INTRODUCTION

PAUL G. MAHONEY

SEARCHING FOR THE RIGHT MIX OF FREEDOM AND REGULATION IN CORPORATE LAW

MICHAL BARZUZA

REGULATORY STRUCTURE AND THE INTELLECTUAL PROPERTY SYSTEM

JOHN F. DUFFY

“A TOWERING FIGURE”

DOUGLAS LAYCOCK
INTRODUCTION

This is the fourteenth issue of the Virginia Journal. Prior issues have profiled thirty-nine different members of our faculty. That in itself speaks volumes about the level of scholarly activity on the Virginia faculty. This is a genuine community of scholars in which everyone seeks to contribute to our understanding of law and its role in society. This issue also highlights our breadth of research interests and methodologies. The three professors profiled here use varied mixes of doctrinal analysis, theory, interdisciplinary insights, and empirical analysis to shed light on intellectual property, religious freedoms, remedies, and corporate governance. Each of the three, however, has one important characteristic in common: Their work has had real impact on the world of legal policy and practice. I hope you enjoy learning more about these talented and influential scholars.

As a young scholar, Michal Barzuza has done something many would have thought impossible by generating powerful new insights in the well-rehearsed debate on the efficiency of state corporate law. She was the first to note that the structure of Delaware’s franchise tax creates an incentive for its legislature to increase the number of firms incorporated in Delaware but not their value. She has more recently turned her attention to Nevada, a relatively new entrant in the competition for charters. Nevada competes, as Barzuza notes, on the basis of more lenient liability standards for directors. This leads Barzuza to her most important contribution to the corporate law literature—that there is segmentation in the market for corporate law, with different jurisdictions seeking different types of firms. Much of her work uncovers subtle differences among states in areas of law that are often described as uniform.

John Duffy has made his mark in intellectual property as a scholar and litigator, putting his ideas to the test while arguing patent cases in the Supreme Court and courts of appeals. He is, indeed, one of the rare academics who can speak simultaneously and persuasively to fellow academics and practitioners. Duffy began his career with a splash, writing an article challenging a widely repeated, but little analyzed, assertion about the relative institutional competence of courts and legislators. I learned as a law student that legislatures were better able than courts to respond to rapid technological change because courts were institutionally disposed to move incrementally. Duffy and his co-author showed that this deeply conventional wisdom was wrong both in theory and in practice, as incumbent industries have the motivation and capacity to influence legislatures to preserve their advantages over emergent competitors. Duffy is best known, however, as the author of many of the canonical economic analyses of patent law and institutions.

Douglas Laycock, like John Duffy, moves seamlessly between the worlds of academic conferences, Supreme Court litigation, and policy debate. He is one of the most prominent figures in the field of religious liberty. Indeed, he has argued vigorously and consistently that the First Amendment’s religion clauses are first and foremost about liberty, both for the believer and the nonbeliever. He has staked out a position at odds with many contemporary theorists, that the government’s neutral stance towards varieties of religious belief and non-belief must be substantive, not merely formal. The difference plays out most obviously in cases involving the application of generally applicable laws that incidentally criminalize or interfere with religious practices. Laycock’s analyses of these cases are nuanced and contextual. They have put him in great demand as an advocate or expert in litigation, congressional hearings, and policy formation. Laycock is also a legendary teacher, thinker, and writer on the law of remedies.

Paul G. Mahoney
Dean
FOR more than thirty years, scholars have vigorously debated whether the interstate competition for incorporations is a “race to the top,” in which states work hard to offer value-maximizing corporate laws, or rather a “race to the bottom,” in which states lure managers—who affect incorporation decisions greatly—by offering them favorable protections at shareholders’ expense. The debate is well-developed; some might even say that the debate is stale. Michal Barzuza is still early in her career, but she has managed to refresh this debate by bringing new and important insights to the table. Barzuza has revealed overlooked variation among state corporate laws, collected surprising empirical data that cannot be easily explained by established understandings, raised new theoretical arguments regarding states’ incentives and firm heterogeneity, and exposed Nevada’s unnoticed strategy of market segmentation with lax law. Barzuza’s work is helping to create a new understanding of the market dynamics for corporate law—an understanding that has potential implications for other basic issues in corporate law.

Barzuza’s work on the interstate competition for corporate charters most recently led to her surprising findings about the state of Nevada. In two recent projects, “Market
Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction,” and the co-authored “What Happens in Nevada: Self Selecting into Lax Law?” (with David Smith), Barzuza argues that Nevada has embarked on a market segmentation strategy by offering strikingly lax law to corporations that seek protection from liability.

Conventional wisdom had it that Nevada imitates Delaware law and does not derive significant revenues from publicly traded corporations. Barzuza has found evidence to the contrary. Over the past decade, Nevada has raised its taxes on publicly traded corporations. It has also changed its law to protect managers at the expense of shareholders. Strikingly, officers and directors in Nevada face no liability for breach of duty of good faith, and no liability for breach of duty of loyalty except for intentional misconduct or knowing violations of law. In Delaware, by comparison, directors and officers are liable for any breach of duty of loyalty and good faith. Additionally, in Delaware, companies are subject to higher scrutiny when the corporation is subject to a takeover. Nevada, through its secretary of state’s website, also promotes itself as providing more protection from liability than Delaware.

Barzuza suggests that Nevada’s strategy of using lax law helps the state overcome significant barriers to entry in the market for corporate charters. By offering such law, Nevada caters to a group of corporations that are not served by Delaware law. Nevada has recognized what scholars have missed—not all firms are interested in the same type of corporate law. Some corporations have a stronger desire than others to free their officers and directors from liability for their acts. This variation in preferences among firms allows a state like Nevada to pursue a market segmentation strategy. Successfully attracting one segment of the market allows Nevada to charge supra-competitive prices and turn a profit.

Nevada’s lenient liability regime for corporate managers and directors mutes Delaware’s overwhelming market advantages in the competition for incorporations. First, Nevada’s law clearly spells out its no-liability regime, leaving little room for discretion in applying it. This means that Delaware’s main advantages of having a developed body of case law and a specialized judiciary do not provide a significant advantage over the application of clearly defined (and manager-friendly) Nevada law. Moreover, Delaware cannot respond to Nevada by offering similar law because such a move could hurt Delaware’s brand, risk triggering federal intervention, and require Delaware to reduce its price for incorporation. Finally, building on its traditionally lax law in other fields, Nevada has more credibility than Delaware in offering lax law.

Perhaps not surprisingly, the legislative history of the Nevada legislation shows a pronounced concern for the kind of corporations that its recently amended law would attract. The bill’s opponents were concerned that dishonest corporate managers would choose to incorporate in Nevada—opponents predicted that the bill would attract “scoundrels” and make Nevada “the hole in the wall.” There is another perspective, however. Certain firms might appropriately choose Nevada because, for them, Nevada law is efficient.

Attempting to distinguish between these two accounts, Barzuza and Smith investigated differences between firms that choose Nevada and firms that choose Delaware. They found that Nevada corporations file accounting restatements at double the national rate, and at least 30 percent to 40 percent more than corporations in Delaware. Their findings control for firm characteristics, and they remain significant in a matched sample of Nevada and Delaware companies based on size and industry. Barzuza and Smith also found that incorporation in Nevada is not associated with the premium of incorporating in Delaware, though it is admittedly not associated with a discount relative to other states either. The negative market reaction to a filing of an accounting restatement by a Nevada company, however, is stronger than in other states. Barzuza and Smith interpret these findings as consistent with the explanation that firms go to Nevada for different reasons. Mere incorporation in Nevada is thus a mixed signal. Barzuza and Smith argue, however, that the comparatively strong negative market reaction to accounting restatements by Nevada corporations suggests that, when
they restate, Nevada corporations reveal themselves to be more likely to be the type of corporation that incorporated in Nevada in order to seek high private benefits.

Barzuza's work on Nevada thus focuses attention on firm self-selection in a regime where firms choose their state of incorporation. Barzuza argues that such choices are revealing in ways that may help shape policy. For example, if firms that need regulation most opt for the Nevada regime, as is the case for at least some of the firms, shareholders and policymakers should be concerned. On the other hand, Barzuza suggests that the current system where corporations can choose the state of incorporation has an overlooked but important benefit. This firm self-selection, Barzuza argues, could send a useful signal. By transparently choosing Nevada and its lax law, firms reveal information that would otherwise be unavailable about insiders' preferences. Because incorporating in Nevada sends a mixed signal, however, it is unclear whether investors will adequately deter companies that incorporate there for invidious reasons.

Barzuza has developed this last signaling theme rigorously in a related context, where the signal seems to be clearer: the cross-listing of foreign firms on U.S. exchanges. In "Lemon Signaling in Cross-Listing," Barzuza develops a model of signaling of private benefits of control. The model assumes that the market cannot fully observe the differences in manager and controlling-shareholder self-dealing across firms. Under these assumptions, cross-listing—and thereby bonding to a strict jurisdiction—is a signal that insiders do not seek private benefits. Because bonding is more costly to managers who extract high private benefits than to managers who extract low private benefits, cross-listing can separate good managers from bad managers: Managers with less interest in private benefits will choose to cross-list and managers with more interest in private benefits will choose to remain in their home market.

As Barzuza points out, this separation creates a unique signaling behavior in firms that have a controlling shareholder, as many foreign firms do. Unlike managers, controlling shareholders can sell their opportunity to extract private benefits by selling their block of shares. The buyer pays a control premium that reflects, among other things, the potential to extract private benefits from the specific firm. Controlling shareholders may benefit from signaling that they extract high private benefits of control because that would increase the control premium a buyer would be willing to pay. The signaling of private benefits hypothesis thus predicts that managers and controlling shareholders would want to convey different signals. This distinction between two different types of “insiders”—managers and controlling shareholders—could be useful in understanding other choices corporate managers make, such as distributing dividends or raising capital.

Barzuza's recent work focusing on market segmentation is only one part of her contribution to the debate about the consequences of interstate competition for incorporation. In an earlier theoretical paper, “Price Considerations in the Market for Corporate Law,” 26 Cardozo L. Rev. 127 (2004), Barzuza first develops the notion that, in the market for corporate law, there is more complexity than previously understood due to heterogeneity in the incentives of both the states that devise corporate law and the firms that choose that law by selecting their state of incorporation. Barzuza focuses first on the price that Delaware charges for incorporations, which she argues is wrongly ignored in the debate about the consequences of the interstate competition for incorporations. Price considerations constrain Delaware: The more pro-managerial Delaware law becomes, the less the state can charge for its incorporation services and still guarantee shareholders' approval. Price considerations thus prevent Delaware from catering to managers' whims exclusively; it must also attend to shareholders' interests. The price dimension, Barzuza argues, can explain why Delaware law is more protective of shareholders than the law of other states that do not have the market power to charge meaningful prices for incorporations.

In “Delaware’s Compensation,” 94 Va. L. Rev. 521 (2008), Barzuza continues to explore the significance of the price that a state can charge for incorporation. In this paper, she
argues that there is a connection between the structure of Delaware's franchise tax law—the way in which it determines firms' annual franchise tax liability—and Delaware's corporate law. The current structure of Delaware's tax is suboptimal because it is not sensitive to firm value or performance. If the value of firms in Delaware is rising, Delaware receives no additional tax benefit; if it is declining, Delaware's revenues do not decline. Delaware collections are instead affected only by the number of incorporations. A franchise tax that is sensitive to firm performance would be superior to Delaware's current franchise tax, Barzuza argues, because it would align Delaware's incentives with those of shareholders and induce the state to offer corporate law that maximizes shareholder value. Such a franchise tax would have this effect even if Delaware faced no competition from other states over incorporations and even if shareholders were passive. Finally, Barzuza argues that, despite this suboptimal situation, Delaware may not have sufficient incentives to reform its franchise tax law. The current tax law creates a commitment to managers, and assures that Delaware will continue to cater to their interests in the future.

Barzuza has emphasized the role that price plays in the interstate market for corporate charters, but she has also examined that market more generally. In the co-authored “The Market for Corporate Law,” 162(1) J. Institutional & Theoretical Econ. 134 (2006), with Oren Bar-Gill and Lucian Bebchuk, Barzuza develops a formal model of the market for incorporations. It predicts that, in equilibrium, competition among states produces optimal rules with respect to issues that do not have a substantial effect on managers' private benefits, but such competition will not create optimal rules with respect to issues where managers' and shareholders' interests diverge. The model demonstrates that this may happen even where shareholders must approve reincorporation. Because Delaware has significant advantages that other states cannot replicate, shareholders may prefer Delaware over other states, even though its law is not optimal, and even where Delaware law disadvantages shareholders more than other states' laws. The paper analyzes why a dominant state such as Delaware might emerge, the prices that it would set, and the profits it would make. It shows how Delaware's market power allows it to charge a high price, and also to respond to entry by cutting its price. Working on this project helped Barzuza understand the sources of Delaware's dominance in the market.

Barzuza's work has demonstrated that factors like the price states can obtain for incorporations and the heterogeneity of firm and state preferences help determine whether state corporate law is optimal. Through some of her research, Barzuza became convinced that Delaware has better incentives to protect shareholders than other states, and she recently decided to look closely into that question. In “The State of State Antitakeover Law,” 95 Va. Law Rev. 1973 (2009), Barzuza examines differences among state takeover laws. Previous assessments of takeover law have taken Delaware law to be the relevant regime. In Delaware, managers who use defensive tactics in change-of-control situations must meet the enhanced fiduciary duties outlined in the famous cases of Unocal, Revlon, and Blasius. Conventional wisdom has largely assumed that all states follow Delaware's lead in applying this law. Barzuza, however, has shown that the limited available case law from the states actually tends to show considerable variation in courts' willingness to review managers' decisions in change-of-control situations. Some states do follow Delaware's enhanced duties, but others replace the Delaware duties with the lenient business judgment rule. In this project, Barzuza first observed that Nevada law is significantly different from Delaware's. That finding took some digging, however. In Hilton Hotels, a federal judge applying Nevada law stated that Nevada follows Delaware standards of Unocal and Revlon to evaluate defensive tactics adopted by firms that are the target of a takeover. The case is often cited to show that Nevada follows Delaware law. But this piece of conventional wisdom missed the next development in Nevada. Following Hilton Hotels, Nevada's legislature stepped in to clarify that Nevada does not apply Unocal and Revlon to evaluate defensive tactics by takeover targets, but relies instead on the more deferential business judgment rule.
Barzuza’s work has opened several themes that will occupy her in the coming years. She plans to explore how differences in the type and nature of agency costs among firms affect their choices about governing law. As part of this general theme, Barzuza is currently working on a project that challenges the commonly held assumption that in a world of private ordering, firms would sort optimally by choosing the appropriate law. She identifies several examples that illustrate the point that, when firms are able to choose the governing law, the firms that bond themselves to better regulation are the firms that least need that regulation because they already have a stronger shareholder base and their managers enjoy low private benefits.

Barzuza’s project on lemon signaling in firms that cross-list highlights an overlooked difference between firms run by managers and those run by controlling shareholders. She will further compare the implications of this difference to other decisions that managers and controlling shareholders make.

Finally, the case of Nevada itself will require more study. Many papers have been written on Delaware, but very few have been written on Nevada, the only other state that attracts a significant number of out-of-state incorporations. Barzuza says that more research is required to understand the companies that choose Nevada, why they choose Nevada, and what we can learn from the Nevada case about firms’ freedom to choose their governing law.

**EXCERPTS**

**MARKET SEGMENTATION WITH LAX LAW: THE RISE OF NEVADA AS A LIABILITY-FREE JURISDICTION**

**WORKING PAPER (2011)**

**A. OFFERING LAX LAW UNDERMINES DELAWARE’S ADVANTAGES**

1. The Clarity of Lax Law Undermines the Advantages of Specialized Judiciary and Network Externalities

One of Delaware’s primary advantages is that many public companies are already incorporated within the State—i.e., the size of Delaware’s network. The expansive liability protections that Nevada provides, however, offer significant clarity. This clarity compensates for Nevada’s lack of the amenities Delaware provides and contributes to the State’s ability to segment the market. A rich body of case law, specialized judiciary, and network effects associated with a large number of companies are especially important when the law is indeterminate; they are less important when the law is clear. If law is clear, as Nevada law is, other advantages matter less.

2. Nevada Has Competitive Advantages in Offering Lax Law

While Delaware has so many advantages, lax law is perhaps the one field in which Nevada has a clear edge. Nevada has branded itself in other fields as consistently providing lax law. The State’s political climate is generally hospitable to lax law. Offering lax corporate law is merely symptomatic of the State’s broader approach. […]

**B. DELAWARE IS CONSTRAINED FROM RESPONDING EFFECTIVELY**

Another reason that offering lax law is particularly effective is Delaware’s incapacity to respond to Nevada’s entry. As discussed above, Delaware’s ability to respond to entry would deter most states from attempting to enter the market. In
response to market entry, Delaware could change its law and/or reduce the price it charges, making its overall package more desirable than that of any prospective entrant. [...]  

1. Delaware Is Constrained from Responding to Nevada’s Entry by Degrading Its Law  

(A) The Risk of Federal Intervention in Corporate Law  

First, in degrading its law, Delaware would increase the risk of federal intervention in corporate law. [...] If Delaware were to follow Nevada by degrading its corporate law, Congress might intervene. Since federal intervention could take many forms—even, in the most extreme scenario, the sweeping federalization of corporate law—Delaware could not afford to degrade its law as much as Nevada does.  

To be sure, Nevada also stands to lose from federal intervention. But Nevada is less likely to trigger federalization than Delaware is. Nevada is still a relatively small player in the market. Because of the smaller number of companies that Nevada attracts, the State is much less likely to draw the attention of Congress. Because of its size, Nevada is able to externalize some of the risk of federal intervention onto Delaware. [...]  

(B) Delaware’s High Franchise Tax  

Delaware’s franchise tax—the price that it charges for incorporations—further constrains its ability to respond to Nevada. In a previous work, I argue that Delaware is able to command a premium for incorporations due to the advantages that it offers shareholders. If the State were to degrade its law to favor managers, the value of its entire incorporation package, and concomitantly the premium it can charge for that package, should decline. In competing with Nevada, Delaware has to be careful not to risk diluting the surplus it offers to firms that incorporate there. Nevada’s tax rate, while higher than the rates of many states, is still far lower than Delaware’s.  

(C) Delaware’s Brand  

Delaware has branded itself as providing efficient packages that do not rely on favoritism towards managers. Instead, Delaware’s promoters stress its specialized judicial system, the system’s efficiency, the State’s experienced judiciary, and the State’s developed body of case law.  

When Delaware has been criticized for being too protective of managers (in contrast to Nevada), its players have vigorously maintained that Delaware does not exhibit favoritism towards management. Rather, they have insisted that Delaware achieves a balance between shareholders’ and managers’ interests. If Delaware were to follow Nevada and degrade its own corporate law, its brand would suffer.  

(D) The Type of Firms that Delaware Attracts  

Delaware may also have preferences regarding the types of firms it attracts; to wit, it may prefer to attract firms with lower agency costs. Indeed, Delaware players have pronounced their preference to attract the good firms in the market. To the extent that strict law attracts firms with lower agency costs and better corporate governance, Delaware may be reluctant to risk losing those firms.  

2. Can Delaware Respond with an Additional Menu?  

An alternative to degrading its corporate law would be for Delaware to offer firms a menu of corporate law forms with multiple options from which firms could choose. [...] For the following reasons, offering an additional menu would also impose costs on Delaware.  

(A) Information to Investors  

If Delaware were to provide a variegated menu, the signal that investors would receive when a firm incorporated in Delaware would become distorted. A firm’s decision to incorporate in Delaware signals that its management believes in the superiority of the State’s law, but it does not ipso facto explain why management arrived at that conclusion. For investors to ascertain why a firm chose to incorporate in Delaware would potentially require that they undertake costly investigations. This would diminish the benefit that managers presently realize from Delaware incorporation.  

(B) Signal Effect  

Companies might choose to incorporate in Nevada for a variety of reasons. For instance, some companies might choose Nevada because it charges a lower franchise tax; oth-
ers might prefer Nevada because of the protections offered to directors and officers. Thus, while a firm’s choice to incorporate in Nevada may suggest that it is seeking lax law, the signal is a noisy one. [...]

If, however, Delaware were to offer two distinct menus—a lax one and a strict one—firms choosing the lax option would broadcast a strong signal that they are interested in lax law. As a result, these firms would suffer more significant discounts in their valuations. [...]

(c) Delaware’s Brand

As discussed above, Delaware’s brand may constrain it from responding to Nevada’s strategy. Offering a more management-friendly menu could also damage Delaware’s brand as a provider of balanced corporate law, even if that menu would only be optional.

C. COMPARISON TO OTHER STRATEGIES

Having argued that market segmentation can be an effective strategy to overcoming significant barriers to entry, the question becomes, could segmentation be successful if attempted with strict, rather than lax, law? [...]

The following discusses a notable but thoroughly unsuccessful attempt to challenge Delaware by offering shareholder-friendly law. This example shows the challenges of these strategies.

1. North Dakota—Why Segmentation with Strict Law Wouldn’t Work

A recent example has demonstrated the difficulties of attempting to enter the market from the top. North Dakota recently adopted a law that is more shareholder-friendly than Delaware’s. However, North Dakota succeeded only in attracting a single out-of-state firm, American Railcar Industries Inc. Majority owner Carl Icahn lobbied strenuously for the North Dakota bill’s adoption. In firms other than American Railcar, managers and shareholders alike have overwhelmingly opposed proposals to reincorporate in North Dakota.

Why has segmenting the market with strict law been so unsuccessful? There are two main challenges that impede segmentation from the top. For one, firms in Delaware have the option to voluntarily opt out of Delaware law to adopt terms that are more shareholder-friendly. For example, Delaware firms can choose to have proxy access, not to have staggered boards or a poison pill, or to hold their directors liable for breaches of their duties of care. Thus, a state that offers strict law does not add much compared to Delaware. Yet opting out from existing law is not cost-free and is often a complicated affair. Thus, one could argue, a state that offers a comprehensive strict menu could have some advantages for firms interested in such a menu, even though it could theoretically be achieved under Delaware law.

There is another reason, however, for why Delaware provides a better alternative than North Dakota. This reason is related to Delaware’s other advantages, apart from the law on its books. The added value of Delaware’s other advantages makes the State attractive to firms that are interested in maximizing shareholder value, even as compared to a state that offers a somewhat better law.

As a result of Delaware’s advantages, its overall package may be worth more for shareholders than the package that North Dakota or any other state is capable of offering.

2. Why There Are No Other States Along the Agency Costs Spectrum

If not from the top, could another state emerge with a law that targets firms with agency costs greater than those of firms in Delaware but less than those of firms in Nevada? [...]

If there is any gap between Nevada and Delaware, it is probably quite a narrow one. It is still possible, however, that another state will attempt to bridge that gap. Such a state, for example, could offer Delaware law as a default with an option to opt into Nevada law. This would mean permitting companies to opt out of liability for duty of loyalty and duty of good-faith violations, as in Nevada, but conditioning this opting-out on shareholder approval. The question is whether this strategy caters to a sufficiently large segment to make it profitable.
Antitakeover law, which regulates what management can and cannot do in change-of-control situations, is one of the most heavily researched, debated, and litigated areas in corporate law. While the use of antitakeover devices may serve business purposes, it may also reflect conflicts of interest and weaken the disciplinary power of the market for corporate control.

Since half of all publicly held companies are incorporated in Delaware, the debate over antitakeover law has tended to focus almost exclusively on Delaware law. This law can be straightforwardly summarized. First, although management’s conduct in running the day-to-day affairs of the company is subject to a deferential standard of judicial review under the business judgment rule (“BJR”), managers in change-of-control situations are subject to enhanced fiduciary duties under the Unocal, Revlon, and Blasius standards. Second, while Delaware courts allow management to fight hostile takeovers by using the classic poison pill, they do not allow the use of extreme versions of the pill—the so-called “dead hand” and “slow hand” pills.

But what about non-Delaware antitakeover law, which controls the other half of publicly held companies? To date, no one has examined systematically whether other states follow Delaware standards. Other states have adopted some antitakeover statutes addressing management’s use of defensive tactics, including pill endorsement and other constituency statutes, but conventional wisdom has been that since Delaware case law has allowed managers to use the pill vigorously, these statutes do not create a substantially different regime from Delaware law. To date, however, no one has examined how these statutes are actually applied. And in particular, whether they lead courts to apply similar or different fiduciary duty standards for management use of defensive tactics. This Article will document, for the first time, a systematic study of state antitakeover law. It focuses on one question: what are the standards that courts in states with and without antitakeover statutes—especially pill endorsement and other constituency/directors’ duties statutes, which regulate management’s use of defensive tactics (“Defensive Tactics Statutes” or “DTS”)—apply to managers defending against a takeover? Do they follow Delaware enhanced fiduciary duties or do they impose weaker fiduciary duties?

The Article [...] will report the results of an examination of all available antitakeover case law [...] and a fifty-state survey of DTS.

The results are surprising and differ from common assumptions. The research finds that some states have rejected the Unocal and Revlon standards that impose enhanced managerial duties in Delaware, and shows that it is questionable whether these standards apply in other states. In particular, [this Article] finds that to the extent we can observe, courts in states with relatively strong (and sometimes even weak)
DTS have relied on these statutes to reject the imposition of enhanced duties and apply the BJR. States with no DTS follow Delaware standards. These results, by and large, are supported by comparison of cases before and after the passage of the statutes. Furthermore, in Nevada, where a court decided to follow Unocal and Revlon despite the state’s relatively strong statutes, the legislature stepped in to correct the mistake. Finally, subject to a small number of observations, the findings suggest that extreme pills might be allowed in some other states.

PRICE CONSIDERATIONS IN THE MARKET FOR CORPORATE LAW

Which system, of all possible ones, is likely to produce corporate law that maximizes shareholder value? One of the most fundamental questions in American corporate law is whether the current system, which allows firms to incorporate in a state of their choice, enhances shareholder value or should be replaced, either in whole or in part, by federal legislation. […]

Notwithstanding the extensive theoretical and empirical literature on this question, there is no consensus as to the desirability of the current system. Although some believe that it creates competition for incorporations among states that induces them to produce efficient corporate laws, others doubt that such competition is desirable or that it even exists. While race to the top proponents point to the relative performance of Delaware, the dominant state in the market for corporate law, as an indication that the race is indeed one to the top, others argue that the current system provides incentives to produce corporate laws catering to the interests of managers. Puzzlingly, evidence exists to support all sides in the debate.

Although commentators hold opposing views regarding the desirability of the current system, they all share certain assumptions. Generally, they assume that Delaware designs its law to maintain and enhance its incorporation-related revenues. In addition, they share the belief that Delaware derives significant revenues from attracting a great number of incorporations and from charging a price significantly higher than its marginal cost for those incorporations. Yet, in applying the assumption of revenue maximization to analyze Delaware’s choices, commentators generally focus exclusively on Delaware’s interest in attracting more firms, setting price considerations aside. Thus, during this three-decades-old debate, one dominant assumption on all sides of the debate has been that Delaware seeks to maximize the number of domestic incorporations.

By contrast, this article argues that Delaware revenues do not necessarily increase in quantity. Instead, it highlights the role that price, in addition to quantity, plays in determining Delaware revenues.

Unlike a producer in a competitive market that gets a competitive price from the market, Delaware, which enjoys substantial market power, can increase the price it charges for its law above its marginal cost of production. The extent to which Delaware can raise its price is affected by the two special characteristics of this market: the shareholder-manager agency problem on the demand side and the current American corporate law rule that requires manager initiation of and shareholder approval for any re-incorporation decision.

Given these characteristics, to induce managers to re-incorporate to Delaware, Delaware must cater to their interests. To induce shareholders to approve reincorporation to Delaware, and to attract firms when they first go public, Delaware must ensure that firm-value will be greater in Delaware than in other states. Thus, it must not charge firms more for incorporation than the net value that Delaware incorporation confers upon them. This net value equals the value arising from Delaware’s competitive advantages—such as its specialized judiciary, its developed body of case law, and the network externalities associated with its law—minus the harm to shareholders that is caused by its pro-managerial corporate laws.

Delaware revenues, therefore, do not necessarily increase
as the volume of incorporations increases. Instead, price considerations present Delaware with the following trade-off: the more pro-managerial its law is, the more managers it attracts but the less it can charge each firm. As managers have heterogeneous preferences toward the extraction of private benefits, the more Delaware offers corporate law that appeals to managers, the more managers it attracts. Yet, the more its law protects managers, the greater the decline in firm value and hence the less it can charge for incorporation.

As a result, if Delaware indeed maximizes its revenues as commentators assume, it necessarily designs its law taking into account not only its effect on the number of firms Delaware attracts but also its effect on the price Delaware charges. Moreover, price considerations are important even if Delaware cannot or is not interested in raising its price above a certain threshold, if it is merely interested in retaining its revenues rather than enhancing them, or if different constituencies in Delaware that have influence on Delaware law promote other interests. As long as Delaware charges a significant price, this price constrains the incentives of the legislative body and the incentives of other constituencies to cater to managers’ interests, since doing so might cause Delaware to lose its leading position in the market. Lastly, the analysis is important even if Delaware adopts its law for reasons other than price considerations, as it can explain why Delaware does not have strong reasons to change its law.

The price considerations analysis has important implications for the corporate law that Delaware and the other states produce, the assessment of the current system of state corporate charters, and the determination of the desirable extent of federal intervention in the market for corporate law.

First, the analysis solves one of the main puzzles about Delaware’s strategy. Conventional wisdom has it that Delaware provides managers with excessive hostile-takeover protection devices. At the same time, Delaware has traditionally been relatively mild on this front as compared to other states. As a recent work forcefully points out, since Delaware did not seem to be engaged in a race to the top or to the bottom, both sides of the debate could not fully account for its behavior. The account put forward in this article is consistent with Delaware’s behavior. To attract and retain managers, Delaware needs to cater to their interests by producing pro-managerial rules that reduce firms’ value. To be able to charge a positive price, however, Delaware needs, simultaneously, to take into account the interests of shareholders. Racing to the top or to the bottom instead of choosing a middle ground could only impair Delaware revenues.

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ARTICLES
IN the field of intellectual property law, Professor John F. Duffy has been identified as one of the 25 most influential people in the nation and one of the 50 most influential people in the world by prominent legal news magazines. Duffy has published articles on intellectual property law in leading academic journals, such as the *Yale Law Journal*, the *Stanford Law Review*, the *University of Chicago Law Review*, the *New York University Law Review*, the *University of Texas Law Review*, and the *Supreme Court Review*. He has litigated major patent cases at the Supreme Court and at the Court of Appeals for the Federal Circuit, and articles describing his scholarly work and influence in the field have appeared in publications such as *Business Week* and *The New York Times*.

Yet Duffy began his academic career not as an intellectual property scholar, but as a professor of administrative law and regulation. In law school, he studied administrative law and regulatory industries, was an Olin Fellow in Law and Economics, and never took any intellectual property classes. Prior to entering academics, he clerked for former administrative law professors (Judge Stephen Williams of the D.C. Circuit and Supreme Court Justice Antonin Scalia), worked at the Department of Justice’s Office of Legal Counsel (which advises the Attorney General and the President on issues of separation of powers and other structural constitutional is-
sues), and practiced appellate and administrative law at Covington & Burling in Washington, D.C. His first two articles as an academic addressed the relationship between statutory and judge-made law in the fields of communications regulation and in the law governing judicial review of administrative agencies.

Fundamentally, however, Duffy’s intellectual property scholarship represents not a change but an extension of his interests in regulation, in law and economics, and in the legal institutions that produce good regulation. His scholarship has repeatedly applied general insights from regulatory law and theory, institutional design, and even constitutional law to the problems of intellectual property law.

His first two academic articles addressed classical problems of administrative and regulatory law—namely, the relationship between the courts and the legislature and the methods by which those institutions develop regulatory law. In the essay “Technological Change and Doctrinal Persistence: Telecommunications Reform in Congress and the Court,” 97 Colum. L. Rev. 976 (1997), Duffy and his co-author, the communications scholar Monroe Price, observed that both judges and legislators were frequently invoking technological change as a justification for the then-ongoing legislative and judicial efforts to reform telecommunication regulation. The article demonstrated that, although the advent of new technology is used as a justification for legal change in both the courts and the legislature, technological change may counterintuitively be more likely to lead to revolutionary changes in judicial doctrine than in legislation because technological advance provides an accepted ground for liberating courts from the constraints of stare decisis. By contrast, legislatures are likely to be lobbied by established industrial sectors seeking to have their existing interests protected. The authors noted that, although legislators had identified technological convergence as a prime justification for enacting the Telecommunications Act of 1996, the statute itself was littered with special-interest deals that tended to preserve pre-existing regulatory boxes that were highly technology-specific. In both the legislature and the judiciary, technological changes appeared to be deployed as an excuse to pursue goals having little necessary connection to those changes.

Duffy’s first solo-authored article, “Administrative Common Law in Judicial Review,” 77 Tex. L. Rev. 113 (1998), continued his exploration of how judges and legislators develop regulatory law, but this article sought to explain a concrete legal development spanning the better part of the twentieth century: the rise and demise of judge-made law governing judicial review of administrative action. The article explained why such judge-made law arose; why it continued to grow after the enactment of the federal Administrative Procedure Act, which Congress intended to be a comprehensive statute on the subject; why that common law began to meet its demise at the end of the twentieth century; and why that change was for the best in terms of the constitutional position of the courts. The ABA Section of Administrative Law and Regulatory Practice awarded the article the Section’s prize for the best piece of administrative law scholarship of the year.

Just over a decade ago, Duffy turned his attention to the field of intellectual property, but he continued to focus on issues familiar to regulatory scholars. Several of his first contributions in the patent law field, for instance, explored the institutional relationships among legal actors and the means by which the law develops. In the symposium piece “The FCC and the Patent System: Progressive Ambitions, Jacksonian Realism, and the Technology of Regulation,” 71 U. Colo. L. Rev. 1071 (2000), Duffy compared the regulatory structure and processes of communications law with the patent system and found that the patent system, with an administrative agency having modest powers coupled with strong judicial oversight, had proven more enduring and more capable of accommodating technological change than many more modern administrative agencies that have been granted far more power. In 2002, Duffy became a co-author with Robert Merges of Patent Law and Policy (3rd ed. 2002), one of the leading casebooks in the field. Among the innovations Duffy introduced to the casebook was a chapter devoted to the “Legal Process of the Patent System,” which...
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was designed to introduce students to the institutional and structural issues associated with the patent system. Finally, in “The Festo Decision and the Return of the Supreme Court to the Bar of Patents,” 2002 Sup. Ct. Rev. 273 (2003), Duffy comprehensively examined the Supreme Court’s patent law jurisprudence and predicted that the then-recent patent cases at the Court should be viewed as signaling the beginning of “a return of the Supreme Court to the field of patent law.” That prediction, though controversial at the time, turned out to be accurate and the article’s discussion of the likely role of the Supreme Court in the modern patent system opened up a vein of subsequent scholarship on the topic.

Duffy soon began to analyze the law and economics of patent law, and he has made a wide variety of contributions to the field. In “Rethinking the Prospect Theory of Patents,” 71 U. Chi. L. Rev. 439 (2004), Duffy expanded on the ideas in University of Virginia law professor Ed Kitch’s famous article “The Nature and Function of the Patent System,” 20 J.L. & Econ. 265 (1977). Duffy pointed out that the patent system attempts not so much to limit but to channel competition—so as to generate long-term competition that promotes innovation rather than short-term competition that reduces prices. Duffy’s article was heavily influenced by regulatory scholarship. He relied on the comparison between the patent system and the franchise-auction mechanism proposed by Harold Demsetz in a classic article on the theoretical basis for regulating so-called natural monopoly industries.

In “The Marginal Cost Controversy in Intellectual Property,” 71 U. Chi. L. Rev. 37 (2004), Duffy critiqued a then-recent vein of intellectual property scholarship recommending significant public subsidies so that intellectual property could be made available at its marginal cost. A nearly identical “marginal cost” proposal had been made decades earlier in the field of regulated industries, Duffy observed, but that earlier proposal was subject to a withering rejoinder by the economist Ronald Coase (a former University of Virginia professor), who explained in the “Marginal Cost Controversy,” 13 Economica 169 (1946), that the governmental taxation and subsidy scheme necessary to achieve marginal-cost pricing would entail at least as much inefficiency as the perceived problems with prices set above marginal cost. As Duffy explained, Coase’s critique was so successful that modern economics textbooks routinely accept that industries will price above marginal cost. Intellectual property scholars should not forget the important lessons from this historic debate and, in particular, Duffy argued, they should not be lured into believing that marginal-cost pricing is a necessary goal and social subsidies are a panacea toward achieving that goal. In “Intellectual Property Isolationism and the Average Cost Thesis,” 83 Tex. L. Rev. 1077 (2005), Duffy responded to other scholars who argued that intellectual property rights should be granted “only to the extent necessary to enable creators to cover their average fixed costs.” That rule, Duffy demonstrated, provides no policy guidance because, in a market economy with a free flow of capital, those who invest resources in creating intellectual property will, on average, always expect to recover the fixed costs of producing that property—no less and no more—without regard to the strength of intellectual property rights. If that were not true—if investors in intellectual property creation earned either above or below their average costs—new investors could be expected to enter or leave the market, respectively, until the returns on investment equaled the returns on investment in other areas of the economy. In “Intellectual Property for Market Experimentation,” 83 N.Y.U. L. Rev. 337 (2008), Duffy and his co-author, Professor Michael Abramowicz, showed that the market failures justifying the creation of intellectual property also extend to the production of information about markets. Thus, intellectual property may be socially valuable not only because it spurs the creation of books, songs, movies, and innovations, but also because it encourages entrepreneurs to take risks in developing information about new markets.

Duffy’s most recent work in the law and economics tradition, “The Inducement Standard of Patentability,” 120 Yale L.J. 1590 (2011), also written with Abramowicz, argues that the standard of patentability—the fundamental legal metric regulating whether a particular innovation merits patent protection—should be governed by a test discussed
in Supreme Court precedent, but which is strangely absent from subsequent administrative and lower court precedent: Patents should be awarded only to “those inventions which would not be disclosed or devised but for the inducement of a patent.” This “inducement” test of patentability is fundamentally an economic inquiry, but as Duffy and his co-author argue, that is one of its greatest strengths, for it grounds patentability decisions in a more rigorous economic framework and thereby brings patent law closer to the vast body of modern regulatory law that generally relies on economic analysis in deciding the proper scope of regulation.

Although he has devoted substantial scholarly effort to the economic analysis of intellectual property law, Duffy has continued to explore the institutions that create and shape regulatory law with an emphasis on the law regulating intellectual property. “Inventing Invention: A Case Study in Legal Innovation,” 86 Tex. L. Rev. 1 (2007), traced the rise of patent law’s obviousness doctrine in legislation and judicial decisions across multiple countries. The article showed that this doctrine was itself invented and refined by judges and legislators throughout the world, but the process of invention and refinement of the doctrine took about a century. That history—particularly the timescale necessary for the development of what is now viewed as a crucial piece of intellectual property law—provides a general lesson about regulatory law: There is a loose fit between the state of the law at any given time and the positive efficiency of that law, and thus policymakers should have a healthy skepticism that the law in any particular country at any particular time is optimal.

Similarly, in “Why Business Method Patents?,” 63 Stan. L. Rev. 1247 (2011), Duffy examined the reasons for the controversial rise of business method patents over the past two decades. Though many professors, lawyers and judges have blamed judicially active courts for changing the law to permit such patents, the article demonstrates that the growth of business method patents in the late twentieth century is best explained by developments that occurred outside of any legal institution. During the last quarter of the twentieth century, the fields of economics, business, finance and the like began to develop into much more technological disciplines, and that transition was the catalyst for the burgeoning number of business method patents. Once again, this case study in an intellectual property area provides a more general lesson concerning the development of regulatory law: Convincing explanations for the general arc of the law’s development can often be found only by looking beyond legal doctrine to the full panorama of social, industrial, and technological developments that are driving the underlying needs of society.

Duffy has always been a scholar who writes for multiple audiences. His work is firmly rooted in the scholarly tradition, but he also has his eye on the development of patent law and policy in Congress and the courts. Duffy has litigated several important patent cases in the Supreme Court and the Federal Circuit. But few scholars have had the kind of real-world impact that he has had with a single piece of scholarship. In “Are Administrative Patent Judges Unconstitutional?,” 77 Geo. Wash. L. Rev. 904 (2009), which was initially published on the Internet, Duffy argued that the appointments of all administrative patent judges since 2000 were unconstitutional under the Appointments Clause. The article generated considerable press coverage. Adam Liptak of The New York Times described the work as a “short paper [that] seems poised to undo thousands of patent decisions concerning claims worth billions of dollars.” The Department of Justice declined to defend the constitutionality of the appointment process, and Congress ultimately enacted corrective legislation to change the method for appointing patent judges.

Duffy’s work demonstrates that those who study regulation and those who study intellectual property have something to teach each other. He believes that theories of intellectual property should be harmonized with more general theories of regulation and institutional design. Of equal importance, the particular experiences and problems of intellectual property law can shed new light and new perspectives on long-running debates about the optimal rules of regulation and institutional design in society. As the legal profession enters the second decade of the twenty-first century—a
time when the information revolution of the past half century continues unabated—Duffy’s work aims to make the law of intellectual property appreciated as an essential, and indeed central, component to effective industrial regulation of the modern world economy.

EXCERPTS

ADMINISTRATIVE COMMON LAW IN JUDICIAL REVIEW
77 TEX. L. REV. 113 (1998)

There is no such thing as a common law of judicial review in the federal courts.

—Felix Frankfurter

Justice Frankfurter wrote those words in 1944. They were part of a dissenting view to the reality of judge-made or common law then governing judicial review of federal administrative agencies. Two years later, in 1946, Congress enacted the Administrative Procedure Act (APA), which was designed to govern both internal agency procedure and judicial review and was thought to be “complete enough to cover the whole field.” But the enactment of the APA did little to displace the domination of common law in the field. If anything, the growth of purely judge-made law accelerated. Decades after the enactment of the APA, Professor Kenneth Culp Davis could accurately note: “Perhaps about nine-tenths of American administrative law is judge-made law, and the other tenth is statutory ... Most of it is common law in every sense, that is, it is law made by judges in absence of relevant constitutional or statutory provision ....” This common-law tradition had a particularly strong hold on the doctrine governing judicial review of administrative action, an area that Professor Louis Jaffe described in 1965 (again, quite accurately) as encompassing “a whole congeries of judicial theories and practices”—a “body of power and doctrine that we would call ... the common law of review, and which is a significant part of the ‘administrative law’ of the jurisdiction.”

Now, finally, this administrative common law of judicial review is beginning to abate; it is being replaced, albeit slowly, by doctrine grounded in the judicial review provisions of the APA and other statutes. This Article explains why a common law of judicial review ever existed in the first place, why it continued to grow after the enactment of the APA, why much
of it is now meeting its demise, and why this change is for the best. It is a tale not only of the continuing development of administrative law doctrine, but also of the legacy of some of the oldest statutes in the Republic, of the crucible of New Deal politics that both gave birth to the APA and also nearly killed it in its infancy, and, perhaps most importantly, of the federal courts’ conception of their own legitimate powers in the constitutional system.

Let us first set the stage. Justice Frankfurter’s concern over “common law” in the federal courts touches upon a basic distinction in Anglo-American law generally, one that has special importance to federal courts. Anglo-American courts traditionally follow one of two methods to decide a case. Under the common-law method, a court decides a case without guidance from any textual codification of law and policy. As Judge Posner describes it, the “essence” of this method “is that the law itself is made by the judges. They are the legislators.” A second method—one that has become increasingly important in this age of statutes—turns on the interpretation of an authoritative, extra-judicial text. In nonconstitutional cases, this method can be referred to as the statutory method. The “essence” of this method is that the legislators are the law-givers, for, at least under classical schools of interpretation, courts deciding statutory cases are bound to follow commands and policies embodied in the enacted text—commands and policies that the courts did not create and cannot change. And even today, while some modern theorists have sought to relax that traditional assumption, few would contend that statutory and common law are indistinguishable.

As a matter of doctrine and theory, the distinction between statutory and common law is crucial for federal courts. Well before the Court in Erie Railroad v. Tompkins declared that “there is no federal general common law,” the concept of federal common law was recognized as theoretically and constitutionally troubling. As early as 1812, the Supreme Court in United States v. Hudson held that federal courts possess no common-law criminal jurisdiction, and by 1834, the Court found it “clear” that “there can be no common law of the United States” because “there is no principle which pervades the union and has the authority of law, that is not embodied in the constitution or laws of the union.” Even under Swift v. Tyson, the federal courts applied what they believed to be general, not federal, common law. Current Supreme Court doctrine teaches that the instances in which federal courts may legitimately fashion “federal common law” are “few and restricted.” A consensus of modern scholars agrees that, to create judge-made law, a federal court “must point to a federal enactment, constitutional or statutory, that it interprets as authorizing the federal common law rule.” This constraint on federal common law reflects the more general constraint familiar to courts reviewing administrative action—that institutions wielding governmental power must have authority in the law for their actions.

One might expect that administrative law would be a most unlikely place to find an enormous body of judicially developed common law. Administrative agencies, after all, blossomed in the late nineteenth and early twentieth centuries as an alternative to regulation by common-law courts; their creation signaled a “rejection of the common law system.” Enthusiasm for new expert agencies was coupled with pessimism about the ability of generalist courts to develop law consonant with changing modern conditions. Moreover, the substantive law applied by federal agencies was—and still is—statutory law. And, of course, ever since 1946 there has been the APA. One might therefore expect that Justice Frankfurter’s claim would be close to the truth or, at the very least, that courts engaging in judicial review—courts demanding executive branch agencies to identify the basis in law for their actions—would be careful to identify the statutory or constitutional basis for their power to fashion judge-made law. But that has not been the case.

Consistent with Professor Jaffe’s description, judicial review of agency action remains dominated today by judge-made law—doctrines identified by case titles (e.g., Chevron, Vermont Yankee, and the Greater Boston “swerve” doctrine), or by names originating in judicial decisions and found nowhere in statutory law (e.g., ripeness and exhaustion). For
some of these doctrines, a moment’s reflection reveals the underlying statutory basis for the apparent “common law.” Thus, for example, the Greater Boston doctrine—which requires an agency that is “changing its course” of regulation to “supply a reasoned analysis” for the swerve—is simply an interpretation of Section 706(2)(A) of the APA, which authorizes reviewing courts to set aside “arbitrary” and “capricious” agency action. The doctrine is merely an example of statutorily-authorized common law—a rule based on an interpretation of a broad, vaguely worded statute. Such statutorily-based law presents no theoretical difficulties, for it conforms to the fundamental requirement that federal courts ground their decisional law in some constitutional or statutory text.

For many other standard administrative law doctrines, however, the textual home in statutory law either is nonexistent or has never been identified. In a few extreme examples, current law seems wholly at war with statutory language. Thus, the Chevron doctrine requiring deferential review of an agency’s interpretation of a statute it administers seems to contradict the command in Section 706 of APA that reviewing courts “shall decide all relevant questions of law,” a direction that Congress plainly thought “required courts to determine independently all relevant questions of law.” This apparent conflict between the common-law doctrine and statutory law is noted, if at all, as nothing more than a curiosity, to be politely ignored by practitioners and courts.

Solving the puzzle presented by these common-law doctrines requires some history, which is provided in Section I of this Article. Judicial review in the early administrative era grew up in the federal equity jurisdiction, which was filled with judge-made law fashioned within the tradition of equity. The dominance of judge-made law there, however, is not troubling. It is merely another example of a statutorily-authorized common law, as the statutes conferring equity jurisdiction did vest the federal courts with a power to fashion and administer a judge-made law of equity. Things should have changed in 1946—not because the APA forces courts to reach dramatically different results, but because the courts’ method of analysis should have changed: Statutory law should have assumed the dominant position in cases covered by the APA (which means just about all cases reviewing federal administrative action).

Yet that did not happen, or rather, did not happen for decades. A confluence of forces helped to continue the common-law tradition. Partly it was the legacy of equity. Equity had been federal judge-made law since the founding of the Republic, and it is not surprising that judges would cling to their roles as law-givers in the doctrinal area that was one of waning equity’s most significant contributions to the twentieth century—judicial review over the newly created administrative agencies. But other forces were also working against the ascendancy of statutory law. The influential Attorney General’s Manual on the Administrative Procedure Act, a highly political document designed to minimize the impact of the new statute on executive agencies, shrewdly characterized the APA provisions governing judicial review as merely a “restatement” and thereby invited courts and the bar to treat the Act as something less than a statute, as subservient to judge-made doctrine. In addition, the preeminent commentators on administrative law in the quarter century following 1946, Professors Jaffe and Davis, both promoted the continued development of administrative common law and either largely ignored the APA (Jaffe) or encouraged courts to supplement its provisions with judicial innovations (Davis).

These forces alone probably could not account for the continuation of the common-law tradition were it not for a pervasive and overarching intellectual movement in federal law. For this was also, in the words of Judge [Henry] Friendly, the era of “The New Federal Common Law”—an era when leaders of the federal bar and bench were calling for an aggressive formulation of federal common law. For a time stretching from the 1950s into the 1970s, this view reigned. The federal judges of the time were, as Judge Friendly affirmed, “ready, even eager” to undertake a “law-making function,” and the administrative common law governing judicial review was one result. But beginning at least with Justice Powell’s influential dissent in Cannon v. University of
Chicago, the New Federal Common Law has been receding into history. Federal judges are becoming less “eager” to be federal law-givers, and they are devoting renewed attention to the traditional limits on their powers to act as common-law judges. The effects of this change are beginning to be felt in administrative common law.

This Article examines four doctrinal areas where the law is slowly evolving from a common-law method to a more rigorous statutory method based on the APA: exhaustion, ripeness, judicial control of agency procedures, and the standard of review for questions of law. The transformation is most nearly complete in the area of exhaustion, where the Supreme Court in 1993 finally afforded the proper respect to a provision of the APA that had been, to the Court’s surprise, “almost completely ignored” for forty-seven years. In each of the other areas, the evolution is not yet complete, and statutory law and judge-made doctrines continue an uneasy coexistence that cannot be reconciled with the theoretical limits on federal common law.

Still, change in the administrative common law is occurring, and it should be welcomed. Courts engaging in judicial review of administrative action should be particularly mindful of the constraints on federal court power to fashion judge-made law, for to disregard those constraints is inconsistent with the purposes of the judicial role in administrative law generally. Judicial oversight of administrative agencies is itself justified in terms of forcing governmental agencies to heed limitations on their authority. As Professor Jaffe put it:

> From the point of view of an agency, the question of the legitimacy of its action is secondary to that of the positive solution of a problem. It is for this reason that we, in common with nearly all of the Western countries, have concluded that the maintenance of legitimacy requires a judicial body independent of the active administration.

Yet in fulfilling that important function—in forcing executive agencies to pay attention to the legitimacy of their action—federal courts seem to have fallen into the very trap identified by Jaffe: They have treated the question of legitimacy of their own action as a secondary issue. It is time to end this error. It is time that the federal courts judicially review their own law of judicial view.

**THE MARGINAL COST CONTROVERSY IN INTELLECTUAL PROPERTY**


In 1938, Harold Hotelling formally advanced the position that “the optimum of the general welfare corresponds to the sale of everything at marginal cost.” To reach this optimum, Hotelling argued, general government revenues should “be applied to cover the fixed costs of electric power plants, waterworks, railroad, and other industries in which the fixed costs are large, so as to reduce to the level of marginal cost the prices charged for the services and products of these industries.” Other major economists of the day subsequently endorsed Hotelling’s view, and in the late 1930s and early 1940s, it “aroused considerable interest and had already found its way into some textbooks on public utility economics.”

In his 1946 article, *The Marginal Cost Controversy*, Ronald Coase set forth a detailed rejoinder to the Hotelling thesis, concluding that the social subsidies proposed by Hotelling “would bring about a maldistribution of the factors of production, a maldistribution of income and probably a loss similar to that which the scheme was designed to avoid.” The article, which Richard Posner would later hail as Coase’s “most important” contribution to the field of public utility pricing, was part of a wave of literature debating the merits of the Hotelling proposal. Yet the very success of the critique by Coase and others has led to the entire controversy being “largely forgotten today.” Modern regulatory policy generally accepts that a declining average cost industry—that is, a so-called “natural monopoly”—will not have its fixed costs subsidized from general government revenues and that therefore the industry must be allowed to price above marginal cost so
that it can cover its fixed costs. The rejection of the Hotelling thesis is so complete that reputable economics encompasses the very opposite of Hotelling’s view—“that, generally, prices which deviate in a systematic manner from marginal costs will be required for an optimal allocation of resources, even in the absence of externalities.” Indeed, in the parlance of public utility regulation, the very phrase “marginal cost pricing” now refers not to Hotelling’s proposed marginal cost pricing and subsidy scheme, but rather to a pricing system akin to the “multi-part” pricing system that Coase advocated as the more efficient alternative to Hotelling’s proposal. In short, modern public utility theorists generally do not recommend using pervasive public subsidies to chase the Holy Grail of global marginal cost pricing.

Yet despite this consensus, a recent vein of literature on the economics of intellectual property seems preoccupied with the perceived problem that prices for intellectual property may sometimes exceed marginal cost. This literature proposes the institution of significant public subsidies to resolve or at least to ameliorate the marginal cost pricing problem, and such proposals are already beginning to affect the course of policy debate in prominent public fora. This literature has developed thus far with little apparent recognition that it is a modern reprise of the marginal cost controversy of the mid-twentieth century. The literature treats the marginal cost pricing problem of intellectual property as a unique phenomenon, and it remains isolated from the more general literature on public utility regulation.

This Essay is a first step toward ending that isolation. Part I begins by establishing the parallels between the economic theory of public utility regulation and that of intellectual property law. Part II reviews the recent literature proposing public subsidies for intellectual property and shows that these proposals are subject to the same objections that Coase raised in the public utility context more than a half century ago. Furthermore, the recent subsidy literature has not examined the important question whether intellectual property possesses some distinguishing features that make it a more appropriate target for public subsidies than other industries having natural monopoly characteristics. Part III addresses this question and finds that, while there are distinctions between intellectual property and traditional natural monopolies, these distinctions do not uniformly favor subsidizing intellectual property over other natural monopolies. Part IV concludes with the hope that, as the marginal cost controversy continues in the field of intellectual property, it will proceed with a more complete understanding of the earlier controversy, and that perhaps it can offer new insight into a very old and very fundamental debate.

THE INDUCEMENT STANDARD OF PATENTABILITY
(WITH MICHAEL ABRAMOWICZ)
120 YALE L.J. 1590 (2011)

The inherent problem was to develop some means of weeding out those inventions which would not be disclosed or devised but for the inducement of a patent.

—A unanimous Supreme Court in Graham v. John Deere Co.

The quotation above is one of the most memorable and insightful lines from arguably the most important patent law case of the twentieth century: the Supreme Court’s 1966 decision in Graham v. John Deere Co. Graham’s preeminent place in the patent canon is well justified, for it is the Supreme Court’s seminal opinion on a patent law doctrine—the “nonobviousness” requirement—that is typically introduced as “the most important of the basic patent requirements,” “central to determining patentability,” “the key to defining what is a patentable invention,” or simply “the ultimate condition of patentability.” The basic rule of nonobviousness is easy enough to recite: under 35 U.S.C. § 103, a patent may not be granted on an invention that “would have been obvious at the time the invention was made to a person having ordinary skill in the art.” But the apparent simplicity of the require-
ment belies the complexities and difficulties that have historically bedeviled the doctrine. The inducement standard, as articulated in *Graham*, appears to be vitally important to understanding the statutory nonobviousness requirement, for it offers a simple explanation for why society should deny patents on some innovations: if the innovation would be created and disclosed even without patent protection, denying a patent on the innovation costs society nothing (because the innovation would be developed anyway) and saves society from needlessly suffering the well-known negative consequences of patents, including the restriction on output caused by a patentee’s exclusive rights and the administrative and litigation costs associated with running a patent system.

Yet despite its apparent promise as the theoretical basis for the most important patentability doctrine, *Graham*’s inducement standard has achieved only a modicum of influence. Though frequently cited, the inducement standard is often relegated to a passing mention or a footnote in introducing the patentability standard. Some articles have devoted more extended attention to the inducement standard, but these too have generally highlighted the difficulties in using the standard to decide cases or to shape legal doctrine. For example, Ed Kitch’s classic verdict on *Graham*’s inducement standard emphasized that the nonobviousness requirement, as articulated by the courts, provides only an “awkward” tool “to sort out those innovations that would not be developed absent a patent system,” with the “focus” of the legal doctrine always being on other issues. Kitch’s view has become the consensus. Thus, in a widely cited and influential 2003 report, the Federal Trade Commission summarized the testimony of numerous legal and economics scholars as demonstrating that, even though the inducement standard represents “the right way to assess whether to grant a patent” from a “theoretical perspective,” the standard is not “administrable,” so “the more manageable standards of the patent statute have evolved to serve as the means by which to measure when to grant a patent.”

In some ways, we agree with these prior assessments of the inducement standard. There is a certain awkwardness in the relationship between the inducement standard and the nonobviousness requirement, at least as that requirement has previously been articulated by the courts. Moreover, the Supreme Court in *Graham* did not provide a rigorous foundation for deriving the inducement standard from the statutory language. The absence of such a legal foundation may explain why courts and the Patent and Trademark Office (PTO) have typically avoided looking to the inducement standard for guidance in interpreting and applying the statutory nonobviousness requirement. The one exception, an insightful but ultimately flawed panel opinion by Judge [Richard] Posner, relied on the inducement standard to invalidate a patent but nevertheless failed to identify any administrable test or metrics for applying the inducement standard to the specific facts of that case or other cases. Posner’s panel opinion was vacated en banc, and that history has perhaps cemented the notions that the inducement standard conflicts with the statutory obviousness standard, is anti-patent, or is simply too difficult to apply in actual cases.

This Article aspires to show those notions to be wrong and to revitalize the inducement standard as the touchstone for understanding and refining the obviousness doctrine. The result should be more coherent, defensible, and predictable decision making than is possible either under the current doctrine or under Judge Posner’s treatment, which missed important implications of the inducement standard.

There are two motivations for undertaking this project. First, the time is right. In its 2007 decision, *KSR International Co. v. Teleflex, Inc.*, the Supreme Court overturned a quarter-century-old test for nonobviousness that the nation’s expert appellate court for patent law, the Court of Appeals for the Federal Circuit, had meticulously constructed. The *KSR* decision has precipitated a vibrant debate among scholars seeking to help the courts rebuild a pragmatic obviousness doctrine that yields predictable answers and is more theoretically sound than the Federal Circuit doctrine rejected in *KSR*. That reconstruction project can have little hope of enduring success without reexamining and reevaluating the ultimate goal of the nonobviousness requirement.
A second and more important motivation is the promise of the inducement standard in providing significant insights into some of the most difficult theoretical and practical problems in the field. Economic analysis of patent law frequently begins with the assertion that patents present a social tradeoff between providing incentives for innovation at the expense of accepting the deadweight loss associated with monopoly-like exclusive rights. And even beyond the law-and-economics literature, legal scholars often frame intellectual property law generally and patent law in particular as presenting a conflict between the public and private domains—a choice between openness and exclusivity. If, however, the law follows Graham’s inducement standard, such tradeoffs and conflicts do not necessarily exist.

Under a rigorously enforced inducement standard, patents would cover only those innovations that otherwise would not be created or disclosed—in other words, patents would cover only innovations that, without the patent system, would not have been in the public domain. The patent system would then have only positive effects on the public domain: patents would cover only inventions that would otherwise not be in the public domain and, when the patents expire, the inventions would enter into and enrich the public domain. Similarly, the apparent deadweight losses created by patent rights would be an illusion because, if patent rights had not been available, the invention would not have been available from competing firms but instead would have been either unavailable or covered by trade secrecy. As we will show in this Article, the optimal implementation of the inducement standard may not achieve such a Panglossian resolution because, at least in some circumstances, patents should be allowed even if they merely induce earlier innovation. Thus, the analysis suggested by the inducement standard helps to identify more clearly the precise economic tradeoff at issue: patents produce earlier innovation but at the cost of higher prices and associated deadweight loss in a later period (when the invention would have existed even without the inducement of the patent). This point highlights another deep theoretical strength of the inducement standard, for it holds out the hope of grounding patentability decisions in a more rigorous economic framework and thereby bringing patent law closer to the vast body of modern regulatory law that commonly uses economic analysis in making specific decisions about the scope and extent of regulation.

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Douglas Laycock is a towering figure in the law of religious liberty. He has been a path-breaking scholar, a successful appellate litigator, a legislative advocate instrumental in the development of statutes protecting religious liberty, and a commentator known for his ability to summarize church-state law and debates cogently and with sympathy for the conflicting sides. He has defended the rights of individuals and groups of almost every possible religious view, from evangelical Christians to Santeria animist worshipers to atheists. As a result, he is respected by people on both sides of the culture wars that animate many Religion Clause controversies.


And that is only one part of Doug Laycock’s portfolio. He is also a leading figure in the law of remedies. He serves as vice president of the American Law Institute, which is an active, and not just ceremonial, role. Most of his work focuses on religious liberty and remedies, but Laycock has also published on sex discrimination, affirmative action, freedom of speech, and a range of other constitutional law topics. Not only does Laycock seem to have boundless energy, but he makes remarkable contributions wherever he devotes his attention.

Laycock is best known for his work on religious liberty, where he occupies an unusual position. As a vigorous defender of both free exercise and disestablishment, he has never been for or against religion, but for liberty with respect to religion—for believers and nonbelievers alike. He has strongly defended the rights of individuals and organized groups to believe what they will about religion, to speak about those...
beliefs and attempt to persuade others, and to act on those beliefs. He has strongly opposed all efforts to get government to take sides with respect to beliefs about religion, to conduct religious exercises at government events, or to erect the symbols, texts, or displays of majoritarian religion. In *Same-Sex Marriage and Religious Liberty* (Rowman & Littlefield, 2008), and in correspondence with legislators in states considering marriage legislation, he has supported same-sex marriage and also supported religious exemptions for conscientious objectors.

Laycock’s fundamental perspective of liberty for all is associated with a series of theoretical and policy principles that the academic literature generally credits to him, although he insists that none of these principles is entirely unique to him. Laycock argues for substantive, as opposed to formal, neutrality. Formal neutrality means religiously neutral categories—religion-blind government. Substantive neutrality, on the other hand, means religiously neutral incentives. The goal of substantive neutrality is to assure that government conduct, insofar as is possible, neither encourages nor discourages religion. Laycock argues that religiously neutral incentives protect religious liberty, while religiously neutral categories do not. Government routinely encourages and discourages all sorts of secular behavior. If government is to avoid encouraging or discouraging religious behavior—that is, to provide religiously neutral incentives—religion requires special treatment.

Like most religious liberty scholars, Laycock believes that the free exercise of religion sometimes requires that religiously motivated conduct be exempted from generally applicable laws, as when some faiths refuse to ordain women as clergy, or when they give sacramental wine to children and adolescents. In a pervasively regulated society, such exemptions are essential to religious liberty. Exemptions can, of course, be denied when necessary to prevent significant harm to others or to otherwise serve a compelling government interest.

Regulatory exemptions for religious practice are sometimes criticized as special treatment for religion; they are a departure from neutrality measured by religiously neutral categories. Laycock’s insight is that exemptions are often consistent with substantive neutrality, measured by religiously neutral incentives. In order to create religiously neutral incentives, exemptions are sometimes necessary, because fines, imprisonment, or loss of government benefits will obviously discourage religious practices that run afoul of some law or regulation. “But exemptions usually do not create incentives in the other direction,” Laycock says. “Exemptions do not encourage people to join a religion or participate in religious practice, because much religious behavior is meaningless or personally burdensome when separated from the religious belief that gives it meaning.”

Most exemptions, in other words, will not encourage strategic behavior. Substantive neutrality, with its focus on neutral incentives, attempts to reconcile the widely shared intuition that government should be neutral toward religion with the widely shared intuition that exemptions are necessary to religious liberty.

Laycock does concede the exceptional cases in which religious practice aligns with secular self-interest. His standard example is religious objections to paying taxes. Under Laycock’s approach, a religious exemption from paying individual income taxes would not be neutral by any criterion. Exemptions would encourage a religious belief, and government will often have a compelling interest in avoiding large numbers of claims arising from real or feigned religious conversions.

Although most religious liberty scholars agree that exemptions from generally applicable laws are sometimes necessary to permit the free exercise of religion, the Supreme Court does not. In *Employment Division v. Smith*, 494 U.S. 872 (1990), the Court held that there is no federal constitutional right to exemptions for religious practice. As a scholar and an advocate, Laycock has been a central player in the debate over *Smith*. Laycock notes that exemptions granted by the political branches have been central to the American experience of religious liberty since the seventeenth century, and that Congress and a majority of the states have acted to make such exemptions judicially enforceable as a general matter by
statute or by interpretation of state constitutions.

Laycock argued the Supreme Court’s first free exercise case after Smith, Church of the Lukumi Babalu Aye, Inc. v. City of Hialeah, 508 U.S. 520 (1993), on the right of an Afro-Caribbean religion to sacrifice small animals to its gods. Nearly everyone he consulted told him not to take the case because the facts were ugly and they feared that he would only make more bad law. Laycock won the case 9-0. He says it was all a matter of perspective; he focused the Court on the discrimination in Hialeah’s ordinances.

Four years later, Laycock appeared before the Supreme Court again to defend Congress’ reaction to Smith, but this time he did not prevail. Congress responded to Smith with the Religious Freedom Restoration Act, 42 U.S.C. §2000bb et seq. (2006), creating a statutory right to religious exemptions, subject to the compelling interest test. The Supreme Court held that law unconstitutional as applied to the states in City of Boerne v. Flores, 521 U.S. 507 (1997). Boerne is the Court’s leading decision on the scope of congressional power to enforce the 14th Amendment. In the wake of Boerne, Laycock was a frequent congressional witness and the leading theoretician for the effort to enact the Religious Land Use and Institutionalized Persons Act, 42 U.S.C. §2000cc et seq. (2006).

“How zoning and prisons came together in the same bill is an only-in-Washington political story,” he says. His role was to explain how the bill was constitutional despite Boerne and the Supreme Court’s other federalism decisions in the 1990s.

Another principle closely associated with Laycock’s work is church autonomy. His view is that religious organizations are entitled to manage their own internal affairs free of government interference. Church autonomy is distinct from, and independent of, the more widely understood claim of a right to regulatory exemptions on the basis of specific religious doctrines or conscientiously held beliefs—and therefore, Laycock says, it is unaffected by the Supreme Court’s decision in Smith.

“A church’s right to select its own clergy, define its own governing structure, and resolve its own internal disputes should not depend on whether it can show in every case that its decisions are based on some specific church teaching,” he says. Rather, the right to make such internal religious decisions is inherent in religious liberty and in the separation of church and state.

As in the debate over Smith, Laycock is once again acting as both a theorist and a practical lawyer. In October, Laycock will argue a Supreme Court case involving an important application of church autonomy when he represents the church in Hosanna-Tabor Evangelical Lutheran Church and School v. Equal Employment Opportunity Commission. The case focuses on the “ministerial exception,” the established rule in the federal courts of appeal and state supreme courts that a minister cannot sue his church for employment discrimination.

“If the rule were otherwise, courts would be in the position of deciding whether a church took an employment action for discriminatory reasons or religious reasons, and in effect, deciding whether the plaintiff was doing a good job as a minister despite the church’s claim that he was not,” Laycock says.

Lower courts are in agreement that this rule extends beyond pastors of congregations; it includes others who do important religious work for religious organizations. The original issue in Hosanna-Tabor was whether the ministerial exception includes a fourth-grade teacher in a religious school who taught religion and led worship 45 minutes a day, was required to integrate religion with the rest of the curriculum, was required to complete eight college-level theology courses in order to get the job, was “called” to her position by a vote of the congregation, and was a “commissioned minister” in the church. The Sixth Circuit said that the teacher was not a minister for purposes of the ministerial exception, because she spent most of her time teaching the secular curriculum.

In the Supreme Court, the issue has become much bigger. The EEOC and the private plaintiff now argue that the Supreme Court should repudiate the ministerial exception entirely. They would let priests, pastors, and rabbis sue their employers, subject only to some modest limits on what evi-
dence they could introduce about their religious job performance, and perhaps subject to limits on reinstatement as a remedy. It is no surprise that Laycock vigorously disagrees.

Another principle prominent in Laycock’s work is that religious speech by citizens speaking in their private capacity is constitutionally protected, while the same religious speech by government employees speaking in their governmental capacity, or by private citizens with preferential access to a government forum, is constitutionally prohibited or very tightly restricted. In a 1986 article, he fully elaborated the case for guaranteeing religious speakers equal access to the public forum, including in sensitive contexts such as public schools. He has repeatedly represented evangelical Christians, or supported them in amicus briefs, in their continuing efforts to enforce such rights. But he also successfully represented parents and students who objected to prayer at Texas high-school football games in *Santa Fe Independent School District v. Doe*, 530 U.S. 290 (2000), and in articles and amicus briefs he has opposed government-sponsored crosses, crèches, and Ten Commandments monuments. Laycock sees no tension between protecting private religious speech and prohibiting similar speech by government officials or those with preferred access to a governmental forum. “The government abandons neutrality when it censors religious speech,” he says, “and it abandons neutrality when it endorses the majority’s religion.” In his view, equal liberty for all is a powerful principle.

Laycock is a scholar and an advocate, but he is not a hired gun. In fact, he jokes that he is rarely hired at all. Most of his religious liberty litigation is pro bono. More fundamentally, he will not take a position in a brief that he would not take in a law review article. His interests are eclectic, and occasionally more theoretical than practical, but in general, he wants his scholarship to deal with practical problems and to potentially have practical consequences. And to accomplish that, he has to address multiple audiences. He has no illusion that judges or legislators are reading his many law review articles. “If you hope to influence judges, you have to write briefs,” he says matter-of-factly.

Laycock’s lasting contribution to our understanding and the development of the law of religious liberty will be reflected in a four-volume series published by Eerdmans Publishing and the Emory University Center for the Study of Law and Religion. The volumes collect his writings on religious liberty, *Volume 1: Overviews and History*, and *Volume 2: The Free Exercise Clause*, are already out. *Volume 3, Religious Liberty Legislation*, and *Volume 4, The Free Speech and Establishment Clauses*, are in preparation. The quote that opened this article is from Professor Thomas Berg’s review of *Volume 1*. The review was titled “Laycock’s Legacy,” but Laycock says he’s not ready to think about legacies yet; he’s still working and writing.

Laycock’s influential work in religious liberty is only part of his story. He is also a dominant figure in the field of remedies, and indeed, his approach to the field has helped transform it. Laycock’s most important work in remedies is *The Death of the Irreparable Injury Rule* (Oxford University Press, 1991). Based on an exhaustive analysis of reported cases, the book shows that the traditional doctrinal “rule”—that no equitable remedy will issue unless legal remedies are inadequate, or in the alternative formulation, unless necessary to prevent irreparable injury—does not affect decisions at the stage of permanent injunctions or final decrees for specific performance. A version of the rule is important at the stage of preliminary relief, but the content of the rule with respect to preliminary injunctions is substantially different from the content of the rule with respect to final judgments. Based on his analysis of the cases, Laycock identified a series of more functional rules, mostly having to do with the relative costs and benefits of alternative remedies, that explain decisions at final judgment.

Readers who follow the Supreme Court may know that the Court has talked a lot about irreparable injury and adequate remedy at law lately, and that it has failed to distinguish preliminary from permanent injunctions. Laycock sees no repudiation of his thesis, but merely a continuation of the judicial behavior he described in his book. In each of the recent cases in the Supreme Court, there were clear functional reasons to refuse the injunction. And one of the central
points of his book is that when there are functional reasons to refuse the injunction, many courts find it almost irresistible to say that there is an adequate remedy at law and no irreparable injury. Usually the court will also talk about the real reasons for decisions, and the Supreme Court followed that pattern; sometimes the court will merely imply the real reasons in its statement of the facts. Either way, what courts say about adequate remedy and irreparable injury in cases where they deny the injunction is seriously inconsistent with what they say about adequate remedy and irreparable injury in cases where they grant the injunction. Laycock notes that when the Supreme Court reviews injunctions it wants to affirm, the irreparable injury rule does not stand in the way—not in the cases he reviewed in 1991, and not in 2011 either.

Laycock is also the sole author of the leading casebook, Modern American Remedies: Cases and Materials (4th ed., Aspen 2010). The first edition of that book, in 1985, reorganized the field, arranging the material in remedies categories (compensatory damages, punitive damages, injunctions, declaratory judgments, restitution, etc.), instead of cause-of-action categories (remedies for breach of contract, remedies for personal injury, remedies for loss of property, etc.). Many law students now learn remedies the Laycock way. Not only is his book the leader in the field, but all of the competing books have moved substantially in the direction of his organization.

Keeping up with two seemingly unrelated fields keeps Laycock stretched rather thin at times, but both fully engage his interest. And every area of law presents remedies issues, including religious liberty cases, for which he has written remedies briefs. Laycock regrets not having time to write amicus briefs in the Supreme Court’s recent injunction cases. He has no illusions that he might have changed any of the results, but he wonders if he might have helped the Court provide more sophisticated explanations.

Laycock was once spread even more thinly than he is now. He taught employment discrimination for ten years, and co-authored important articles on sex discrimination in insurance with his wife, Teresa Sullivan (now president of the University of Virginia), Lea Brilmayer (now at the Yale Law School), and Richard Hekeler (now a demographer in the insurance industry). Brilmayer and Laycock were the lawyers; Sullivan and Hekeler were the demographers—the scholars who study life expectancy and mortality.

He also taught commercial law for ten years. His knowledge of commercial law and the basics of bankruptcy turned out to be indispensable when a religious liberty issue broke out in consumer bankruptcies in the 1990s. The issue involved consumers who made contributions to a church every week, and later filed for bankruptcy. Bankruptcy trustees began to argue that the contributions were fraudulent transfers, because the consumer got nothing of value in exchange. It followed that the churches had to give back all the contributions received within the statute of limitations, which could be as long as six years in some states. Because 97 percent of consumer bankruptcies were no-asset cases, churches were becoming the principal source of funds for distribution to creditors.

Laycock argued In re Young, 154 F.3d 841 (8th Cir. 1998), the leading case holding that imposing this liability on churches violated the Religious Freedom Restoration Act (still in effect as applied to federal law), and he helped draft the Religious Liberty and Charitable Donations Protection Act, codified in scattered sections of the Bankruptcy Code, which fixed the problem for religious and secular charities alike.

He gave up commercial law and employment discrimination not for lack of interest, but for lack of time. He says he’s not sure he ever encountered a legal problem that failed to arouse his interest. But he couldn’t be an expert in so many different fields. “I eventually disciplined myself not to follow up on most of the legal problems I encountered,” he says.

Laycock has not always kept that promise. He served for fourteen years as an adviser to the Restatement (Third) of Restitution and Unjust Enrichment (2011), and now he is writing about restitution. The creation of the modern remedies course caused classes in restitution to drop out of the curriculum, and he thinks that was a mistake. Restitution is a
source of distinctive remedies, which are part of his remedies course. But restitution is also a source of distinctive causes of action addressing the myriad ways in which one person can wind up in possession of another’s property without having breached a contract or committed a tort. Despite his best efforts at doing so, he believes these causes of action cannot all be jammed into the interstices of a remedies course.

“I learned a lot of restitution law serving as an adviser,” he says. Now there are writing projects growing out of the final publication of the new Restatement. He is doing a book review of the Restatement for the Michigan Law Review, hoping to explain why it should be on the shelf of every litigator and why someone (he is not volunteering) should do a casebook, so the subject can be restored to the curriculum.

In September, Laycock was as busy as ever. He finished the reply brief in Hosanna-Tabor, he had an oral argument to prepare for, and he has some writing projects from last year to wrap up. It will be a busy year—like all the years before it. When you write for academics, and for courts, and for legislators, and when you’re a “towering figure” in two fields that barely intersect, you’re a busy guy.

EXCERPT

THE RELIGIOUS EXEMPTIONS DEBATE

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The United States claims religious liberty as one of its great contributions to the world, but we cannot seem to agree on what that means. American debates over religious liberty have had remarkable persistence. Political fights over religious observance in public schools date to the creation of the public school system in the second quarter of the nineteenth century. Debates over public funding of religious education started about the same time. Those are the Johnny-come-lately issues.

Debates over exempting religiously motivated behavior from government regulation have continued off and on since the seventeenth century. The colonies exempted Quakers from swearing oaths and exempted dissenters from paying taxes to support the established church. They exempted members of pacifist faiths from bearing arms in person, although those conscientious objectors had to perform alternative service or pay extra taxes to support the war effort. Military service was as important then as it is now, and more dependent on compulsory service, so this last exemption was the subject of much political debate.

The exemption issue arose intermittently in the antebellum state courts, with cases going both ways, and in the United States Supreme Court in the late nineteenth and early twentieth centuries, where the religious claimants lost. The issue eventually appeared to be settled by the Warren and Burger Courts, in Sherbert v. Verner and Wisconsin v. Yoder. Large majorities in those cases held that the Free Exercise Clause requires a compelling government interest to justify any government-imposed burdens on the exercise of religion. The settlement, however, was short lived.
The Reagan Administration saw the Sherbert-Yoder rule as a prime example of judicial activism. Reagan did not run on the issue, and his advisers did not want the evangelical part of his base to know what they were doing, but his Justice Department initiated the current round of the exemptions debate, quietly hammering at the Free Exercise Clause in briefs to the Supreme Court. That effort bore fruit after Reagan left office. Employment Division v. Smith distinguished Sherbert and Yoder, interpreting those precedents narrowly and shrinking the scope of the Free Exercise Clause.

Smith triggered a fierce political reaction, which made the exemptions debate far more contentious than it had ever been before. The modern debate has been more public, although it still gets remarkably little attention from the press. Congress enacted a series of statutes to protect religious liberty: the Religious Freedom Restoration Act, the American Indian Religious Freedom Act Amendments, the Religious Liberty and Charitable Donations Protection Act, and the Religious Land Use and Institutionalized Persons Act. Sixteen states enacted state Religious Freedom Restoration Acts, and many state courts have interpreted their state constitutions to mean something more like Sherbert-Yoder than like Smith. Smith is still the law of the federal Free Exercise Clause, and it has now been the law for longer than Wisconsin v. Yoder was the law, at least in the original understanding of Yoder. But there are many other sources of law more protective of free exercise, so Smith is the effective law in fewer than half the states. On the other hand, most of the new state provisions are relatively untested.

There is also a split in the circuits over what Smith actually means. Smith says that neutral and generally applicable laws are not subject to judicial review under the Free Exercise Clause, but if a law burdens religion and is not neutral, or is not generally applicable, then the burden on religion must be justified by a compelling government interest. So what counts as a generally applicable law? Some courts have said that all laws are generally applicable unless they were enacted with anti-religious motive or single out religion for uniquely disadvantageous treatment. Other courts have said that a law that is generally applicable is a law that applies to everybody. If a law has a secular exception that undermines its purpose, then it must also have a religious exception—or a compelling reason why not.

There is only one Supreme Court decision since Smith that casts any light on the meaning of neutral and generally applicable—Church of the Lukumi Babalu Aye v. City of Hialeah. There are facts and language in Smith and in Lukumi to support either the singling-out interpretation or the one-secular-exception interpretation. There is very little to support the bad-motive interpretation, and seven Justices refused to join a bad motive opinion in Lukumi, but that has not stopped government lawyers from arguing for it, or some lower courts from adopting it.

All this legislation and litigation has sustained a serious academic debate about religious exemptions from regulation. This round of the debate is now approaching its thirtieth year, counting from those first briefs filed by the Reagan Justice Department, or its twentieth year, counting from Smith.

The disagreement is about cases in which one of America’s remarkably diverse religious practices comes into conflict with one of its diverse and remarkably pervasive regulatory laws. Whether and when to exempt religious practices from regulation is the most fundamental religious liberty issue in the United States today. What is at stake in the debate over religious exemptions is whether people can be jailed, fined, or otherwise penalized for practicing their religion in the United States in the twenty-first century. This issue arises in widely varied contexts instead of a few recurring patterns, so it is hard for the press to cover. Here are some examples, nearly all from real controversies, and the rest from real regulatory threats:

Can a city prohibit believers in Santeria from sacrificing small animals, which is the central ritual of their faith?

Can the federal government punish religious use of a tea that contains a mild hallucinogen and is part of the central ritual of a faith?

Can a city designate a church as a landmark and refuse to permit any expansion of the building, even though the
church is regularly turning people away from Mass?

Can a trustee in bankruptcy force churches to repay contributions, made in good faith by donors who subsequently went bankrupt, for the benefit of the donor’s creditors?

Can a city police department require its officers to be clean shaven, forcing Muslim officers to resign or to violate what they understand to be a religious duty?

Can zoning authorities exclude the Metropolitan Community Church from a city, probably because of the city’s hostility to the church’s mission to gay and lesbian Christians (but of course that motive would be hard to prove)?

Can zoning authorities exclude a Methodist church from a city, on the basis of resistance to church tax exemptions or vague claims about traffic?

Can suburban authorities prohibit a church from replacing its 36-square-foot sign, on its frontage facing an interstate highway, with a 250-square-foot sign?

Can authorities penalize a church that refuses to perform gay weddings? (So far, this is just a much discussed hypothetical rather than a real case.)

Can authorities penalize a religious association that refuses to let its gazebo be used for a same-sex civil commitment ceremony?

Can the state refuse a driver’s license to a Christian woman who wants no graven image (i.e., no photograph) on her license, or to a Muslim woman who is willing to be photographed only while wearing her veil?

Can a school board refuse to allow Muslim girls to wear long sweat pants, instead of shorts, in coed gym classes?

Can prison authorities refuse to provide kosher meals to Jewish prisoners?

As these examples illustrate, there are endless variations in religious commitments, and endless variations in regulation. Some of the laws at issue are important. Some are trivial. Some are stupid. Some of the religious commitments are central to the faith; some are marginal. Some seem sympathetic to outside observers; some seem incomprehensible; some seem repulsive.

Another reason the issue of religious exemptions gets less public attention than Establishment Clause issues is that it splits both left and right, so that neither side campaigns on it. Religious conservatives tend to think that exemptions for religious practice are central to religious liberty; secular conservatives tend to think that any right to religious exemptions encourages judicial activism. Civil libertarian liberals think that religious exemptions are a core civil liberty; anti-religious liberals think that they provide preferential treatment for a mostly conservative interest group. And all sides tend to waffle in application, depending on what they think of the competing secular interest. Religious conservatives, religious liberals, and secular civil libertarians made up the wall-to-wall coalition that supported the Religious Freedom Restoration Act. That coalition broke apart in the late 1990s over the question whether civil rights in general, and gay rights in particular, are such compelling interests that they universally trump any claim of religious liberty, in any context, without regard to the facts of individual cases.

For the religious believers—especially the believers whose faith is at odds with the culture—and for the civil libertarians, the argument for religious exemptions is simple and straightforward. There can be no coherent understanding of religious liberty without the right to actually practice your religion. When the state says, “You can believe whatever you want but you can never act on it,” that is not religious liberty, and it is certainly not the free exercise of religion. “Exercise,” now and in the Founders’ time, means actions and conduct.

More fundamentally, religious liberty that does not include the right to actually practice the religion does not solve the problem that religious liberty was designed to solve. The most obvious problem was conflict and human suffering for sake of conscience; people were penalized for things they were unwilling to give up because they believed them to be ordained by God. If Massachusetts says, as it once did, that Quakers are banned from the jurisdiction, that is a violation of religious liberty. If Massachusetts says, “OK, you can live here, but you have to attend the established Congregational worship service, and you can’t have public worship of your own,” that does not solve the problem. A conscientious
Quaker still cannot live in Massachusetts. Now suppose Massachusetts says, “Alright, we’ll waive the explicitly religious requirements. You can live here, and you can conduct your Quaker meetings, but you have to serve in the military, and you can’t testify in court unless you swear an oath.” It still has not solved the problem. A conscientious Quaker cannot serve in the military, and he cannot swear an oath, and if he can’t testify in court, his neighbors can cheat him or steal from him at will, knowing he can never testify against them. So he still can’t live in Massachusetts, and if he tries, he will be in frequent conflict with the state. Bans on practices central to a faith are equivalent to a ban on adherents. Meaningful religious liberty requires allowing people to practice their faith, not just to believe it.

This is the core of the argument for regulatory exemptions, although this core is so obvious to supporters of exemptions that it is not explicitly stated as often as it should be. There is much more to be said about constitutional text, original understanding, historical practice and experience, judicial doctrine, practicality and implementation, and all the other modes of constitutional argument. But the core of the argument is that bans on important religious practices are equivalent to a ban on adherents. Even bans that are neutral and generally applicable in form are experienced as religious persecution by the victims, and because resistance provokes reaction, even bans that appear neutral and legitimately motivated at the outset can easily transform into active and aggressive persecution by enforcers of the law.

The text of the constitution applies to all forms of religious practice, central or peripheral. Still, the argument against oppression is strongest with respect to the most important religious practices, and weaker with respect to marginal practices that believers might be willing to give up. But the importance of religious practices varies from person to person, and is difficult for courts to assess. The Court is right that it would be a mistake to hold that practices central to a religion are constitutionally protected and that practices below some threshold of centrality are not constitutionally protected. A far better rule is that all exercise of religion is constitutionally protected, but that less weighty government interests can justify burdens on less weighty religious practices. A threshold requirement of centrality would be an all-or-nothing rule; it would treat a continuous variable—religious significance—as though it were a dichotomous variable, and it would thereby greatly magnify the consequences of the inevitable errors in assessing religious significance. Such a threshold requirement would wholly deny protection, instead of according somewhat less protection, when religious significance is somewhat underestimated. But the impossibility of fairly administering a threshold requirement of centrality does not mean that the courts should wholly ignore the importance of the religious practice when they are asked to decide a claim to exemption. The compelling interest test is best understood as a balancing test with the thumb on the scale in favor of protecting constitutional rights. The best way to formulate the question is whether the government interest compellingly outweighs the religious interest. The compelling interest test is not often formulated that way, but I think that it must operate that way in practice, and sometimes in the course of applying the test, the Court seems to say as much. To borrow and correct Justice Scalia’s example, it is easier for the government to justify a ban on throwing rice at weddings than to justify a ban on getting married in church.

The argument against religious exemptions is more diverse; people oppose exemptions for different reasons. Some opponents appear to say that any exemption for religion is bad policy, or an unconstitutional preference for religion, or both. These people are mostly academics or secular activists. They have no votes in any legislature, and few votes in any court. The coalition that successfully argued for the Religious Freedom Restoration Act was wall-to-wall, religious and secular, left and right. And there are some two thousand specific exemptions in state and federal statute books, many of them not at all controversial.

Those who oppose all exemptions are not always clear about their proposed solutions, but they offer a range of possibilities. Some at least imply that regulatory exemptions on
grounds of conscience should be totally banned; others leave open the possibility that exemptions should be permitted if granted to all people with intense personal objections to a law, religious and secular alike. To those who say that any exemption from regulation violates the Establishment Clause, the answer to them is brief. Government does not establish a religion by leaving it alone; government does not benefit religion by first imposing a burden through regulation and then lifting that burden through exemption, and, in most cases, such exemptions do not encourage anyone to engage in a religious practice unless he was already independently motivated to engage in the practice. The Supreme Court has repeatedly and unanimously rejected the argument that religious exemptions generally, or in principle, violate the Establishment Clause, and eight Justices reaffirmed that view, with no dissent from the ninth justice, when the Court invalidated a particular exemption as discriminatory and not needed to relieve a regulatory burden on the free exercise of religion. There is absolutely no support in the original understanding for the claim that exemptions raise Establishment Clause issues. Whether it is more nearly neutral to leave religion alone or to treat it just like analogous secular activities is a question of baselines that is treated elsewhere.

The more common opposition to exemptions is to argue that they can be created only by legislatures, but never by courts in the interpretation of a constitution. These opponents of exemptions divide into two further categories.

Some would let legislatures enact general religious liberty statutes, such as a Religious Freedom Restoration Act (RFRA). These acts say that no other law enacted under the authority of the same jurisdiction shall be applied in any way that substantially burdens the exercise of religion, unless that burden is the least restrictive means to serve a compelling government interest. The reference to laws of the same jurisdiction simply means that the federal RFRA applies to federal law, the Pennsylvania RFRA applies to Pennsylvania law, and so on.

This general formulation sends the problem back to the courts for detailed implementation, but with some important differences from the same compelling-interest test as a matter of constitutional interpretation. The courts act with a modern legislative mandate (and at least for a while, a recent legislative mandate). This legislative mandate addresses the exemption issue in more specific language than the language of the Free Exercise Clause. And because the right is statutory, it is subject to legislative amendment. If the legislature doesn’t like the judicial interpretation that emerges, or even if it feels threatened by pending litigation or hypotheticals, it can amend its RFRA. State legislatures have exercised this power, not always wisely.

Other opponents of judicial exemptions say that neither a modern legislative mandate, nor leaving final authority to the legislature, is enough to justify a general standard for the grant of exemptions. They insist that the legislature must strike the balance itself and enact specific rules for every instance of conflict between religious practice and secular law.

Such case-by-case legislation is obviously unworkable as a matter of legislative calendars and attention spans, and it does not appear to be the Supreme Court’s position. The Court unanimously upheld the Religious Land Use and Institutionalized Persons Act against Establishment Clause attack, and it has shown no interest in constitutional attacks on the Religious Freedom Restoration Act as applied to federal law.

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