2009

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CHICAGO

JOHN M. OLIN LAW & ECONOMICS WORKING PAPER NO. 491
(2D SERIES)

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THE LAW SCHOOL
THE UNIVERSITY OF CHICAGO

November 2009

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Justifying Jones

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I.

Jones v. Harris Associates,¹ which the Supreme Court is considering in its 2009-2010 term, is ostensibly about how much investment advisors are paid to manage the mutual funds they start and are then hired by the fund’s independent board to advise. But Judge Frank Easterbrook’s opinion in Jones, which this Essay considers in honor of his quarter century on the Seventh Circuit, is as much about the inadequacies of federal courts and the Federal Rules of Civil Procedure as it is about the compensation of investment advisors. So while Judge Richard Posner’s dissent (from a denial of a rehearing of the case en banc) claims the key issue in the case is what he broadly calls “executive compensation” and the economic models underlying our system of it,² the relevant Supreme Court precedents for Jones are not the Supreme Court’s cases on paying executives (for example, Rogers v. Hill³), but rather its recent civil procedure cases, Bell Atlantic Corp. v. Twombly⁴ and Ashcroft v. Iqbal.⁵ This Essay will show how Jones follows directly from these precedents.

But the opinion is more interesting than that. Judge Easterbrook boldly disregarded the interests of the parties before the court in order to serve broader societal interests. The opinion was not one either party in Jones predicted or wanted, and everyone involved disavows to this day.⁶ The losers (the plaintiffs, their lawyers, and plaintiffs’ lawyers generally) were given a much worse defeat than if Judge Easterbrook had just affirmed the district court for the reasons it gave. Jones made future mutual fund compensation cases much less likely by making a breach of the statutory fiduciary duty much more difficult to prove – plaintiffs under Jones must show a lack of disclosure or conflict of interest on the board amounting to self dealing; bald assertions of excessive pay will be insufficient as a matter of law. This means the business of bringing these suits is now much less profitable.

But even the winners were losers. The opinion generated a grant of certiorari, which imposed additional litigation costs on Harris. Judge Easterbrook is trying to do away with this class of claims generally, and Harris is

¹ 527 F3d 627 (7th Cir 2008).
² 537 F3d 728 (7th Cir 2008).
³ 289 US 582 (1933).
⁶ Amazingly, no briefs at the Supreme Court defend the approach Judge Easterbrook took. The amicus brief of the industry, submitted by the Investment Company Institute (ICI) asserts that Gartenberg provides “real and substantial protection to investors.”
being forced to pay the freight. But it is unlikely that the intended beneficiaries – mutual funds in general – were happy with the outcome in Jones either. The opinion raised the saliency of mutual fund pay at a politically inopportune time, and may generate a rule the industry likes less than the then-prevailing Gartenberg rule, or, even worse, legislative action. (Better Gartenberg than Barney Frank.) We can think of the Gartenberg rule as a “tax” on mutual fund profits, and it may be rational for mutual fund advisors to prefer what turns out to be a very small tax to the risk of a reconsideration of advisor pay generally, especially when they can simply pass on the tax to investors. Insofar as the tax is small and random, no individual fund or the industry as a whole should be bothered by the current rule. It should not be surprising therefore that the industry is calling for Gartenberg to be reinstated. Society, however, is likely better off under Jones than Gartenberg. This Essay will explain why and defend Judge Easterbrook’s boldness and creativity using both theory and some casual empirical analysis of the costs of this type of litigation. A rough estimate of costs and benefits of Gartenberg shows that Judge Easterbrook was right to reject it.

II.

In the cottage industry of mutual fund compensation cases, the dispute in Jones is about as vanilla as can be. Plaintiffs complained that the Oakmark Funds, which defendant Harris Associates started and then was hired to advise, were paying Harris too much for this work. The law on point is section 36(b) of the Investment Company Act of 1940, which makes fund advisors, like Harris, fiduciaries with respect to compensation received, and Gartenberg v. Merrill Lynch Asset Management, Inc., which established a multi-factor test for courts to apply to determine when pay was so much it amounted to a breach of the § 36(b) duty. (Question: Why do lawyers love multi-factor tests? Answer: They generate uncertainty, which generates disputes, which in turn generate fees.) Judges are not routinely in the business of adjudicating the fairness or efficiency.

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7 There is some evidence that the suits are not random, but are correlated with asset inflows. [cite].
8 Investment Company Amendments Act of 1970 § 36, 15 USC § 80a-35(b) (2000) (“[T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services . . . paid by such registered investment company . . . to such investment adviser . . .”).
9 694 F2d 923 (2d Cir 1982).
10 According to the district court in Jones, these include: “the cost to the adviser to provide services to the fund; the nature and quality of the services that are provided, including the fund’s performance history; whether and to what extent the adviser realizes economies of scale as the fund’s assets increase; the volume of orders from the fund’s investors that need to be processed . . . ; and the conduct of, expertise of, and level of information possessed by the trustees charged with approving the fee at the outset.” See Jones v. Harris Associates, 2007 WL 627640 (ND Ill Feb 27, 2007).
of private compensation contracts, but the pay of mutual fund advisors may be different.\footnote{The analogy between the compensation of executives of business corporations and the advisors of mutual funds is extremely weak. [cite].}

Legal disputes about advisor compensation arise because of the unique governance structure of mutual funds. A sponsoring investment company creates each mutual fund as a separate legal entity. Each fund is managed by a board of directors, which is appointed by the sponsor of the fund. The fund, acting through the board, then chooses an advisor who will raise money, make investments, and then manage those investments. The board virtually always chooses the sponsor as advisor, and, as a practical matter, never replaces the advisor. Funds that perform badly are closed; they do not get new management. The potential governance problem here should be obvious – the board is supposed to negotiate a compensation schedule with the advisor, but the advisor cannot be fired and it is the advisor (when acting as sponsor) that appointed the board in the first place.

The law does two things to try to solve this problem. The first is the requirement that the board of directors be composed of a certain percentage of “independent” directors.\footnote{At the time of the suit, the law required 40 percent of the board to not be “interested persons” as defined by the ICA. See 15 U.S.C. §§ 80a-2(19), 80a-10, 80a-15(c).} They are designed to be, and think of themselves as,\footnote{Based on ten confidential telephone interviews conducted with board members of ten different mutual fund companies conducted during September and October 2009.} watchdogs for the interest of investors. This is an attempt to put meaning in the separate legal entity distinction. Independent directors are thought to owe their allegiance to the fund, not to the sponsor or its advisor, and could be sued by investors in the fund if they violate this duty. But practice may deviate from theory here. Even perfectly independent board members may be less vigorous than desired at negotiating against the people to whom they owe their jobs and with whom they interact with on a daily basis. In order to provide extra incentives for arm’s-length bargaining, there is a second requirement: section 36(b) requires that the investment advisor assume the status of a fiduciary of the fund and its investors with respect to compensation received for its services.

\textit{Jones} was not the first case brought under § 36(b) alleging a breach of this duty. Since the fiduciary duty was mandated in 1970, there have been hundreds of cases in which investors have sued investment advisors claiming a breach of the fiduciary duty with respect to compensation.\footnote{Lyman Johnson, \textit{A Fresh Look at Director “Independence”: Mutual Fund Fee Litigation and Gartenberg at Twenty-Five}, 61 Vand L Rev 497 (2008).} Defendants have “won” every case, meaning a court has never held a mutual fund advisor violated its § 36(b)
fiduciary duties. Jones was no exception. The district court granted Harris’s motion for summary judgment based on Gartenberg, rejecting plaintiffs’ argument that because Harris charged a lower rate for institutional investors than it did for individual ones this proved that the latter fees were too high. The court concluded that the fees charged were not so disproportionate to the value received that they amounted to a breach of the fiduciary duty. Although Judge Easterbrook approved of this result, he disagreed with the district court’s reasoning, choosing instead to jettison the Gartenberg factors and the judicial inquiry (read: costs) they beget.

III.

Why would a judge reject a legal rule that had always resulted in victory for defendants? The result for Harris would have been the same (but cheaper) had Easterbrook followed Gartenberg; the Supreme Court would not have granted certiorari; and the issue of advisor pay would not be a potential political issue. So why did Easterbrook create a controversy, risk reversal, and impose substantial costs on Harris by writing the opinion he did?

The answer has to do with civil procedure and the ineffectiveness of federal courts at efficiently processing litigation. If litigation were not costly, Easterbrook would have undoubtedly found the Gartenberg standard less objectionable. Although defendants can be confident ex ante about prevailing against § 36(b) claims, this litigation is costly, and these costs attract plaintiffs (or, rather, their lawyers) who can promise to settle the case for less than these costs and allow the defendants to avoid the time, hassle, and reputation costs of litigation. Board members and advisors likely fear the publicity and process of litigation (especially being deposed) more than anything, and therefore may be eager to settle, especially since they may be able to pass on the costs to investors.

In this case, the district court decided for Harris only after summary judgment, at which point Harris had likely spent millions of dollars on discovery and lawyers. To bless the district court’s decision at this point would suggest that what the court did was correct, not only on the merits but also in terms of the analysis and the timing of its decision. If decisions about pay are to be made at

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15 See James D. Cox & John W. Payne, Mutual Fund Expense Disclosures: A Behavioral Perspective, 83 Wash U L Q 907, 923 (2005) (noting plaintiffs have yet to win a single case based on § 36(b)).

16 Harris has to pay to defend its district court victory at the Supreme Court, which must be an expensive undertaking.

17 Easterbrook might still believe that judicial resources could be better spent elsewhere.

18 Defendants undoubtedly write the check for any settlement, but it is likely that fees increase generally to account for expected settlements. While defendants pay, investors ultimately bear the costs.
summary judgment (or after), this sets the value of any settlement much higher than if the same decisions can be made earlier in the litigation, especially before discovery. A simple affirmance of the district court might have been the victory Harris wanted, but it would have been a defeat for other funds or for investors, since it would have left open the possibility of future suits of this kind and encouraged them to go to later stages of litigation when courts had the facts they needed to apply the Gartenberg factors.

Rent extraction of these expected litigation costs from defendants is what the suit in Jones was about. The probability of victory at trial for plaintiffs was zero when they filed the case. No set of facts had ever resulted in liability against mutual fund investment advisors, and, as the district court opinion makes clear, the facts in Jones were unremarkable. Fees paid to Harris were about what prevails in the industry among similar funds and there was no evidence of significant conflicts of interest, lack of disclosure, or other tricks that would generate judicial concern. Importantly, plaintiffs’ best argument, that Harris was paid more to manage the accounts of individual investors than it was to manage the accounts of institutional investors has been rejected by many other courts.19 Putting aside the merits of this argument, the chance that this district court would reach a different conclusion than the numerous other courts that had considered precisely the same argument in the exact same context and rejected it absolutely as a legal matter, means the case was a sure loser. And yet, there it was, imposing costs on Harris, using judicial resources, and diverting plaintiffs and their lawyers from more meaningful pursuits.

Judge Easterbrook intended Jones to do more than simply declare a winner in the litigation between Jones and Harris – he wanted to declare an end to § 36(b) litigation altogether, or, at least, the kind brought by private plaintiffs up to this point. He wanted to put district courts out of the business of weighing the Gartenberg factors because the process is very costly, the results of the process are already known, and the existence of the process does nothing to deter the kinds of abuse the statute was designed to prevent. Easterbrook’s opinion deploys a theoretical claim about markets and a plausible reading of the statute, but there is another unwritten factor driving his conclusion.

The theory is based on the fact that investing is voluntary and in open-ended funds, like Harris’s, investors can withdraw their money at any time at market value. So long as some investment decisions by some investors are somewhat rational (that is, made based on returns net of fees), advisors are

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19 See, for example, In re Evergreen Mutual Funds Fee Litigation, 240 FRD115 (SDNY 2007) (“[S]uch comparisons are not necessarily informative when assessing whether fees are disproportionate to the services rendered.”); see also Strougo v BEA Assocs, 188 FSupp2d 373, 384 (S.D.N.Y.2002); Schuyt v Rowe Price Prime Reserve Fund, Inc, 663 FSupp 962 (SDNY1987), aff’d 835 F2d 45 (2d Cir.1987).
prevented from charging excessively high fees, even where governance constraints are imperfect. There are over 8,000 funds competing heavily on price to attract nearly $16 trillion in investment dollars; Easterbrook doubts whether courts and their costly process can add much to this market for setting fees. This is consistent with the long-standing practice of courts addressing issues of executive compensation. In the absence of obvious conflicts of interest or egregious failures of the pay-setting process, courts rarely, if ever, substitute their judgment for those of the market.\footnote{See, for example, In re Walt Disney Co. Derivative Litigation, 906 A2d 27 (Del. 2006) (refusing to review pay of Disney executives).}

Critics say the market for advisor fees is imperfect, and some recent empirical scholarship suggests there may be some investors who pay too much for what they are getting.\footnote{See Javier Gil-Bazo and Pablo Ruiz-Verdu, “The Relation Between Price and Performance in the Mutual Fund Industry,” 64 J Fin 2153 (2009).} While these studies are interesting and bring important attention to the question of the participation by unsophisticated investors in securities markets, the result should hardly be surprising. In every market, whether it is for cars, legal services, or haircuts, some people pay more than they should for what they are getting. Smart businesses look for less price-sensitive customers, and, where they can, charge them more than they charge more sophisticated shoppers. Courts are not involved in remedying price discrimination. This is because the relevant question is not whether the market works perfectly, but whether a judicial inquiry will make it better than it would be without such an inquiry.

A response to this is to point to § 36(b) as evidence that Congress wanted courts involved – a variant of the classic go-talk-to-the-legislature defense to objectionable statutes. Easterbrook dispenses with this argument by noting that the statutory command – being a fiduciary – means nothing more than being honest and forthcoming; it does not mean agreeing to a cap on the amount that can be charged. After all, lawyers, brokers, trustees, and CEOs are all fiduciaries, and there are no limits on what they can charge, assuming they are truthful and play no games.

This interpretation is consistent with the judicial treatment of fiduciary duties in other cases involving compensation of agents. Corporate managers, for instance, are fiduciaries of their shareholders, and yet courts do not inquire into whether their pay is “excessive” absent a gross conflict of interest (for example, self dealing) or abysmal failure of process. Cases alleging too much pay in Delaware, for instance, are required to allege a breach of the duty of care (insufficient process), a breach of the duty of loyalty (a conflicted board), or that the pay was so extreme as to suggest a failure of process or a hidden conflict. In addition, the demand requirement in derivative litigation means plaintiffs must
generally overcome procedural hurdles, such as showing the board is conflicted or self dealing, before a case can proceed to discovery. Courts in Delaware throw out cases baldly asserting too much pay without imposing any significant costs on defendants. Excessive pay litigation (without allegations of self dealing) is simply more expensive in Delaware than it is in federal courts, and so we observe a trivial number in comparison.\textsuperscript{22}

As for the statute, Easterbrook interprets § 36(b) as delegating to courts the authority to determine the nature of the “duty” inquiry based on market and other factors. Instead of saying that pay must be “reasonable” or is capped at a certain level or subject to a certain type of review, the statute punted this question to judges in the future. It might be that in a market in which there is very little competition, say because there are few funds or limited flows in and out of funds, a fiduciary duty might justify a robust judicial inquiry, while in a market with robust competition it would justify a hands-off approach. This choice fairly represents the natural evolution of the mutual fund market over the time since § 36(b) was passed, and it would take an heroic interpretation of the language of the statute to suggest Congress meant to freeze eternally a particular process unalterable by changes in the market.

A final argument left unwritten in Easterbrook’s opinion, and one I take on below, is based on the fact that these cases were always losers and yet were generating a significant number of cases. In short, the § 36(b) duty as interpreted by courts to this point generated large costs without attendant benefits. The blame here is on federal courts. In federal courts, where litigating the reasonableness of pay is costly, plaintiffs can extract larger settlements than they can in state courts, like Delaware, where the costs are nearly zero. As a result, we see a similar legal standard – a fiduciary duty with a limit on excessive compensation\textsuperscript{23} – generating hundreds and hundreds of federal cases and few if

\textsuperscript{22} The leading study on state law pay litigation finds just 124 cases from 1912 to 2000 in all states. See Randall S. Thomas & Kenneth J. Martin, “Litigating Challenges to Executive Pay: An Exercise in Futility?,” 79 Wash. U. L.Q. 569 (2001). The study finds that there are very few cases in this nearly 90-year period in which there were bald allegations of too much pay without corresponding claims of process failures or conflicts of interest. Id. In addition, it finds that claims are much more likely to be brought and to succeed against private firms, where the risk of expropriation from minority shareholders is much higher than for public firms. Id. (Mutual funds are much more akin to publicly traded companies, since there are no minority shareholders whose interests are frozen in the corporate form in a mutual fund, as they may be in a privately held corporation.) This data fits with the perspective of experts in Delaware litigation that there are no cases filed in Delaware courts today in which plaintiffs allege simply that executives are paid too much without allegations of procedural irregularities or loyalty problems. Telephone interview with Charles Elson, Director of the John L. Weinberg Center for Corporate Governance at the University of Delaware.

\textsuperscript{23} In state courts, the standard is whether the pay was so excessive as to constitute a “waste” of corporate assets, see Rogers v Hill, 289 US 582 (1933), while in federal courts it is whether the advisor pay is “so disproportionately large that it bears no reasonable relationship to the services
any state law cases. This despite the fact that, as Judge Posner hints at in his separate opinion, there is as much evidence or more evidence of failures in the executive compensation market as there is in the advisor compensation market.

A problem for Judge Easterbrook is that on their face the Federal Rules of Civil Procedure do not obviously permit federal courts to weed out cases in the way that the Delaware Chancery Court can, using the demand requirement and expedited review processes at early stages of the litigation. The notice-pleading standard of the current rules allow plaintiffs to proceed to discovery so long as they state clearly a claim upon which relief can be granted. In § 36(b) cases, this would seem to only require plaintiffs to complain that the pay of the advisors was so high that it breached the statutory duty. Rule 8 does not seem to permit courts to dispense with § 36(b) cases at the motion to dismiss stage so long as the complaint is well plead.

Although Easterbrook does not cite them, two recent Supreme Court cases, Twombly and Iqbal, implicitly amend the rules of civil procedure to bless the kind of end run Easterbrook makes. Where discovery will not add value to the analysis a court will make, Twombly and Iqbal instruct lower courts to dispose of cases quickly and with low cost, so that strike-suit incentives are reduced. Richard Epstein describes what the Supreme Court was doing in Twombly as follows:

> The truth of the matter, quite simply, is that the Supreme Court looked over the allegations in the complaint, thought of all the reasons why they did not make any sense in the context of this . . . industry, and then refused to allow discovery to go forward because it had no confidence that thousands of hours of work would dredge up any new information that would alter its priors.

A bare allegation of a price fixing conspiracy, as was plead in Twombly, would normally be sufficient to get past a motion to dismiss based on allegations of parallel conduct, but the large discovery costs would not add much to the analysis that was not available from public records, which are not costly to produce. Where there are two plausible theories of the case (one benign and one sinister), and the answer about which one is more likely can be determined without taking the case further and imposing costs on the parties, courts should opt for an earlier decision on the merits. Epstein summarizes this reading of Twombly: “discovery is appropriate only when there is some evidence from some nonpublic rendered.” In both cases, the concern is whether the pay can reasonably be said to be the result of arm’s-length bargaining.

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24 The relevant comparison is cases without allegations of conflicts of interest or a failure of process, of which there are numerous filed every year under § 36(b) and nearly zero in Delaware.

source that justifies the greater expense of the discovery on the case.”

Caution about the judicial role is warranted because there is an asymmetry between the two types of errors that courts can make. False positives (Type I) attribute sinister behavior where there is none, while false negatives (Type II) do not catch such behavior where it does exist. While both errors may arise, they should not have equal weight in the costs of litigation when there exist external factors that discipline firms from acting badly. If a cartel (as in Twombly) or overpaying advisors (as in Jones) is difficult to maintain in the long run because of market pressures, then false negatives will be rare because of this instability. False positives may be more likely, however, because of the ex post bias of litigation and the limited information and expertise that courts have on these issues. In addition, it is difficult to undo a judicial order committing a Type I error, while a Type II error is unlikely to persist for long. Twombly hammers home this important gatekeeping function of pleading rules by trying to limit the judicial role where Type I errors likely swamp Type II errors.

Jones follows directly. There are perfectly sensible reasons why funds might charge lower fees for bigger customers (Jones’ best argument), and none of the facts about how much Harris was charging to whom or why was hidden from the public at the early stages of the litigation. In other words, the Gartenberg factors – for example, questions about economies of scale – apply across the board for all funds and are answerable at a general level. No one before Jones disputed that funds charged these different fees, that fees are fully disclosed, that there are different services provided to different customers, and so on. It may be that as a normative matter funds should charge less for unsophisticated investors or more for sophisticated ones, but this is beside the point. Costly litigation is unlikely to aid our understanding or analysis of the problem.

Like the Court’s opinions in Twombly and Iqbal, Jones is about reducing the social costs of meaningless litigation. Easterbrook believes § 36(b) cases are unjustified, absent self dealing or problem with the pay-setting process, based on an analysis of the economics of mutual fund compensation. While this argument has some appeal, it is not even necessary. All the evidence one needs to conclude that the game is not worth the candle with these cases is the simple fact that § 36(b) plaintiffs have never won and yet they have filed hundreds of cases in an attempt to extract settlements from defendants. The next Part considers these costs and shows why there are no corresponding benefits or why whatever benefits exist are dwarfed by the benefits or could be achieved in other, less costly ways.

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26 Id.
27 For an argument that unsophisticated investors benefit from higher fees, see D. Bruce Johnsen, “Myths about Mutual Fund Fees: Economic Insights on Jones v. Harris,” Journal of Corporation Law (forthcoming).
IV.  

A.

There are several costs of § 36(b) litigation that are readily apparent. Most obviously, there are the actual legal costs of prosecuting and defending these suits. Other costs include: the distraction that litigation causes for advisors and boards; the negative consequences of making boards focus on regulatory matters and compliance instead of business or strategy matters; and the potential false sense of security that the law gives investors.

We can get a rough idea of the (lower bound) cost of § 36(b) litigation by looking at the legal work involved in these cases. Although data is unavailable as to the specific costs, one need only look at Jones to see that the amounts are significant. Sixteen attorneys were involved in Jones at the district court, and they filed over 20 motions or memoranda, which in turn generated five published court opinions in the case so far. The costs for Harris to defend the suit to this point are in the tens of millions of dollars, according to lawyers familiar with the litigation.28

To get a sense of the costs of this kind of litigation more generally, I pulled a random selection of 20 of the more than 150 cases involving § 36(b) claims under the Gartenberg standard, and examined the publicly available records of the legal work involved. The average case was on the judicial docket for over two years, involved about a dozen lawyers, and generated over ten published orders from the courts involved. If we extrapolate the average of these cases to 150 cases (a rough estimate of the number of published § 36(b) opinions), we can get a sense of what was at stake for the mutual fund industry (as opposed to Harris) in Jones. These cases likely involved over 1600 lawyers filing nearly 1000 motions and about 1500 legal briefs, and generating over 1400 judicial orders. There is no data available on how much any of this costs, but it is undoubtedly significant, especially because the number of published cases must be dwarfed by the number of cases that are filed but settled before they could generate a written opinion.

We can get a ballpark estimate of the total costs of § 36(b) litigation by making some reasonable assumptions based on information from industry experts and insiders. We know from Professor Lyman Johnson that there have been about 150 cases citing Gartenberg that have generated published opinions.29 According to his data, about 60 percent of these were cases that were resolved prior to summary judgment and 40 percent at summary judgment or later. One estimate from an industry insider is that taking a § 36(b) case to

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28 Confidential telephone interview with lawyer familiar with the litigation on September 29, 2009.
29 See Johnson, supra note 11, Appendix A.
summary judgment costs defendants about $20 million per case. If we assume that the cases resolved at the motion to dismiss stage are much cheaper, say $1 million, then we can get an estimate of the defendants’ costs in these 150 cases over the past 27 years – about $1.3 billion.30

In addition, there are a number of other cases filed that settled before they can generate a written legal opinion.31 One estimate from an industry expert is that each fund, of which there are about 8000 today, has about a one percent chance of being sued every year.32 This generates about 80 additional cases per year, or about 2160 additional cases that have been settled since 1982.33 The cost of the average settlement must be less than the cost of going to summary judgment, so we can ballpark this at about half the cost of summary judgment, or about $10 million for each settlement. Industry experts confirm that this is a reasonable estimate, although no publicly available information exists. This means there is an additional cost of $21.6 billion over the past 27 years. The total cost for defendants to defend or settle these suits is therefore about $23 billion.34 This amounts to nearly $1 billion in costs per year for the industry as a whole.

This is a large amount in the aggregate, but amounts to only about $125,000 per fund per year. As discussed further below, if the average fund has assets of $2 billion and a management fee of about 1 percent,35 this means that the management fees are about $20 million per year. Expected litigation costs of $125,000 per year therefore amount to a litigation tax of just 0.6 percent of revenue. This is therefore a case in which there are potentially large aggregate costs (about $1 billion per year) but very small private costs for each actor; and hence the seed for justifying Judge Easterbrook considering the aggregate costs of § 36(b) litigation instead of just the interests of the parties.

30 This is calculated as: 75 cases times $20 million plus 75 cases times $1 million.
31 Some recent settlements include: Dumond v Mass Fin Srvcs Co, Case No 04-11458 (D Mass Nov 20, 2007); Strigliabotti v Franklin Res, Inc, Case No 04-0883 (ND Cal Aug 9, 2007); Sins v Janus Cap Mgmt, LLC, Case No 04-01647 (D Colo May 2, 2007); Vaughn v Putnam Inv Mgmt, LLC, Case No 04-10988 (D Mass Mar 31, 2007); Hunt v Invesco Funds Group, Case No. 04-2555 (SD Tex Jan 29, 2007); Williams v Waddell & Reed Inv Mgmt Co , Case No 04-2561 (D Kan Sept 25, 2006).
32 Confidential telephone interview with industry expert on October 1, 2009.
33 If the percentage estimate applies to fund families, instead of funds, the total number of cases per year looks more like 5, since there are about 500 fund families. In that case, the total costs for these cases is about $1.4 billion (5 x $10 million x 27), giving a total cost of about $3 billion since 1982, or about $200,000 per fund family per year.
34 Plaintiffs have costs too, but these are likely trivial in comparison, since they involve only lawyer fees, and do not include discovery costs, which are likely the biggest costs. If it costs plaintiffs $1,000,000 in legal fees to take a case to summary judgment, and just $100,000 otherwise, then the total costs for these cases are only about $300 million over the 27 year period. We can therefore safely ignore them, since they are within the margin of error of the assumptions.)
35 There are about $16 trillion in assets under management at about 8,000 funds, meaning the average fund has about $2 billion in assets under management. One percent is the approximate management fee charged by defendant Harris Associates for the Oakmark Funds, which the parties and the court characterized as about average.
B.

Litigation has not only costs but also benefits, and we should encourage laws that generate disputes in which the latter generally outweigh the former. The only possible benefit of § 36(b) would be that funds are deterred from overcharging their investors because of the risk of litigation. In order to support Gartenberg, one would have to believe that without the right to sue under this standard, investment advisors would pay themselves more than they currently do, and that this amount exceeds the costs of the litigation. It is possible that an articulate and administrable rule punishing advisors ex post for wrongdoing could efficiently reduce the monitoring costs of unsophisticated advisors, but there is no reason based on the experience to date to think that Gartenberg gets this right. In contrast, Easterbrook’s rule seems to provide for punishment based on the worst type of abuses while minimizing the possibility that Type I errors will impose large costs on investors.

The Gartenberg standard might have some deterrent effect if boards and advisors believe suits under § 36(b) occur when funds charge fees that are relatively high or are otherwise unjustified by the performance of the fund. If boards believe that if charge higher fees they will be sued, this may deter them somewhat from charging those fees. But if boards believe that the chance of suit is independent of the amount of fees they charge, then it will not deter overcharging as well, if at all. An unscientific but random sample of board members and industry insiders interviewed for this Essay suggest that board members believe suits under § 36(b) are not correlated with anything related to the rate of fees charged, the board process for setting those fees, or whether the fees are deserved in some sense. Board members describe the chances of being sued in a § 36(b) case as “unrelated to the amount of fees paid,” “the same no matter how much we negotiate or how much due diligence we do,” “as random as being struck by lightning,” and “related more to the size of the fund and whether a plaintiff can be found than anything to do with fees.” Whether or not these assertions are true, boards seem to think they are true, which undermines any deterrent effect that the law as implemented may provide.

As mentioned above, there is some evidence that some (small) funds charge higher fees than their performance would seem to warrant, but according to industry observers and lawyers involved in these cases (on both sides), these

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36 Bruce Johnsen claims that this entire inquiry is irrelevant, because if a fund lowers its fees, while holding performance constant, it should see a corresponding increase in the assets of the fund that perfectly offset the drop in fees. See D. Bruce Johnsen, “Myths About Mutual Fund Fees: Economic Insights on Jones v. Harris,” GMU Working Paper, available at http://works.bepress.com/d_bruce_johnsen/3/.

37 Based on ten confidential telephone interviews conducted with board members of ten different mutual fund companies conducted during September and October 2009.
are not the firms that get sued.\(^{38}\) Plaintiffs’ lawyers recognize that the Gartenberg standard is nearly impossible to meet, so the chance of being the first case to ever prevail at trial is very low. If this is true and the object of the suit is settlement, it makes much more sense to go after big-pocketed defendants. This is especially true given that the amount of damages is capped at the amount of “excessive” fees paid in the prior year. Since fees are based on a percentage of total assets, and it presumably costs the same to go after the adviser to a big fund as a small one, it makes sense, all else being equal, to target the big ones. One might argue that big funds will be more ably represented, but because settlements can be won without any consideration of the merits, the fact that the case against large funds might not be as good as against smaller funds is irrelevant. Insofar as the merits are meaningless, the quality of lawyering should not be a major factor in the decision of who to sue, especially since good lawyers presumably cost more than bad ones, which just raises the value of any settlement.

Not only are § 36(b) cases believed to be uncorrelated with the relative size of fees, but as a practical matter, the size of any deterrence from these cases is likely to be trivial given the relatively low stakes of the litigation compared to the size of the industry and the compensation of investment advisors. To see this, consider the defendants in \(\text{Jones}\), the Oakmark Funds managed by Harris. According to the district court, the funds had about $5 billion in assets and management fees of about 1 percent of this amount, or $50 million per year. If plaintiffs were successful in their litigation, and were able to reduce Harris’s fees to, say, 0.7 percent, the damages would be about $15 million.\(^{39}\) This means that for Harris to be deterred from charging “too much” (1 percent versus 0.7 percent), it must face an expected cost from litigation of more than $15 million per year.\(^{40}\) (If litigation costs are expected to be less than $15 million, Harris would pocket the “extra” $15 million, pay the costs of litigation, and keep the (positive) difference.)

But expected litigation costs are likely much less than $15 million per year. The best available data suggests firms have about a 1 percent chance of suit in a given year, meaning a suit would have to cost (either in damages, settlement costs, or litigation costs) more than $1.5 billion in order for the fund to be deterred from charging “excessive” fees. But the statute limits damages to the excessive fees charged in the year prior to the suit, and as such, this is impossible. Or, looking at it another way, if litigation fees are $20 million to get to summary judgment, and probability of being sued in any year is 1 percent, then the value of

\(^{38}\) Anecdotal evidence based on in-person interviews with lawyers and industry experts.

\(^{39}\) That is, 1% minus 0.7% times $5 billion = $15 million.

\(^{40}\) Importantly, section 36(b) limits the amount of damages to the one-year period prior to bringing the suit. See section 36(b)(3) (“No award of damages shall be recoverable for any period prior to one year before the action was instituted.”).
the deterrence is $200,000 per year. If the fund has $5 billion in assets under management this would amount to a difference in fees of 0.004 percentage points (e.g., 0.996% instead of 1% in fees). A final way of seeing this is to point out that if it costs $15 million to settle a suit and the gains from excessive payments are about $15 million per year, then to be deterred from overpaying, funds would have to face a 100 percent probability of suit every year.

This crude model shows that financial deterrence is a very weak basis for justifying the Gartenberg rule. To be sure, this analysis assumes a rather crude model in which the board is functioning purely as a collective version of homo economicus. But the model does not describe the reality of actual board-advisor negotiations, rather it merely points out the incentives under which advisors and board members operate, whether they are cognizant of this or not.

Nevertheless, one could argue that § 36(b) has a deterrent effect because the independent directors of funds disregard the simple economics of the litigation threat, and instead want to do the right thing and take their fiduciary duties seriously. While undoubtedly accurate, this description does not square with the view of board members that suits are not correlated with the seriousness with which they take their job. It also is inconsistent with a regime in which most cases settle privately – if board members can avoid non-monetary costs, such as negative publicity, being deposed, and so on, by paying to make suits go away, then any deterrence must be viewed in monetary terms.

Board members, who are represented by their own counsel and by all accounts take their role seriously, are faced with two external constraints on the fees they authorize – market forces in the form of attracting assets and the threat of litigation. If the latter is purely random, and the former is highly (but not perfectly) correlated with the payment of reasonable fees, then the market forces constraint will dominate. If we relied solely on the litigation deterrent, the analysis returns to the financial incentives discussed above, and these would be plainly insufficient to reduce pay. When Easterbrook writes that the problem with Gartenberg is that it relies too little on market forces, this is what he has in mind.

There may be some value in best-practices standards, like those found in Gartenberg, and in a random (or, better yet, targeted) audit of funds. Under this theory, the test is important because it makes them do work they would otherwise not do, and, even if suits are random, improves the terms of any settlement or the likelihood of prevailing at trial. Even if plausible, there is no reason to think that the current system of private enforcement of § 36(b) is the most efficient way of achieving this goal. The Securities Exchange Commission and a variety of quasi-governmental agencies, such as those regulating brokers and other securities professionals, have several advantages over courts. First, as experts in this area, these agencies are likely better positioned to make the judgments about the reasonableness of fees based on the latest empirical data and the state of the
market as a whole. Second, government agencies presumably have less incentive to engage in strike suits, since the lawyers bringing the cases are not compensated directly via the size of any settlements. In other words, all else being equal, government prosecutors have stronger incentives to represent the plaintiffs who are most likely harmed by the current compensation scheme for fund advisors – that is, less sophisticated and less price sensitive investors in smaller funds.

The comparative advantage of the government as prosecutor here points to an answer to another puzzle about the case: why would the Supreme Court reinstate a standard that never results in victory for plaintiffs, is used by plaintiffs’ lawyers to extract settlements from large and relatively well-paying funds, and is providing little or no deterrent effects? One answer might be that the Gartenberg standard preserves the possibility that the government might someday bring a § 36(b) case. The billions spent on (wasted) private litigation to date seem like a fairly stiff price to pay for a remote future possibility of government action. In addition, the SEC could, through rulemaking, enforcement of existing rules on brokers, education of investors, jawboning, or other means, try to influence the behavior of fund advisors or investors in funds allegedly charging excessive fees. Nothing in Jones ties the hands of the government in solving this problem, if one exists. And, in fact, the expert agencies are the ones likely better positioned to make both the judgment about whether there is a problem, and if there is, what the most efficient solution to it is.

V.

Jones is a remarkable opinion because it lays bare the costly but mutually beneficial game being played by both sides in mutual fund fee litigation. Gartenberg imposes a random but very small tax on mutual fund advisor compensation, which the industry can simply pass on to its investors. For nearly three decades, courts have handled hundreds of cases (and spawned hundreds more that have settled) under this standard, and thereby allowed a multi-billion dollar wealth transfer from investors to lawyers, without any benefit to investors. Jones boldly tries to end this profitable game by calling the bluff of plaintiffs’ lawyers. The importance of Jones lies in the fact that everyone involved – the advisors, the courts, the lawyers – were fine with the existing regime, since it was in their interest to maintain it. But the investors § 36(b) was designed to help were not helped by it, and what Easterbrook does in Jones is bring them to the table.

Easterbrook’s opinion, which essentially is about collapsing the merits inquiry to the motion to dismiss stage, also points to the danger of the federalization of corporate law issues generally. As noted above, state courts are
much better at processing fiduciary duty claims efficiently. Delaware courts have a long tradition of collapsing litigation in this way, through mechanisms like the demand-excuse doctrine and expert courts that are able to efficiently sort meritorious from meritless cases, and are willing to dismiss meritless cases quickly. Section 36(b) and state fiduciary duty law on executive compensation are nearly indistinguishable, and yet state courts are not subjected to the same strike suits that federal ones have been. This may be because federal courts apply the pleading and discovery rules similarly across substantive areas out of fear that Balkanizing the rules risks losing cases that would vindicate important rights. Whereas the specialty Delaware business courts can apply merits-collapsing rules in corporate law cases without risk of deterring tort or civil rights suits, the same might not be true of federal courts. If true, then we should resist attempts to make more corporate law matters within the jurisdiction of federal courts.

This concern may be ameliorated to some extent by the Supreme Court’s recent civil procedure jurisprudence. We can view Twombly and its progeny as an attempt by the Supreme Court to delineate some standards for targeting the rules of civil procedure to particular substantive areas based on the external forces and incentives of the litigants and other parties in the disputes. Antitrust and national security issues are already identified as cases in which federal courts should be attuned to the tradeoffs between the costs of litigation and the information needed to make good decisions. Judge Easterbrook’s opinion in Jones, suggests mutual fund advisor compensation is one of these areas too.

This reading is therefore how we can square Easterbrook’s opinion in Jones with his more general views about civil procedure and merits-collapsing doctrines. Easterbrook is generally opposed to the approach he seems to take in Jones. In a decision issued two weeks before Twombly, Judge Easterbrook states his views clearly:

Civil Rule 8 calls for a short and plain statement; the plaintiff pleads claims, not facts or legal theories. Factual detail comes later—perhaps in response to a motion for a more definite statement, . . ., perhaps in response to a motion for summary judgment. Until then, the possibility that facts to be adduced later, and consistent with the complaint, could prove the claim, is enough for the litigation to move forward. Although we appreciate the pressure that a heavy flux of litigation creates, and the temptation to get rid at the earliest opportunity of claims that do not seem likely to pan out, Rule 12(b)(6) does not serve this function.41

This view is no longer universally true, as Twombly teaches. But it may continue to make sense in much, if not most, civil litigation where the value of additional

information and adversarial process is clear and where the incentives of the litigants is not as skewed in terms of the merits mattering.

Pay will never be perfect, but this does not mean judges have much role to play given the (decision and error) costs of their involvement. Critics of this deferential approach want to turn the inquiry into the price of advisor services into rate regulation, with courts using the adversarial process to (ex post) determine what the right amount of pay should have been. This is not a new desire. Monks and other thinkers of medieval Europe, known as the Scholastics, believed the price of something was determined not by the market but by expert analysis of the things that go into prices.42 This is the Gartenberg approach, which is not only an impossible task for a non-expert court, but also creates the litigation incentives dynamic described above. Easterbrook, like Delaware courts applying fiduciary duties and more sophisticated monks, like Thomas Aquinas, recognize that the “just price” is the one set by the market, unless there is a monopoly problem.43 There is no monopoly of advisor services, and while some will do poorly even without one, these exceptions cannot swallow the whole.

Twombly teaches that where there is an economic theory that shows the game is not worth the candle, then we should err on the side of early dismissal with the ultimate objective of deterring the suits from being filed in the first place. This is especially true when the type of evidence adduced – such as lots of money being made – may be prejudicial of the inquiry into the reasonableness of the compensation.44 In other words, where we see litigation that produces costs that dwarf the benefits, we should lower the stakes of the litigation for plaintiffs.

VI.

This Essay defends Judge Easterbrook’s opinion in Jones as the efficient outcome from a social welfare perspective, but the Supreme Court may disagree. This raises the more general question of how Judge Easterbrook’s opinions fair when reviewed by the Court – on average, how does Judge Easterbrook do compared with his contemporaries when the Supreme Court reviews his opinions?

Jones will be only the sixteenth time that the Supreme Court has reviewed an Easterbrook opinion. In his 25 years on the bench, Easterbrook has authored about 1650 opinions, meaning the Court has reviewed less than one percent of his opinions. This is a bit better than the average judge in the dataset, and

42 See, for example, David D. Friedman, “In Defense of Thomas Aquinas and the Just Price,” 12 History of Pol Econ 234 (1980).
43 Id.
44 Easterbrook’s opinion could be read You could be read as saying that no amount of evidence purely of excessive compensation is enough to find liability under a standard that merely requires the recipient not to abuse those paying for its services.
significantly better than Judge Harvey Wilkinson of the Fourth Circuit, who is twice as likely to have an opinion considered by the Court, and Judge Stephen Reinhardt of the Ninth Circuit, who is more than five times as likely to be reviewed by the Court. The infrequency of Court review of Judge Easterbrook’s opinions shows the importance of *Jones* in his oeuvre and supports the view that federal appeals court judges have fairly wide latitude in making law given the Court’s fairly limited use of judicial review.

When the Court does review an opinion by Judge Easterbrook, the party defending Easterbrook’s opinion usually prevails – the Court has affirmed ten Easterbrook opinions and reversed only five.\(^{45}\) Easterbrook’s “batting average” at the Supreme Court is thus an impressive 67 percent. We can also calculate Judge Easterbrook’s overall reversal rate as about 0.3 percent.\(^{46}\) This means only about one out of every three hundred and thirty Easterbrook opinions is reversed – about one every five years.

To put Easterbrook’s success at the Supreme Court in some context, we can compare his success with the success of the average opinion reviewed by the Court. According to data from Professor William Landes, respondents, who are always more or less defending the courts of appeals decision, win at the Court only about 35 percent of the time. This means that respondents from decisions written by Judge Easterbrook are twice as likely to prevail as respondents from all other courts of appeals judges.\(^{47}\)

A perhaps better comparison group, however, is the subset of courts of appeals judges who have similar tenure and experience to Judge Easterbrook. I constructed a dataset of 13 courts of appeals judges with similar tenure to Easterbrook. The dataset includes almost every judge on the federal courts of appeals appointed around the time as Easterbrook and with similar numbers of total opinions.\(^{48}\) Every court of appeals is represented. The judges are quite similar to Easterbrook in terms of rough political affiliation, since President Reagan appointed most to the bench.\(^{49}\)

Among this peer group, Judge Easterbrook’s success is striking. The mean judge in Easterbrook’s peer group is affirmed by the Supreme Court just 37

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\(^{45}\) One was vacated and remanded.

\(^{46}\) Calculated as 5 divided by 1647.

\(^{47}\) The average non-government respondent wins 35 percent of the time at the Supreme Court, but the respondent when Judge Easterbrook writes the opinion wins 67 percent of the time.

\(^{48}\) We can be fairly confident about the representativeness of this sample based on the fact that the average success rate for the judges in sample when the Court considers their opinions is the same as the average success rate for respondents generally at the Court over the past 50 years. Since 1953, respondents have won at the Supreme Court about 35 percent of the time (Data on file with author from dataset compiled by Richard Posner & William Landes); the average rate of affirmance for the judges in Easterbrook’s peer group is about the same (37 percent).

\(^{49}\) There are a few political or judicial “liberals,” but the results do not change significantly if they are removed.
percent of the time, compared with nearly 70 percent for Easterbrook. Peer judges are reversed about 0.6 percent of the time, twice as often as Judge Easterbrook. He is, to the best of my knowledge, the judge in his peer group least likely to be overturned by the Supreme Court. For instance, Judge Stephen Reinhardt has a batting average of 16 percent, and a total reversal rate of nearly 4 percent. Another judge with similar tenure, Judge Bruce Selya has a batting average of 13 percent and a total reversal rate of 0.6 percent. On average and without considering the merits of the case, respondents defending a Judge Easterbrook opinion are more than five times as likely to prevail at the Supreme Court compared with those defending opinions of these two judges. Easterbrook does even better than famed colleague, Judge Richard Posner. Posner, who disagreed with Easterbrook in *Jones*, has a (lower) batting average of 57 percent and (higher) reversal rate of 0.4 percent.

Although the historical data suggest Judge Easterbrook’s opinion is likely to be affirmed, no one believes the historical percentages tell us much about how these nine justices at this time and with these facts are likely to judge what he has done in *Jones*. The Court has a new justice, the country has a new president and is in the midst of an economic crisis, and the case is seemingly about executive compensation at a time when populism, especially about pay, seems to be resurgent.50

Also perhaps pointing in the direction of reversal is the utter boldness of what Easterbrook was trying to do in *Jones*. Judges of course know that the legal rule they create or invoke will do more than decide the case or controversy before them, but it is probably quite rare for judge to put the interests of all litigants before the court now or in the future to the side. When no parties support a court’s opinion, it suggests the court was probably on to something important. Easterbrook’s opinion is a bold attempt to achieve his view of the optimal and efficient rule from a social-welfare perspective, and to further delineate the boundaries of the Supreme Court’s sub-rosa amendments to the Federal Rules of Civil Procedure. As litigation costs rise and more corporate issues become matters of federal concern, this is an important move the Supreme Court should be loath to throw away.

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50 A government “pay czar” recently made recommendations to lower and alter the pay at seven large financial institutions, see Deborah Solomon, “Pay Czar Targets Salary Cuts,” WALL ST J, Oct 6, 2009.
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Justifying Jones / 21

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22 / Henderson

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