 9% -- a 50% increase in the price of money.

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64 See, e.g., Deposition of Kelly, Willis v. American Honda Finance Corporation, p. 61:
Q. Do your disclosure policies include disclosing the buy rate to the consumer?
A. The buy rate that we -- that we have from particular outlet? No.
Q. And do your disclosure policies include disclosing the markup to the consumer?
A. No need to. No.
Q. Do your disclosure policies include disclosing the existence of markup?
A. No need to. No.

This policy of allowing markups on selective loan programs created two potential sources of inequality. First, the lenders’ decision to grant dealers markup discretion (instead of requiring a standardized across-the-board markup) created the possibility that dealers would disproportionally burden minorities with loans that allowed markup. Second, the lenders’ decision to selectively ban markups on certain types of loans could induce a disparate racial impact if minority borrowers were less likely to qualify for the no-markup or low-markup loans.

Lenders’ policies for setting higher buy rates for borrowers with poorer credit scores also had a disparate impact against African American buyers. That is because African American applicants as an empirical matter had on average poorer credit scores than Caucasian borrowers. But the plaintiffs in this litigation were careful not to challenge the disparate racial impact of the lender’s buy rate policies. The plaintiffs in this litigation challenged only the disparate racial impacts of the markups—markups that were almost completely unrelated to the dealers’ or the lenders’ costs of doing business. The markup component of the APR is much closer to pure economic profit—or at least the markup compensation that exceeds the dealer’s cost of arranging the loan. It is highly implausible that the markups could represent payments for the dealers’ costs of arranging the loan, since when the lender and dealer negotiated loan arrangement

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66 The disparate impact created by tying buy rates to credit scores is potentially justified. People with poorer credit scores are more likely to fail to pay back their loans, or fail to pay them back in a timely matter, and thus impose higher costs on lenders. Buy rate policies that allow interest rates to cover lenders’ expected costs are presumptively legal—even if they lead to minority borrowers disproportionately paying higher interest rates. But buy rate policies that imposed grossly inflated rates on poorer credit-score borrowers might still be unjustified. If a poorer credit score imposes a 1% higher cost on a lender, but the lender increases the buy rate by 2% then this inflated, supra-competitive increment might, according to the theory of this paper, be actionable.

67 Many of the lenders’ programs did expose the dealer to a risk of borrower prepayment or nonpayment for the first two or three payments of the loan. See, e.g., Ayres Primus Report at 22. For example, if the borrower paid off the loan or failed to pay on the loan during this period, the dealer might have to pay back to the lender the compensation for arranging the marked up loan. But the industry norm was that the dealers did not bear the risk of paying back the principle if the borrower failed to pay. Testimony from dealers revealed that the three-month risk of a dealership losing its markup compensation did not restrain dealers from setting as high a hidden markup as they thought a borrower would be willing to sign. See, e.g., Ayres NMAC Report, at 37 (citing to deposition of Brent Adams).
compensation, it was usually on the order of two or three hundred dollars – much less than what
the markup compensation often turns out to be.\textsuperscript{68}

A prime example of the disparate impact of selective markup caps were the “recent
college graduate” programs offered by several lenders, which offered special interest rates that
dealers were not allowed to mark up. Just as the employer’s high school diploma requirement in
\textit{Griggs v. Duke Power} induced a disparate racial impact, the (recent) college diploma
requirement at times caused a disparate racial impact in markup as African American borrowers
were less likely to qualify for this favorable program.\textsuperscript{69}

Indeed, the standard industry practice with regard to all advertised “special APR” loans
was to prohibit dealerships from marking up the subsidized interest rates. But these below-
below market rates – including the 0\% specials that were ubiquitous in the wake of 9/11 – were
usually only available for “well-qualified” borrowers who had superior credit scores. In practice,
these special APRs created a “double whammy” that could dramatically increase the disparity in
interest rates paid. Imagine that a given lender was willing to lend to Smith at 6\%, and Jones at
9\% (because Smith had a better credit history). After 9/11 and the special APRs for well-
qualified borrowers, Smith might walk away from dealership with a 0\% loan, shielded from
dealer markup, while Jones might walk away with a rate as high as 12\%. What started out as a
justified 3\% difference might become an APR that was twelve percentage points higher.
Because minorities disproportionately fail to qualify as “well qualified borrowers,” they not only

\textsuperscript{68} AHFC, for example, as of 2004, typically paid dealers a loan arrangement fee of just $100 for
promotional loans. Ian Ayres, AHFC Declaration, at 7. In an unrelated example, one particular New York dealer
agreed, as part of a settlement with the Attorney General, to fixed-fee compensation for loan arrangement, and
estimated the fees would be in this same range. \textit{NY Dealer Sees Spitzer Settlement As A Win, CAR DEALER INSIDER 1}
(April 5, 2004) (“Metzner [the dealership owner] figures the average fee is about $225, but will rise to $300-350 as
more lenders come on board and he negotiates higher fees.”)\textsuperscript{69}

\textsuperscript{69} See for example Ayres NMAC report at 19 n. 24 (“Whites were 19 percent more likely than African-
Americans to borrow under defendant’s recent college graduate program” – but noting that this program only

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lose out on the APR buy-down, they are disproportionately subject to markups that are not related to dealer or lender cost.

The impact of the markup policies of five major automobile lenders – Primus, American Honda Finance Corporation (AHFC), Ford Motor Credit Corporation (FMCC), Nissan Motors Acceptance Corporation (NMAC), and General Motors Acceptance Corporation (GMAC) – is reported in Table 1 below. The table summarizes an analysis of over 3 million car loans including more 350,000 loans to African-American borrowers. Overall, African-American borrowers paid on average almost $400 more in markup than white borrowers in loans from these lenders. The average white markup was $302 while the average African-American markup was $695 – more than twice as high. Across the five lenders, white borrowers had a 31% chance of receiving a loan with a markup, while 53.2% of African American borrowers were marked up.

produced a small amount of the overall racial disparity).

This data is taken from Mark Cohen’s expert report in the Primus Automotive Financial Services (“Primus”) litigation. Primus is a wholly-owned subsidiary of Ford Motor Corporation and services many non-Ford brands such as Mazda, Volvo and Jaguar. I have also worked as an expert in litigation involving the following lenders American Honda Finance Corporation (“AHFC”), Ford Motor Credit Corporation (“FMCC”), Nissan Motors Acceptance Corporation (“NMAC”), General Motors Acceptance Corp. (“GMAC”), DaimlerChrysler Financial Company (“DFC”), Among the financial institutions were AmSouth Bank Corp (“AmSouth”), WFS Financial Inc. (“WFS”), BankOne, Bank of America, and U.S Bank.

The fact that median white borrower paid no markup is itself strong evidence of the disparate impact of lender programs which selectively banned dealer markup. The median white borrower paid zero markup not because whites were disproportionately adept at bargaining. Most whites were unaware that APRs were negotiable. Rather the higher proportion of no markup loans can be attributed to a higher proportion of whites qualifying for no-markup loan products.
The distributions of markups were highly skewed to the right. For example, over half of white borrowers paid no markup at all. But 10% of GMAC borrowers paid more than a $1000 markup and the top decile of NMAC customers paid a markup of more than a $1600. The top 10% of GMAC borrowers produced more than 63% of the GMAC total markup profits, while a mere 5% of GMAC borrowers produced 42% of the total markup profits. And the disparate racial impacts were even more pronounced with regard to borrowers in this right-hand tail of the markup distributions; the most profitable borrowers were disproportionately black. For example, while black borrowers represented only 8.5% of the overall GMAC sample of loans, they

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73 Cohen GMAC Report, tbl. 8. The story was much the same at the other lenders: The 5% of GMAC borrowers paying the highest markup paid 42% of the total markup profits. Cohen GMAC Report, at 3. Similarly, in FMCC, 25% of FMCC borrowers produced 53.1% of the total markup profit. Cohen FMCC Report, at Table 8. The 10% of Honda borrowers produced more than 65% of the total markup profits (a mere 5% of Honda Finance borrowers produce 41% of the total markup profits). Cohen AHFC Report, Table 6. At Primus, 10% of borrowers produced more than 45% of the total markup profits (a mere 5% of Primus borrowers produced 26.7% of the total markup profits). Cohen Primus Report, tbl. 6.
represented 21.7% of borrowers in the top decile of markup profitability.\textsuperscript{74} Or analyzed alternatively, African Americans were only 8.5% of GMAC borrowers, but paid 19.9% of the markup profits.\textsuperscript{75}

And the racial disparities tended to grow even larger the further one went into the tail. For example, in the fifteen states for which the data were coded by race, the top 500 Primus borrowers, who each paid more than a $4000 markup, were disproportionately black: while African-Americans were only 16.7% of the Primus borrowers, they represented 30.2% of these 500 most-profitable markups.\textsuperscript{76} The racial disparity was even more extreme for the top 100 GMAC borrowers in Alabama who each paid more than a $5000 markup: African-Americans were only 13.9% of Alabama GMAC borrowers but represented 62 of these 100 most-profitable markups.\textsuperscript{77}

Markup disparities of this magnitude are not plausibly driven by the costs of doing business with certain types of customers. When loan programs prohibit markups, lender compensation to dealers for loan arrangement is on the order of $200 to $400. But the data consistently revealed a substantial number of loans with markups above $1000 and even $1500. And the highest markups in the data were often on the order of three or four thousand dollars. Four thousand dollars cannot be described as compensation for the cost of doing business plus a

\textsuperscript{74} Cohen GMAC Report, tbl. 8. Again, same story elsewhere: While black borrowers were only 11.6% of the overall Honda sample of loans, they represented 26.5% of borrowers in the top decile of markup profitability. Cohen AHFC Report, tbl. 6. While black borrowers were only 16.3% of the overall Primus sample of loans, they represent 30.2% of borrowers in this top decile of markup profitability. Cohen Primus Report, tbl. 6. Or analyzed alternatively, African Americans are only 16.3% of Primus borrowers, but they pay 26.1% of the markup profits. \textit{Id.}

\textsuperscript{75} Cohen GMAC Report, tbl. 8.

\textsuperscript{76} Cohen Primus Report, app. D. Similarly, the top 500 Honda borrowers (from the 15 race-coded states), who each paid more than a $3600 markup, were disproportionately black: African-Americans are only 11.47% of the Honda Finance borrowers in the 15 states but they represented 36.4% of these 500 most-profitable markups. Cohen AHFC Report, app. D.

\textsuperscript{77} Cohen GMAC Report, app. D.
fair profit margin. Rather, my reports characterized these supra-competitive markups as “price gouging.”

The term “price gouging” has been legally defined. A number of states expressly prohibit price gouging in the aftermath of a natural disaster. For example, a Tennessee statute makes it unlawful for

any person to charge any other person a price for any consumer food item; repair or construction services; emergency supplies; medical supplies; building materials; gasoline; transportation, freight, and storage services; or housing, that is grossly in excess of the price generally charged for the same or similar goods or services in the usual course of business immediately prior to the events giving rise to the state of emergency. 78

Similarly, the New York price-gouging statute prohibits “grossly excessive” or “unconscionably excessive” prices. 79 The statute fills out the meaning of the excessive price standard:

[P]rima facie proof that a violation of this section has occurred shall include evidence that: (i) the amount charged represents a gross disparity between the price of the goods or services which were the subject of the transaction and their value measured by the price at which such consumer goods or services were sold or offered for sale by the defendant in the usual course of business immediately prior to the onset of the abnormal disruption of the market or (ii) the amount charged grossly exceeded the price at which the same or similar goods or services were readily obtainable by other consumers in the trade area. A defendant may rebut a prima facie case with evidence that additional costs not

78 Tennessee Price-gouging Act of 2002 § 47-18-5103
79 Mckinney’s Consolidated Laws of New York Annotated § 396-r.
within the control of the defendant were imposed on the defendant for the goods or services.

These statutes make it clear that the term “price gouging” is more than a free-form pejorative conclusion that the price charged is too high.

The markups observed in automobile lending – the price dealers exact for arranging loans – would clearly violate the gouging element of these price gouging statutes. The amounts “charged grossly exceed the price at which [similar] services were readily obtainable by other customers in the trade area.” Indeed, the analogy carries water in both directions. The types of pricing prohibited by the price-gouging states are not the types that are “consistent with business necessity.”

In real world settings, it may at times be difficult to distinguish policies that allow a business to cover its cost and earn a reasonable economic return from those that allow a business to earn supra-competitive profits. But the facts of the automotive lending cases did not present a hard case. The markups paid were not just supra-competitive, they were “grossly in excess of the price generally charged.”

The price-gouging statutes have traditionally only regulated pricing during emergencies or natural disasters. But the evidence from automotive lending shows that price-gouging can persist over longer periods when consumers have limited information (and sellers act to keep

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Richard Givens defended the traditional limited scope of the statute:  
The ability of the market to ration supplies through higher prices and encourage additional output because of the profit offered works only over a sufficient period of time and cannot avoid cutoff of supply to many when a spike-like price rise occurs for a temporary period, giving a windfall to holders of supply where encouragement of output cannot take effect within that time span. Over a longer period, antitrust rather than antigouging law becomes the protective legal principle most likely to turn out to work and to be useful. Price controls which continue in effect for an appreciable period cause shortages to develop rather than be overcome, and lead to the necessity for rationing supplies, with debilitating results that increase with time.
buyers uninformed). This article has not suggested making price-gouging per se illegal – but it
does suggest that price-gouging which disparately impacts minorities should at least as
problematic as advantage taking in the shadow of natural disasters.81

The markup litigation thus provides a stark test case for our intuitions about the central
thesis of this paper. We are confronted with a set of lender policies that clearly produced a
pronounced disparate racial impact. At NMAC, for example, the median markup for white
borrowers was $0, while the median markup for black borrowers was over $750.82 And the
lender policies were a but-for cause of that disparity because there would be no racial disparity if
Nissan dealer compensation were fixed at a constant, say, $300 per loan (or any other fixed
amount). But the lender policies were also clearly profitable. In exchange for engaging in a
paper-transaction (typically demanding only a minimal amount of time), where the dealer usually
bore no risk of repaying the principal, dealerships often reaped thousands of dollars in profits.
This is not the increased profitability of a policy that ensures that costs are covered, but rather the
increased profitability of prices that far exceeded cost.

The underlying facts in these cases thus ask very clearly whether price gouging can be
considered a business justification. Or put more formally, this litigation forces us to ask whether
policies that increase profits via supra-competitive pricing are a defense to a prima facie showing
of disparate impact. I predict that no court would say that price-gouging is a defense, or that
profitability created by price-gouging is a defense. In my capacity as expert witness, I was

Practice Commentaries, Mckinney’s Consolidated Laws of New York Annotated § 396-r.

81 Price gouging after a natural disaster while inequitable can actually enhance allocative efficiency. When the
demand for batteries is greater than the supply, then charging higher prices may do a better job than a lottery or first-
come, first-serve allocations in helping to assure that the batteries are not used for playing Gameboy. See Jack L.
Knetcsh & Richard Thaler, Fairness as a Constraint on Profit Seeking: Entitlements in the Market, 76 Am. Econ.
Rev. 728,735 (1986). Price-gouging to a subset of auto loan borrowers does absolutely nothing to enhance allocative efficiency.

82 Cohen Supplemental NMAC Report, at 60 (Table 22).
convinced that no court would accept the profitability of these markups as a defense to what the data laid so bare: a profound disparate impact. Indeed, I felt that just forcing the defendant attorneys or experts to utter the phrase “price gouging” – even if only to deny it – would go a long way toward convincing a court to accept the central thesis of this paper.\(^83\)

But of course my voice was not the only one heard in this litigation. Besides the able statistical experts and lawyers hired by both sides, the defendant lenders retained the services of three extraordinarily capable academics – in turn Richard Epstein, James Heckman and George Priest – to rebut the idea that policies that produce supra-competitive profits do not justify what would otherwise be an actionable disparate impact. These experts put forward a number of arguments for why liability was not appropriate given the facts of this case.\(^84\) Many of their opinions challenged whether plaintiffs had even established a prima facie case of disparate impact.\(^85\) A rehashing of that statistical and data-driven debate is not my aim in this paper. Instead, in the remainder of this section, I will focus on how these experts responded to the justification theory propounded in this paper.

B. Richard Epstein – “Competition Drives Out Unearned Rents”

University of Chicago law professor and titan of the law-and-economics movement, Richard Epstein was hired by Nissan Motors Acceptance Corporation (NMAC) to rebut my

\(^{83}\) My reasoning parallels the attempt of Alan Dershowitz in representing Klaus Von Bulow to lure the prosecution on appeal into “taking the bait” and rearguing the question of guilt. Alan Dershowitz, Reversal of Fortune (1986).

\(^{84}\) For example, defendants in various cases argued that: (1) Defendants were not “lenders,” but merely repurchased loans that had been initiated by dealers. See Epstein NMAC Report. (2) Defendants were justified in allowing markups, because if they didn’t allow dealers to price gouge, dealers would have directed the business to another lender that allowed price gouging. Priest Primus Report. (3) Defendants were justified in selective markup caps because they had a legitimate motive to try to sell cars. Epstein NMAC Report.

\(^{85}\) For example, as discussed below, George Priest argued evidence of disparate impact with regard to markups was not sufficient to prove that plaintiffs suffered a disparate impact with regard to the net impact of the transaction. See Priest, Primus Report.
price-gouging argument in the first class-action automobile lending suit to proceed to the stage of requiring expert reports and depositions. Epstein’s central argument was simply to deny the premise of price gouging. His elegant and simple syllogism went as follows: (1) the credit market is very competitive; (2) competition drives out supra-competitive pricing; (3) and therefore the interest rate pricing must be competitive. As Epstein testified in his deposition:

[Epstein’s argument was that the markup was an unearned increment by dealers. I knew that that had to be a preposterous statement of economic reality. Nobody gets a free lunch for that long, not on hundreds of thousands of transactions every day. And by your account, the dealers have done absolutely nothing to earn that money. That cannot be.]

In his deposition, Epstein’s a priori faith in the power of competition to eliminate all supra-competitive pricing bordered on the non-falsifiable:

Q: So one basis of your opinion is your assumption that market forces work efficient and this market is particularly efficient, so this discrimination could not possibly exist. You agree and one of your assumptions in your report is that the markup charges are related to the work performed by the dealer?

A. Uhm-hhm.

Q. And so if those two assumptions were proven to be false, then would you be prepared to withdraw the opinion in your report?

A. Again, I mean, proven to be false – what I would do is – no, I would ask the following question because I simply do not believe that unearned increments exist in this form.

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87 Epstein NMAC deposition, at 86.
By arguing that supra-competitive pricing is just not possible, Epstein was able to avoid confronting whether such pricing would be justified.\(^{89}\)

For Epstein, the great dispersion in markups was completely driven by differences in dealers’ loan arrangement costs. Even though Nobel Prize-winning economist and founder of the Chicago School George Stigler long ago understood that the price dispersion in new car prices could not plausibly be attributable to differences in cost,\(^{90}\) Epstein clung to the notion of purely cost-based pricing. Even stark evidence to the contrary – for example that the median NMAC markup for whites was $0 while 10% of NMAC borrowers paid more than a $1600 markup – would not shake Professor Epstein’s faith in competition.

Indeed, Epstein in his expert report suggested that there was a sharp dichotomy between the pricing of loans for two different types of borrowers:

As a general matter, credit markets are divided into two kinds of transactions: those in which there are no (or tiny) risks of nonpayment, and those in which there is a large but uncertain risk of nonpayment. A treasury bill is the prime example of a riskless form of security, whose interest rate represents only a fee that the borrower pays the lender for the use of the money over time. No private borrower has quite the credit of the United States government, but many purchasers of cars (homes, and other consumer goods) have never

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\(^{88}\) Epstein NMAC deposition 136-37. Professor Epstein’s indifference to the factual record can also be seen in this telling moment of his deposition:

Q. Let me ask you, do you recall–
A. I can’t even recall reading the depositions or doing anything with them.

\(^{89}\) While not a direct assault on my theory of justification, Professor Epstein did argue that my theory of disparate impact would essentially render superfluous disparate treatment liability: “[Ayres] version of the world is essentially one in which there's no percentage whatsoever for using a disparate treatment case anywhere, ever, because you will always do better as a plaintiff by using a disparate impact case.” Epstein NMAC Deposition, at 83. But this criticism clearly misses the mark. The theory of disparate impact justification suggested both in this paper and in my expert testimony would still allow defendants to avoid liability for policies that help them cover their costs of doing business. Cost-based statistical discrimination on the basis of race might therefore be justified under a disparate impact theory but would not be justified under disparate treatment analysis.

\(^{90}\) Stigler, in considering whether the dispersion observed in new car pricing could be attributed to cost-based differences, concluded: “it would be metaphysical, and fruitless, to assert that all dispersion is due to heterogeneity.” G. STIGLER, THE ORGANIZATION OF INDUSTRY 172 (1968).
defaulted on any loan or credit transaction and thus present a well-nigh riskless position. *Dealing in these markets is a straight interest calculation that involves little business acumen, for everyone will set about the same rate for the transactions.* Matters are far more complicated for high-risk credit transactions where the risk of nonpayment, late payment, or partial payment is paramount. In these cases, the negotiated interest must be sufficient to compensate for the additional risk . . .

Epstein reasoned that it was these additional difficulties of arranging loans for high-risk borrowers that justified the high dealer compensation.

But Epstein was never willing to confront the evidence that even borrowers with good credit scores still exhibited substantial disparities in markups. Cohen found that the average markup for black borrowers placed by NMAC in the best credit tier were $361 dollars higher than the average markup for whites placed in the same credit tier (average markup for Tier 1 blacks was $660 v. $299 for Tier 1 whites). Epstein’s own report opines that for these “well-nigh riskless” borrowers “[d]ealing in these markets is a straight interest calculation that involves little business acumen for everyone will set about the same rate for the transactions.”

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92 Cohen NMAC Supplemental Expert Report, at Table 20. The persistence of racial disparity across credit tiers was found for other lenders as well. For example, Cohen’s analysis of GMAC borrowers found substantial disparities within each credit tier for every year analyzed:

<table>
<thead>
<tr>
<th>Year</th>
<th>Credit Tier = S</th>
<th>Credit Tier = A</th>
<th>Credit Tier = B</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>$384</td>
<td>$127</td>
<td>$257</td>
</tr>
<tr>
<td>2000</td>
<td>$367</td>
<td>$111</td>
<td>$256</td>
</tr>
<tr>
<td>2001</td>
<td>$321</td>
<td>$92</td>
<td>$229</td>
</tr>
<tr>
<td>2002</td>
<td>$308</td>
<td>$106</td>
<td>$202</td>
</tr>
<tr>
<td>2003</td>
<td>$283</td>
<td>$100</td>
<td>$183</td>
</tr>
</tbody>
</table>

Overall | $323  | $102  | $221  | $523  | $191  | $332  | $786  | $384  | $402  |

Cohen, Imperfect Competition in Credit Lending at Table 4.
Epstein’s theory suggests that these borrowers would receive uniform and small markups. But the data are starkly at odds with his faith in market competition. Plainly, on Epstein’s own logic, cost could not have been driving disparities as wide as these. Something else was at work.

In February of 2003, the NMAC litigation was settled. NMAC agreed to three core remedies. First, NMAC agreed to limit its markup to 3 percentage points and 2 percent for longer-term finance agreements and 2 percent for used vehicles. Second, it agreed over the course of five years to offer 625,000 African-American and Hispanic borrowers pre-approved no-markup loans. And third, NMAC agreed to engage in substantially enhanced programs of disclosure and consumer education.

C. James Heckman – All Profits Are Justified

In the next case to reach the deposition/expert report stage, GMAC retained the services of one of the great econometricians in the world, Nobel Prize-winning economist James Heckman. Heckman’s report in the GMAC litigation concentrated on responding to the business justification argument at the center of this paper.

93 Cason et al v. NMAC, (Feb. 18, 2003) http://www.consumerlaw.org/initiatives/cocounseling/content/settlement_agreement.PDF
94 The implications of this race-dependent affirmative lending are discussed below at text accompanying note 127.
95 NMAC to contribute $1 million dollars NMAC will contribute $1 million to three national consumer financial education programs. NMAC also promised to mail an educational brochure in English and Spanish to existing customers annually for five years. And NMAC agreed to provide written disclosure on NMAC financing contracts forms that a customer’s annual percentage rate may be negotiable with the dealer. http://www.consumerlaw.org/initiatives/cocounseling/content/outline.pdf
96 One might thus have thought that Heckman would respond to the central econometric claim in my report (as well as the actual econometrics performed by plaintiffs’ expert Mark Cohen). In my report, I opined that in disparate impact cases, it was important to intentionally exclude from regression analysis controls for variables that did not provide a plausible business justification. Even though econometricians are used to worrying about the problem of omitted variable bias, I showed that in disparate impact cases the problem of “included variable bias” was more
So how did Heckman’s report critique the simple idea that policies which have a disparate impact are less justified if they extract supra-competitive profits than if they allow sellers to cover their costs? Like Epstein, Heckman tried to avoid the question, by denying the possibility of supra-competitive pricing. But unlike Epstein, Heckman did not say that the higher markups simply track the higher costs of loan arrangement for some customers. Heckman instead argues that the higher markup profits represented returns on entrepreneurial effort. This section will show that Heckman’s theory (like Epstein’s) ultimately represents a self-sealing, unfalsifiable conviction that firms “need to maximize profits to survive.”

Heckman’s theory that all profits – no matter how high – are justifiable returns to entrepreneurial effort is expressly Schumpeterian. Heckman states in his report:

Those who innovate make what Schumpeter called an entrepreneurial profit. The entrepreneurial activity is distinct from the investment activity which often bears the risk of the entrepreneur's projects. Hence the entrepreneurial profit is distinct from and in addition to any normal return to capital.

Under this Schumpeterian theory, the dealers’ seeming profits are nothing more than returns to

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Footnotes:

98 Id. at 17. See also JOSEPH ALLOIS SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY (1947).
entrepreneurial effort. This theory leaves no possibility for market failure or supra-competitive profit because all the additional revenue merely compensates the entrepreneur for their innovation. Heckman concludes: “[The] extra profits are not an illegitimate ‘market failure’ as Professor Ayres claims. Quite the opposite, they are the engine that drives economic development and growth.”99 Under this theory then, market failure is simply not possible. Heckman doesn’t have to consider whether price-gouging would be legally unjustifiable because, by his lights, there seems to be no such thing as price-gouging.

The Schumpeterian theory of profits as a driving force for innovation in the economy might seem a little misplaced in justifying dealership loan markups. But not to Heckman:

Acts of entrepreneurship do not need to be spectacular. A willingness to finance the sale of a product to someone who could not otherwise afford it, or in a locality that was not previously being served, are forms of innovation. Under accepted economic theory, these would entitle even as mundane an economic actor as a vehicle dealer to an entrepreneurial profit.100

While Heckman casts the dealer-entrepreneurs in a rosy light as finding new ways to finance “someone who could not otherwise afford it,” on the ground his report is trying to justify GMAC’s policy of allowing $5000 dealership markups on hundreds of loans. The true innovation lies not in new products or in servicing a new niche of clients, but instead in devising new ways to extract higher and higher markups from the unwary.

At core, Heckman argues that if firms fail to extract as large a profit as is legally possible, they cannot expect to survive in the Schumpeterian world of dynamic competition. If, say,

99 Heckman GMAC Expert Report, at 17. See also id. at 18 (“The presence of profits is not evidence of market failure, as claimed by Professor Ayres. The expectation of profits to be made provides the incentive to enter existing markets and to create entirely new markets by inventing entirely new ways to meet basic demands.”)
100 Id. at 18.
Microsoft dropped the $299 price of Windows XP Professional by a single dollar, it would put its corporate existence at risk. The reader will doubtless think that I am overstating Heckman’s view. He couldn’t have argued that it is a business necessity for firms with market power to maximize profits. But that is exactly what Heckman argues:

Professor Ayres contends "Exacting supra-competitive revenues from a class of consumers – not because they impose higher costs on the seller but merely because the seller has the power to do so – is not consistent with business necessity." But adopting practices to make the greatest profit subject to obeying the law is a business necessity. For a Schumpeterian there is no such thing as market power, because dynamic competition in Heckman’s words “annihilates” permanent surplus value. Heckman concludes: “[I]f ‘legitimate’ has any meaning in economics, the foregoing discussion shows that increasing revenues and profits is legitimate, indeed is the most legitimate activity of any business in a free market.”

The Schumpeterian competitive mechanism might be reasonably accurate in the long run. But to my mind the Keynesian retort – that “in the long run we are all dead” – is reason enough to be concerned about short run anti-competitive deviations. The difference between Heckman and myself is not the difference between dynamic and static analysis of competition; at core it is Heckman’s unconditional faith in corporate efficiency vs. my empirically-contingent views about the efficiency or non-efficiency of particular sellers. Heckman dismisses my own analysis

102 Heckman GMAC Report, at 18 (emphasis added).
103 Heckman GMAC Report, at 17 (“The competitive mechanism tolerates no permanent surplus values, but annihilates them . . .”).
104 Id. at 18.
as a “polemic” and biased: “Professor Ayres presents, in the guise of economics, what is really his own normative system.”

But Heckman’s untested Schumpeterian commitment and all its laissez-faire entailments represent at least as much a normative system.

If we follow Heckman’s argument to its logical end, then much of antitrust and consumer protection law must fail, as there should be a profitability defense to all business conduct. But there is of course a circularity in Heckman’s claim that maximizing profits “subject to obeying the law is a business necessity.” If the law proscribes price-gouging that has a disparate impact against minorities, then according to Heckman’s own analysis it is no longer a business necessity. In such a world, lenders who refrained from price-gouging would not be put at a Schumpeterian disadvantage by earning lower because by assumption the law would prohibit price-gouging by all lenders in the industry.

Heckman is willing to push his “profit-maximizing is a business necessity” where others fear to tread. Unlike Epstein or Priest, Heckman rose to the bait and openly embraced the wage-gouging hypothetical discussed above in Section I as being consistent with business necessity:

Ayres then gives an example . . . "Consider... an employer who institutes a policy of paying employees who are the primary care givers of school children a substantially lower salary.” The example is clever and polemical. Who could possibly justify such a heartless employer’s practice? [Ayres] goes on: "the employer should not be able to

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105 Heckman GMAC Report, at 15. See also id. at 3. ("[Ayres] phrases his methodology in economic terms. However his methodology depends on assumptions which fly in the face of fundamental principles of economics as a science as well as the principles on which free markets are founded.")

106 Heckman’s also claims that to forego a dollar of profit is economically equivalent to incurring a dollar of cost and therefore that no “valid economic distinction can be drawn between reducing cost and increasing revenue . . .”. Heckman Report, at 2. Heckman opines: “If there is an opportunity to earn revenue and the business fails to obtain it, economists refer to that as an "opportunity cost," Foregoing revenue is an opportunity cost. In the context of negotiation, if a buyer is willing to pay ten thousand dollars and the seller agrees to accept nine thousand dollars, that thousand dollars is an opportunity cost. Thus Professor Ayres’ distinction between revenue and cost is untenable.” Id. at 18. But many areas of the law distinguish between costs and opportunity costs. See, e.g., Fred S. McChesney, Tortious Interference with Contract versus “Efficient” Breach: Theory and Empirical Evidence, 28 J. Legal Studies 131 (1999).
justify paying caregivers less solely because these employees have fewer employment alternatives (say, because of a lower ability to move to other cities). . . “107

Heckman understands that the wage-gouging in this example is analogous to the price-gouging of the dealers – but sticking to his guns, he sees nothing wrong with paying equally productive workers less than they would earn in a competitive market: “Differential search costs of individual persons can produce a result where an identically productive individual gets a lower wage. Workers (male or female) who search less typically get lower wages. Some low wage jobs provide amenities like a location convenient for the employee’s other activities such as caregiving.”108 These sentences are carefully descriptive of economic equilibrium, and in the absence of legal intervention might be true. But Heckman was implicitly arguing that it is legitimate for employers to pay employees less just because they are less able to search for alternative employment. Implicitly he was arguing that it is a business necessity to wage gouge whenever possible. For Heckman, any firm that does not extract the maximum surplus from its employees and customers will soon be thrown on the scrapheap of history.

But this theory is surely not true in the short run and is even weaker in a world where all competitors are restrained from extracting supra-competitive profits that produce disparate impacts. It would be one thing for Heckman to argue that dynamic competition will eventually give rise to a Google-like competitor. But it is quite another to worry about a competitive disadvantage when all other firms in the industry are similarly constrained. Heckman’s strong-form Schumpeterian views are not generally accepted in the economics profession and they do

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107 Heckman GMAC Report, at 31. Heckman goes on to suggest that in this example I am imputing to the employer “an intention of disparate treatment of women caregivers.” Id. But this misses the mark. The example imputes to the employer only an intention to increase its profits by lowering the wage paid to equally productive but less mobile workers. Of course, an intention to wage gouge the vulnerable might result in a disparate impact on a protected class.
not resonate with a reasonable interpretation of ‘job related for the position in question and consistent with business necessity.’”\textsuperscript{109}

A court was never able to consider Heckman’s views, because in February of 2004 the GMAC litigation settled.\textsuperscript{110} The GMAC settlement paralleled the basic structure of the NMAC settlement, but the terms were even more favorable to the plaintiffs’ class \textsuperscript{111}

D. \textit{George Priest – Disparate Treatment and Disparate Impact Are the Same}

The most recent defendants – including Honda, Primus, and Ford – have turned to my friend and colleague, George Priest, as an expert witness. Priest’s testimony in the Primus litigation is particularly important, because the Primus case was the first suit to go to trial.

Unlike his predecessors, Priest did not argue that there was no evidence of supra-competitive pricing, he leveled another objection altogether:

There may be – in these top 100 examples here in Tennessee, there may be individual examples of exploitation of consumers in one way or another. I'm not saying that that doesn't occur. It's just exploitation by the dealer. The suit should be brought against the dealer . . . \textsuperscript{112}

So while Epstein argued that pricing-gouging was impossible, and Heckman argued that pricing-gouging was a business necessity, Priest instead argued that “exploitation” might have taken place but that it was not the lender’s fault. Priest never needed to grapple with the question of

\begin{flushleft}
\textsuperscript{108} \textit{Id.} \\
\textsuperscript{109} See supra note 7 and accompanying text. \\
\textsuperscript{110} See \url{http://www.consumerlaw.org/initiatives/cocounseling/content/GMACSettlementAgrmt.pdf} (Feb. 10, 2004) \\
\textsuperscript{111} For example GMAC agreed to a general markup cap of 2.5% (with a 2% cap for loans with a maturity of more than 5 years). \\
\textsuperscript{112} Priest Primus Testimony, at 55.
\end{flushleft}
whether profiting from anti-competitive behavior was a business justification, because he
carefully limited his testimony so as not to offer a business justification opinion.\textsuperscript{113}

Instead, Priest argued that plaintiffs failed to establish a prima facie case of
discrimination. His argument had two main components. The first component was his claim
that plaintiffs had failed to prove a disparate racial impact because they did not consider whether
other aspects of the transaction made up for the disparate impact that African American
borrowers disproportionately experienced on their loan markups. For example, Priest argued that
lower car prices or higher trade-in prices might have offset the higher markups. Priest never
provided evidence that African-borrowers were in fact paying lower car prices or higher trade-in
prices. He merely argued that these offset effects were a theoretical possibility and that plaintiffs
had failed to establish a prima facie case by presenting sufficient evidence to refute this
possibility.

In an earlier study of an individual Atlanta car dealership that I’d done as part of my
\textit{Pervasive Prejudice}? book, I had found that there was a positive correlation between vehicle
profitability and financing profitability – contrary to Priest’s suggestion of financing profit-as-offset.\textsuperscript{114} Priest’s argument also ignored \textit{Connecticut v. Teal},\textsuperscript{115} which held that an employer was
liable for a disparate impact violation if any part of its selection process has a disparate impact,

\textsuperscript{113} Q. Are you giving a legal opinion here today with respect to the business justification legal defense in the
case? A. No, I'm not.
Priest Primus Testimony, at 192.
\textsuperscript{114} \textsc{Ian Ayres}, \textit{Pervasive Prejudice} (2001). Cohen found a similar positive correlation in analyzing Honda data.
Cohen Honda Report, at 77.
\textsuperscript{115} 457 U.S. 440 (1982).
even if the final result of the hiring process is racially balanced. In effect, *Teal* rejected what has come to be known as the "bottom line defense."\(^{116}\)

Even if a bottom line defense were available as a matter of law in these types of ECOA claims, it was bizarre for Priest to argue that Dr. Cohen’s empirical evidence did not create a rebuttable prima facie case of racial disparity. Dr. Cohen found substantial and statistically significant racial differences in the markup profits. The mere theoretical possibility that dealers from time to time might match high vehicle profits with low markup profits is certainly not persuasive that they do this on average or in general.\(^{117}\) Certainly no Primus policy required dealers who marked up a loan higher to take a lower profit on the vehicle or trade-in portion of the transaction. It would be one thing for Priest to have argued that Primus deserved an opportunity to show that the disparate racial impacts were counter-acted by other aspects of the transactions that were disparately favorable to blacks. Primus almost certainly has better access

\(^{116}\) As a normative matter, I’m not a great fan of *Teal*. See Ian Ayres & Peter Siegelman, *The Q-Word as Red Herring: Why Disparate Impact Liability Does Not Induce Hiring Quotas*, 74 TEX. L. REV. 1487, 1517 (criticizing the perverse effect of *Teal’s* “no bottom-line defense” holding as punishing firms for success in hiring minorities). But its application to ECOA may be particularly appropriate if one concludes that Congress did not intend for disparate treatment on non-credit terms to operate as a defense to racial disparities found in credit terms. 15 U.S.C. § 1691 (2000).

\(^{117}\) This possibility that dealer’s might accept lower profits on the “front-end” of the transaction – by accepting a lower car price and vehicle profit – is undercut by the extreme size of some of the markups at stake. As pointed out by plaintiffs’ counsel, Clint Watkins, in his cross-examination of Professor Priest, setting vehicle price to fully offset some of the large markups would entail selling the car below cost:

Q. Now, is it really rational to think that a dealer would sell an automobile for, say, $8,000 below cost because they’re going to make $12,000 on the finance charge? Do you think that’s rational?

A. Sure.

Q. So, in other words, a customer can go to a dealer and buy a car $8,000 below cost. And the next day they can go to their bank and pay it off. And the dealer just lost $8,000; correct?

A. Well, if they pay it off immediately before the first payment, yes. Just to be precise.

Q. So if it works the way you think, this is a great opportunity for consumers in this country to go to dealerships and let them slam them on the rate, get the car below cost, and the next day go to their bank and pay it off. Aren't dealers simply too savvy to let that happen, Professor?

A. I think it happens all the time, where people use equity credit lines to pay it off or use other forms of assets to pay it off. . . .

Priest Primus Testimony, at 63 (March 10, 2005). This theoretical dealership stratagem of selling a car at a price below its cost would be truly risky in a world in which the borrower could turn around and immediately repay the loan.
to this information than the plaintiffs (who were never given in discovery information about these other aspects of the transactions). But it is quite another for Priest to argue that there is not a genuine question of fact about the existence of a prima facie case created by evidence of substantial racial markup disparities. Even if Teal is ignored, the showing of a disparate impact with regard to markup profits should be sufficient, until empirically rebutted, to make out a prima facie case.

Priest’s second core argument was that plaintiffs failed to prove a prima facie case because they did not compare the markups received by “similarly situated” white customers. The central flaw in Priest’s reasoning was to ignore the difference between disparate treatment and disparate impact claims. He expressly divorced his analysis from the elements of the case:

Q. The fact that this case was brought under a disparate impact theory was irrelevant to your report?
A. It yeah I – it's irrelevant to the economic analysis, yes. Again, it can't be totally irrelevant because I have to place the analysis in a context but it doesn't – the economics don't change according to the legal – the nature of the legal claim.

Q. Would you agree with this statement? In preparing your report, you completely divorced yourself from the issue of disparate impact or disparate treatment?
A. Yes, I tried to perform as clean and thorough an economic analysis as I could.  

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118 Priest Primus Deposition, at 21-22. See also:
Q. What is your understanding as an economist that you need to know as far as the difference between analyzing a claim based on a disparate impact theory and a claim based on a disparate treatment theory?
A. I don't think an economist can comment on that. I don't think there's any economic -- there's nothing from economic theory that relates to that distinction.

Priest Primus Testimony, at 70. And:
Q. So have you approached this case as an economist with an assumption that it was irrelevant to your report, the fact that this is a disparate impact case?
A. Generally, it's irrelevant, yes. . . .

Id.
In contrast, I expressly argued in my report and testimony that economic analysis should flow from the elements at issue in a case:

Because disparate treatment and disparate impact theories of discrimination have distinct elements, it is appropriate when testing for disparate treatment and disparate impact to use distinct statistical methods. When econometricians attempt to test for disparate racial treatment, the goal in a regression analysis is to control for all of the non-race variables that might have explained a particular set of decisions. The regression asks in essence whether -- after controlling for all potential non-race variables – the race, say, of a loan applicant determined the finance charge markup she would be asked to pay.

But tests of disparate impact require a different statistical method. Under a disparate impact theory, it is possible for decision-making policies that are facially race neutral to give rise to liability if they disproportionately burden the plaintiff class. For example, a practice of charging higher finance charge markups to applicants without a high school diploma still makes out a legal claim if this non-race criterion results in a disparate racial impact that has no business justification.\(^\text{119}\)

Because disparate impact as very different elements (especially in that it does not require proof of intent), it was (and is) axiomatic that different statistical tests were required.

But Priest in effect held plaintiffs to a disparate treatment standard. Priest adopted a Steinian view of civil rights economics: discrimination is discrimination is discrimination. For Priest, if there isn’t economic evidence of defendant’s disparate treatment of similarly situated people on the basis of race, then there isn’t discrimination. Plaintiffs’ statistics, for example, were unpersuasive to Priest as evidence of even dealership discrimination because these statistics failed to control for revenue characteristics.\(^\text{120}\) Dealers might have been charging higher markups

\(^{119}\) Ayres Primus Report (September 15, 2004), at 5-6.  
\(^{120}\) For example, Priest testified:
to borrowers because these borrowers had higher search costs or less access to information, and not because these borrowers were African American. If disparate treatment were being alleged, Priest would have a strong point. But in a disparate impact case, the prima facie question is very different. It is whether defendant’s policies had a disparate impact on a protected class.

Indeed, while Priest doesn’t explicitly take up my wage-gouging hypothetical, his approach would find wage-gouging based on worker immobility unproblematic as a matter of civil rights law. Even though the wage gouging was assumed to have a disparate impact against women, Priest would find the wage policy unproblematic because it would not be an example of treating similarly situated workers differently because of their sex. That is, the underlying differences in women’s mobility would justify their different treatment by the employer, who would be basing his wage decisions not on gender but on mobility.

Under the facts of these ECOA cases, the pertinent question is whether the defendants’ policies of granting dealerships selective markup discretion caused African-Americans to pay disproportionately higher markups. The answer to this question is clearly affirmative if one simply compares the observed markups to those that would have obtained if defendants had imposed a fixed dollar markup as compensation for arranging loans. If Primus instead had a policy of compensating $500 (or any other fixed dollar markup) on each loan, there would have been no racial disparities in the markups paid.121 Priest avoided the compelling prima facie

Q. Would you agree that one of the major differences in opinions held between you and Dr. Ayres is that you disagree that markup is revenue based and that you believe that it is more cost based? Would that be fair, at least to describe one of the primary differences between the two of you?

A. Yes. I think that's fair.

Priest Primus Testimony, at 33 (March 10, 2005).

121 This counterfactual also suggests that the causation requirement should merely be that the defendant’s policy was a but-for cause of the disparity, not that the defendant’s policy was the sole but-for cause of the disparity. Even if the plaintiffs’ unwillingness to educate themselves was also a but-for cause, a defendant whose policy is a cause of the disparity should still be liable. In antitrust, courts never inquire whether anticompetitive harm caused by defendant conduct is somehow excused by consumers’ contributory negligence. William M. Landes, Optimal
evidence of a disparate racial impact by insisting that all economic analysis of discrimination must be an analysis of disparate treatment.\textsuperscript{122}

Priest’s insistence on disparate treatment analysis would also have significant and unjust effects on the certification of such suits as class actions. For example, in the parallel litigation against Honda Finance, Priest argued that his requirement of comparing class members with “similarly situated whites” would make the litigation ill-suited for class certification:

To adequately determine whether there is some form of racial discrimination in the setting of dealer (again, not AHFC) markups, it will be necessary to examine and evaluate the multi-faceted transactions of each class member and compare them to the transactions of similarly situated whites. This is likely to prove an extraordinarily difficult task that must be completed on an individual-by-individual basis.\textsuperscript{123}

Priest’s disparate treatment standard would force plaintiffs to control for a seemingly endless

\textsuperscript{122}Sanctions for Antitrust Violations, 50 U. Chi. L. Rev. 652, 674 (1983) (“there should be no defense of contributory negligence”). In \textit{Griggs}, the Supreme Court never suggested that the failure of applicants to earn a high school diploma might have undermined proof that Duke Power’s policy caused a disparity. 401 U.S. at 432-33. See Peter Siegleman, Two-Party Disparate Impact in Employment Discrimination Law (working paper 2005).

\textsuperscript{123}James Heckman similarly conflated the requirements of disparate treatment and disparate impact: “Professor Ayres characterizes his report as a theory of how economists should test for the existence of racial discrimination in automobile credit rate spreads. The main premise of Professor Ayres’ theory is that in testing for such a disparity, economists should ignore the impact of all characteristics of the vehicle dealer and the vehicle buyer (except for race) who negotiate the transactions and of all factors that might affect the disparity. Thus Professor Ayres would have the economist ignore all of the factors that govern whether a disparity exists between \textit{similarly situated} individuals. The only exception Professor Ayres allows is for variables that meet his definition of ‘legitimate business need’ for either GMAC or the dealer.” Heckman GMAC Report, at 2. Heckman’s insistence on comparing “similarly situated” borrowers commits the same error as Priest; it imposes the requirements of disparate treatment on a disparate impact case. As Heckman sees, I would only require a comparison of borrowers who are similarly situated with regard to plausible business justifications. The plaintiffs in \textit{Griggs v. Duke Power Co.} without high school diplomas were not similarly situated with the promoted applicants who held high school diplomas – and according to Priest and Heckman should be excluded from the analysis. But the applicants with and without diplomas were similarly situated for the purposes of a disparate impact test because the Supreme Court found that conditioning employment on a high school diploma was not a valid business justification.
array of non-race factors that might have caused dealers to charge higher markups.

In contrast, the competition standard for business justification suggested in this article suggests that more class actions claims would be viable. Plaintiffs need to shows that common issues of fact predominate not just in establishing a prima facie case but with regard to the defendant’s justification rebuttal case as well. If price-gouging is a business justification, then it will be more difficult for plaintiff classes to be certified. As these cases illustrate, price gouging is often accomplished by sussing out a buyers’ willingness to pay based on a myriad of individualized variables. Under this inappropriately expansive definition of business justification, it would often become unduly burdensome to present class-wide proof. But in contrast, the competitive standard for business justification requires that plaintiffs only control for plausible expected cost differences across different borrowers. As this litigation shows, those plausible differences in expected cost are already well accounted for in the defendant’s database – especially in the defendant’s own choice of the buy rate – and easily discoverable. Obviously, the relative negotiation power of plaintiffs and defendants in civil rights litigation is often hugely affected by class certification. It also seems clear that the jurisprudence of justification can impact that critical moment in litigation enormously.

E. What the Litigation has Wrought

The Primus claims went to a bench trial in March 2005 before Judge Aleta Trauger in the Middle District of Tennessee. Professor Priest and I testified at length and I returned to the stand as the penultimate sur-rebuttal witness. Shortly after the end of trial Judge Trauger ruled from the bench: "What I have decided is that the plaintiffs have proved their case and that they will

123 Priest AHFC Report, at 29.
win in my decision,” Judge Trauger ordered the parties to attempt to reach a remedy or settlement in the matter, but warned the parties: “However, if I am put to it, I will decide how I will structure a remedy in the case.” At this writing, the parties have been unable to reach an agreement and the court has ordered mediation.

Stepping back, there is a strong likelihood that this litigation has reshaped loan pricing throughout the industry. The following table shows some of the major events in the litigation:

<table>
<thead>
<tr>
<th>Time Line</th>
<th>Markup Caps</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-Litigation</td>
<td>No CAPS at GMAC, FMCC, PRIMUS, Bank One</td>
</tr>
<tr>
<td></td>
<td>NMAC had 3% to 5% cap</td>
</tr>
<tr>
<td></td>
<td>AHFC 2% to 3.5% cap</td>
</tr>
<tr>
<td>GMAC and NMAC Litigation Filed – February 1998</td>
<td>PRIMUS institutes cap from 2% to 5%</td>
</tr>
<tr>
<td>Uncertain date – post Feb. 1998</td>
<td>GMAC introduces first rate cap = 4%</td>
</tr>
<tr>
<td>NMAC Report – May 17, 2001</td>
<td>GMAC lowers cap to 3%</td>
</tr>
<tr>
<td>August 15, 2001</td>
<td>FMCC introduces first rate cap = 3%</td>
</tr>
<tr>
<td>September 24, 2001</td>
<td>NMAC agreed to cap of 2% to 2.5%</td>
</tr>
<tr>
<td>November 1, 2002</td>
<td>PRIMUS lowers cap from 5% to 3% (2% on long-term loans retained)</td>
</tr>
<tr>
<td>March 1, 2003</td>
<td>GMAC agreed to cap of 2% to 2.5%</td>
</tr>
<tr>
<td>GMAC Settlement – February 10, 2004</td>
<td>PRIMUS lowers top cap to 2.5%</td>
</tr>
<tr>
<td>Post-GMAC Settlement</td>
<td>GMAC agreed to cap of 2% to 2.5%</td>
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</tbody>
</table>

Before the class action suits was filed, many of the lenders (including Ford Motor Credit and GMAC) placed no limits on the amount by which dealerships could mark up some of their loans.

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125 Id. See order to negotiate remedy available at http://www.tnmd.uscourts.gov/borlay20050527.pdf
But since 2001, a series of lenders have adopted successively lower markup up caps. Professor Heckman attributes some of these industry movements to the impact of the litigation and the indeed the ideas at the heart of this article:

[Ayres’s] advocacy has been influential in public debate and has been persuasive enough to induce defendants to settle some large cases. [H]is doctrines are likely to transform distribution practices of the automobile industry.

The import of the litigation can also be seen in the type of policies changes seen. Instead of across the board caps, many lenders have recently begun imposing smaller caps on extended term loans or loans over a certain dollar amount – which disproportionately burden minority borrowers. Most captive finance companies, banks and other reputable finance sources have imposed reasonable limits of 3% on the finance reserve. The industry publication, Automotive News, has recently opined:

Disclosure isn't required by federal regulations. But if the dealership discloses its share of the deal - which at 3 points or less is a reasonable fee for service - there's no moral problem. It's just business. If the customer knows what's going on, everything is fine. ... As always, honesty is the only policy.

128 The Table is taken from Cohen, Imperfect Competition.
131 See, e.g., Trustmark Rate Sheet, (May 1, 2004) (setting 1% markup on certain loans between 67 and 72 months). See also Nowadays, F&I Should Mean Fair and Impartial, AUTOMOTIVE NEWS (Jan. 12, 2004) (“Most responsible banks and finance companies are capping the finance reserve at three percentage points.”); Cut To the Quick, AUTOMOTIVE NEWS (Dec. 1, 2003) (“Rate caps have little effect on loan profit already clipped by sharp competition among lenders”).
132 See Opinion: California Sounds, supra note 107.
Indeed, some participants now see an almost inevitable movement toward flat-fee compensation.\textsuperscript{133}

Mark Cohen has estimated that the settlements to date may benefit more than 1.4 million black car borrowers an amount more than 800 million dollars.\textsuperscript{134} Minority consumer benefited not only from the reduced caps, but also from defendants’ promises to provide to offer "preapproval, nomarkup loans" to African-Americans and/or Hispanics.\textsuperscript{135} These “no mark up” loans represent a kind of racial set aside that are quite unusual in disparate impact settlements. Normally if a defendant’s race-neutral policy has an unjustified disparate racial impact, the defendant substitutes another race-neutral policy.\textsuperscript{136} Thus, for example, if an employment exam is set aside for having an unjustified disparate impact, a settlement would normally to substitute an alternative race-neutral exam – not a special exam for minority applicants. But under the guise of “affirmative lending” regulation,\textsuperscript{137} the litigants agreed to minority “no markup” set


\textsuperscript{134} See Cohen Damage Declarations in GMAC, AHFC, NMHC, Chrysler, Bank One, US Bank and Bank of America. This estimate probably represents a maximum potential benefit -- as some minorities may not take advantage of the no markup loans or dealers may substitute toward less constrained lenders (although the latter strategy is constrained by the industry-wide cap reductions).

\textsuperscript{135} The details of the promise are described by the Wall St. Journal:

Under such arrangements, auto lenders try to identify the race of potential applicants using ZIP codes or various databases that contain the details of previous loans they have issued. Once the race is established, the lender can send an offer of credit to the potential applicant. The offer discloses the annual percentage rate that the applicant qualifies for, which can't then be marked up at a dealership.


\textsuperscript{136} Bradley v. Pizzaco of Nebraska, d/b/a Domino's Pizza, 7 F.3d 795,799 (8th Cir. 1993), is one of the few cases in which a court ordered a race contingent remedy. The claim was that the defendant employer’s no beard policy had an unjustified disparate impact against African American employees who disproportionately were afflicted with “suffered from pseudofolliculitis barbae ("PFB"), a skin condition affecting approximately fifty percent of African American males.” Id at 796. But instead of enjoining the policy with regard to any employee who suffered from PFB, the opinion only required the employer to make an “exception to its no-beard policy for African American males who suffer from PFB.” Id. 799.

\textsuperscript{137} Race-dependent “affirmative lending” programs are explicitly countenanced as potential means to remedy “discrimination.”
asides. This innovation made it a lot easier for the parties to reach agreement. The class representatives and their attorneys could assure that minority borrowers would have greater access to no markup loans, but defendants would retain an (albeit reduced) ability to extract supra-competitive profits from white borrowers.

But the markup caps contained in the class settlements have also benefited consumers outside the plaintiff class. The reduced caps have saved white borrowers a bundle. Civil rights remedies are sometime seen as a zero sum game. That is, if a court orders defendants to hire more minorities or women, it will often be at the expense of whites and or men. But in this context, the plaintiff class of African-Americans has saved white borrowers hundreds of millions of dollars in loan markups. While African-American borrowers disproportionately pay high markups, it is still the case that the majority of borrowers who pay markups are white. For example, as reported above, while African-Americans were only 16.7% of the Primus borrowers, they represented 30.2% of these 500 most-profitable markups. But this of course means almost 70% of these markups were paid by non-black borrowers. While the caps disproportionately benefited black borrowers on a per capita basis, it is almost certainly the case that in aggregate white borrower benefits were larger – possibly twice larger – than the black borrower cap benefits. The movement of the industry toward progressively lower markup caps – which was plausibly caused by this litigation – has benefited thousands of white borrowers who

\[A\] lender may be permitted to establish a “special purpose credit program” in which “all program participants may be required to share one or more common characteristic (for example, race . . . ).

ECOA Regulation B, 202.8(b)(2).

\[138\] Based on the weighted averages in Mark Cohen’s expert report, for example, whites represented 82.2% of the borrowers who paid markups on their financing with Primus, AHFC, GMAC, FMCC, and NMAC.

\[139\] Cohen Primus Report, app. D.
will never even know they have been benefited. The overall consumer benefit may even be greater than $2 billion.\footnote{The transfer of such substantial dollars from dealers may impact the organization of car sales. Dealers traditionally have been able to charge disparate prices for 1) new and used cars, 2) loan markups 3) trade in amounts and 4) dealer options (insurance, rust proofing). The advent of Internet information has restricted price dispersions with regard to the sale price. The markup litigation has restricted price dispersion in markups. These reduced opportunities for supra-competitive profits may increasingly induce dealers to reorganize as no haggle, high-volume operations. In this new equilibrium, there would be few dealerships (and fewer fixed costs to support) and more standardized pricing. See Ayres, Pervasive Prejudice?, supra note 26, at 154.}

CONCLUSION

On one level, the subject of this paper is an important, but narrow question of disparate impact law – defining the appropriate contours of the business justification defense. I have suggested that anti-competitive conduct by a defendant should not provide a business justification defense in disparate impact litigation – even if the conduct increases the defendant’s profit. Policies that increase a firm’s profits by assuring that the firm covers its costs are presumptively justified. But policies that increase a firm’s profit above the competitive level do not justify disparate racial impacts. Price- (or wage-) gouging is simply not a business necessity.

On another level, this theory of business justification can clarify our understandings of both disparate impact and disparate treatment. Some analysts have viewed the disparate impact cause of action as merely a helpmeet for smoking out and deterring disparate treatment.\footnote{See supra. Some courts have adopted the tactic as well. See, e.g., Okruhlik v. Univ. of Ark., 255 F.3d 615, 625-26 (8th Cir. 2001); In re Employment Discrimination Litig. Against Ala., 198 F.3d 1305, 1316-17 (11th Cir. 1999).} Under this conception, any showing that a policy was motivated by profit and not prejudice should be sufficient to avoid liability. Even a price-gouging motive would seem sufficient to absolve a decision-maker of the wrong of intentional discrimination and hence undermine the
basis of any disparate impact suit. But this paper has challenged that conception.\(^\text{142}\) Not all increases in profitability are equal. Or, in the words of Priest and Heckman, not all profits are “similarly situated.” A policy that moves a firm from a sub-competitive level toward the competitive level of profits is much more attractive than a policy which extracts huge, anti-competitive profits from consumers or workers.

Advocates of stronger civil-right enforcement have been too ready to accept profitability as a defense. At times, these advocates have argued, reasonably, that firms should be forced to accept some modest reduction in profits to reduce the disparate impact of their policies. But their larger mistake has been in tacitly accepting that policies that generate bigger profits are presumptively more justified. Distinguishing pro-competitive increments to profits (those that let firms cover their costs) from anti-competitive increments to profits (those that let firms raise price above their costs) challenges this unconditional deference to the normative reasonableness of profitability. Through this lens we can now see that a policy that generates bigger anti-competitive profits is presumptively less justified. A defendant who comes into court and says it needs to maintain a policy because the policy permits the firm to gouge its employees or customers is making a less compelling argument than a defendant who says it needs to maintain a policy because the policy keeps the firm from losing money.

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\(^\text{142}\) This broader conception of disparate impact resonates with that adopted by Justices Blackmun and Stevens in a pair of decisions. See Wards Cove Packing Co. v. Atonio, 490 U.S. 642, 669-70 (1989) (Stevens, J., dissenting); Watson v. Fort Worth Bank & Trust, 487 U.S. 977, 1001-04 (1988) (Blackmun, J., concurring in part and concurring in the judgment). They objected that non-shifting disparate impact burdens (which were later displaced by the shifting burdens of the Civil Rights Act of 1991) were inconsistent with the independent wrong of disparate racial impacts:

In their view, business necessity was an affirmative defense to be proved by defendants after plaintiffs had successfully established the legal injury of disparate impact. Once a disparate impact had been shown, an employer might be excused from liability on a showing of legitimate motive, but no showing at all about the employer's motive was necessary for liability to be imposed.

Civil rights advocates have been reluctant to attack this profitability issue head on. In attacking particular policies, plaintiffs’ attorneys have at times relied on strained arguments that challenged corporate policies as being simply irrational or irrelevant – arguing that certain policies have either no impact or a negative impact on a firm’s profits. But the idea that firms adopt policies that systematically hurt their profits is often implausible to those of us with an economist’s mindset. It tends to lead back toward the idea of conscious disparate treatment driving policies that sacrifice profits in favor of discriminatory preferences. The unwillingness of plaintiffs’ attorneys to challenge profitable policies that produce disparate impact thus reinforces the idea that disparate impact liability was meant to merely supplement disparate treatment liability. 143

This paper instead suggests that disparate impact liability can also be a helpmeet of consumer (and worker) protection laws. Seeing that anti-competitive behavior can produce disparate impacts provides a more robust motivational theory for corporate action. Civil rights advocates need not fear arguing that a profit motive underlies a policy that disproportionately harmed a protected class.

143 Richard Primus has argued against the idea that “disparate impact law is merely an evidentiary dragnet designed to catch clandestine intentional discriminators”: [A]dopting that idea would erase the theory of Griggs, which . . . spoke explicitly about a concern with self-perpetuating racial hierarchies, hierarchies that could persist even in the absence of new discriminatory acts. As a matter of descriptive interpretation, it is problematic to interpret a doctrine in a way that so thoroughly ignores the fullest (and founding) judicial statement of that doctrine. As a matter of policy, and on the understanding (which I endorse) that the Griggs rationale is normatively desirable, it is problematic to choose an interpretation of Title VII that is wholly about present deliberate discrimination, given that history and de facto segregation remain relevant to the conditions of racial hierarchy in the workplace. To be sure, an honest assessment of the doctrine might require such a reading if Congress had endorsed Wards Cove in 1991. But the 1991 Act is a rejection of the Court's Wards Cove direction. See Primus, supra note 70, at 523 (discussing different plausible goals underlying disparate impact cause of action). Policies might also be misguided because of unconscious bias or other cognitive distortions. See Linda Hamilton Krieger, The Content of Our Categories: A Cognitive Bias Approach to Discrimination and Equal Employment Opportunity, 47 STAN. L. REV. 1161 (1995); Charles Lawrence III, The Id, the Ego, and Equal Protection: Reckoning with Unconscious Racism, 39 STAN. L. REV. 317 (1987); Amy Wax, Discrimination as Accident, 74 IND. L.J. 1129 (1999). But the resistance of corporations to such litigation suggests that profits are often at stake.
Finally, this paper is an invitation to think more about competition and consumer protection law from a civil rights perspective. Inequality and anti-competitiveness often go hand-in-hand. The ECOA litigation against the major automotive lenders is a vivid case in point. But it is part of a far greater “poor pay more” phenomena. It’s not a coincidence that antitrust and civil rights share a common concern – discrimination. Price discrimination and disparate-impact discrimination are often related. It is therefore not a misuse of disparate impact law to restrict anti-competitive conduct which has a disparate impact. And it would not be a misuse of competition or consumer protection law to restrict disparate impacts which are caused by anti-competitive conduct.  

144 The intentionally fluid phrase “unfair and deceptive” in the FTC and baby FTC acts, see, e.g., 15 U.S.C. §45(a)(1) (2000); NY GEN. BUS. LAW §§ 349 et seq. (McKinney 2002); CAL. BUS. & PROF. CODE §§ 17200 et seq., (or even the common-law standards for contractual “bad faith” and “unconscionability”) might evolve to encompass disproportionate profit-taking from minorities. For example, consider Connecticut’s contretemps with Acme RentACar. See Ian Ayres & Barry Nalebuff, Connecticut’s Speeder-Friendly Crackdown, N.Y. TIMES, Aug. 31, 2001, at A19. There, the State of Connecticut went after Acme for charging a $150 penalty for driving more than 80 miles per hour. The State challenged the policy on consumer protection grounds – arguing that it was an unfair and deceptive practice to profit from a liquidated damages provision. Id. But this paper suggests that the State might have alternatively challenged the unfairness of the practice as disproportionately extracting rents from minority customers. Of course, the disparate impact would have to be proved, but I would not be surprised to learn that there are a variety of backend fees that are disproportionately borne by minority customers.