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Challenging Government-Sponsored Private Regulation of Competitors

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1. Introduction

It has been a longstanding practice in America for governments to give private entities made up of professionals in an industry the authority to regulate the profession (e.g., state bar associations regulating lawyers and state medical boards regulating doctors). This private sector self-regulation has its advantages: people in an industry know more about it than government does. When that self-regulation is non-coercive, it seems essentially unobjectionable.

But if the government gives private actors coercive power to regulate their own industry, that power isn't really *self*-regulation: it's really *some people* in an industry regulating *other people* in that industry. Sometimes these regulatory arrangements involve participants in an industry regulating their competitors. In other cases, existing businesses regulate, and possibly exclude, potential new entrants. When industry has a hand in regulating "itself," it's reasonable to be concerned about the potential for self-interested bias and anti-competitive behavior.

This policy brief is derived from "The New Private-Regulation Skepticism: Nondelegation, Due Process, and Antitrust Challenges," *Harvard Journal of Law & Public Policy* (forthcoming 2014), vol. 37. The reader is referred to that paper for a more complete exposition and more complete references. The research for this brief was funded by Reason Foundation, by an Emory University summer research grant, and by Express Scripts, Inc. Neither Emory University nor Express Scripts, Inc. exercised any editorial control over the author's work.

Legislators and regulators need to be aware that recent state and federal court decisions show what appears to be an increasing skepticism of private regulatory delegations where such conflicts of interest may exist. Depending on the context, courts might invalidate an entire agency, prevent it from regulating in certain ways, and/or hold individual regulators liable for damages.

This policy brief uses two recent examples—the Mississippi Board of Pharmacy's regulation of pharmacy benefit managers and the North Carolina Board of Dental Examiners' exclusion of non-dentist teeth whiteners—to explain the various legal doctrines used to challenge private regulatory delegations: state and federal nondelegation doctrines, the U.S. Constitution's Due Process Clause, and federal antitrust law.

North Carolina Board of Dental Examiners: This board, mostly composed of dentists elected by dentists, regulates dentistry in North Carolina. It's illegal to practice "dentistry"—including teeth-whitening services—without a license from the Board. The Board sent dozens of letters to non-dentist providers of teeth-whitening services, asserting that their activities were illegal and ordering them to stop. As a result, non-dentist teeth whiteners were successfully excluded from the state.[1]

Mississippi Board of Pharmacy: This board, composed of pharmacists appointed by the governor from a list submitted by pharmacy associations, regulates the practice of pharmacy and the distribution of drugs and devices in Mississippi. In 2011, at the urging of Mississippi pharmacists, the legislature gave the Board regulatory authority over pharmacy benefit managers (PBMs). PBMs administer prescription drug benefits for HMOs and public and private health plans. On behalf of their client plans, PBMs negotiate discounts with pharmacies and manufacturers, and thus are the market adversaries of pharmacists, competing with them for a share of the profits of the prescription drug business. The Mississippi statute requires that PBMs disclose financial statements to the Board; these statements must include their balance sheets and income statements, as well as "[a]ny other information relating to [their] operations required by the board," excluding "proprietary information." Also, the Board recently attempted to pass a regulation imposing a fiduciary duty on PBMs to avoid profiting at the insureds' expense. Thus, for instance, they might be required to pass on to the insureds all discounts negotiated with pharmacies. Such fiduciary duties can be harmful when markets are competitive. As profit-making entities, PBMs do what they do because they expect to profit, and a requirement to pass on cost reductions would reduce PBMs' profit, reduce entry into the PBM business, and could ultimately limit the extent of cost reductions—which is precisely in the self-interest of pharmacists. But the Board ultimately backed down and declined to impose such a duty.[2]

These two regulatory board examples at first glance appear to be public. The North Carolina dental board is labeled public by statute. The Mississippi Board of Pharmacy members are gubernatorial appointees. And yet, various courts have held that comparable regulatory bodies are private, at least for some purposes. The North Carolina dental board members all have private dental practices and are only accountable to other dentists. The Mississippi pharmacy board could similarly be considered private for some purposes: its members are in private practice, and the governor is restricted to choosing from lists submitted by trade associations.

The following discussion will show how private regulators are legally vulnerable. Even regulators who think they're public might want to exercise caution: a skeptical court might disagree. The court might invalidate the entire agency, or it might prevent certain types of regulation, and—depending on the applicable legal rule—it might hold individual regulators liable for damages.

2. The Due Process Clause

Both the federal and state governments are subject to the federal Constitution's due process clauses, which prevent governments from depriving anyone of "life, liberty, or property, without due process of law." There's no due process doctrine specific to private regulators. But delegation of power plus pecuniary bias is always a due process no-no. And it's easy to imagine (or presume) that such bias may be more likely if a delegate of coercive power is private.

Thus, in *Eubank v. City of Richmond* (1912), the Supreme Court examined an ordinance allowing the owners of two-thirds of the property abutting a street to establish a "building line" beyond which construction would be illegal. The Supreme Court held that this violated due process, because there was no protection against the property owners using their coercive power arbitrarily or self-interestedly.[3] Similarly, in *Carter v. Carter Coal Co.* (1936), the Supreme Court examined the Bituminous Coal Conservation Act of 1935, which allowed the producers of two-thirds of the coal in any "coal district," negotiating with unions representing a majority of mine workers, to set wages and hours for all coal producers in the district. The Supreme Court struck this down with a strong statement against self-interested self-regulation:

> The power conferred upon the majority is, in effect, the power to regulate the affairs of an unwilling minority. This is legislative delegation in its most obnoxious form; for it is not even delegation to an official or an official body, presumptively disinterested, but to private persons whose interests may be and often are adverse to the interests of others in the same business. . . . The difference between producing coal and regulating its production is, of course, fundamental. The former is a private activity; the latter is necessarily a governmental function, since, in the very nature of things, *one person may not be entrusted with the power to regulate the business of another, and especially of a competitor. And a statute which attempts to confer such power undertakes an intolerable and unconstitutional interference with personal liberty and private property*. The delegation is so clearly arbitrary, and so clearly a denial of rights safeguarded by the due process clause of the Fifth Amendment, that it is unnecessary to do more than refer to decisions of this court which foreclose the question [emphasis added].[4]

This due process doctrine remains valid today, as *Gibson v. Berryhill* (1973) illustrates. The Alabama Board of Optometry sued Lee Optical Co. and its employees in Alabama state court, charging that the employees were engaged in the "unlawful practice of optometry" by working for a corporation rather than being self-employed. After the Board won in court, it started delicensing proceedings against the individual optometrists. The optometrists sued, arguing that the Board—composed of self-employed optometrists—was impermissibly biased. The Supreme Court agreed: "those with substantial pecuniary interest in legal proceedings should not adjudicate these disputes," whether as judges or as administrative adjudicators.[5]

Gibson doesn't disapprove of the Board's first step, which was to sue the optometrists in state court—where its claims were evaluated by a disinterested judge. The decision only discusses, and disapproves, the Board's second step, which was the delicensing proceeding in its own tribunal, which gave free rein to its own pecuniary bias. The distinction is between giving private parties *mandatory* control over coercive processes and merely allowing them to petition the government to (in its *discretion*) coerce private parties.

Now let's apply this due process line of reasoning to our two examples. The North Carolina Board of Dental Examiners didn't create the rule against non-dentist teeth-whiteners. Nor can it expel non-dentist teeth-whiteners from the market except by suing them in court. Because it hasn't exercised any mandatory power, its recent actions in ordering non-dentists to stop violating state law don't violate due process (though the Board might still violate due process in other contexts, for instance in its own disciplinary hearings).

The Mississippi Board of Pharmacy is in a grayer zone. Whether it is violating due process depends on what it does, and how. If a requirement that pharmacy benefit managers turn over financial information is required by a statute passed by the legislature, the Board's pecuniary bias doesn't seem relevant unless the Board adjudicates violations in its own tribunal. But if a regulation is enacted by the Board itself, as the fiduciary duty regulation almost was, then the Board's bias can matter. Conceivably, one could challenge the rule based on the Board's bias even in the case of in-court enforcement—and obtain money damages in a civil rights suit against the Board members—though successfully challenging a biased rulemaking is harder than successfully challenging a biased adjudication.

3. The Nondelegation Doctrine

The federal nondelegation doctrine derives from the vesting clause of Article I of the U.S. Constitution: "All legislative powers herein granted shall be vested in a Congress of the United States." This language has been interpreted to mean that Congress can't transfer its powers. The test has been the same since 1928: when Congress delegates, it must provide an "intelligible principle" to guide the delegate's discretion.[6] In other words, it is "constitutionally sufficient if Congress clearly delineates the general policy, the public agency which is to apply it, and the boundaries of this delegated authority."[7] This doctrine applies only against the federal government, not against the states; but many states have similar nondelegation doctrines. The nondelegation doctrine is widely considered an insignificant constraint on delegation of power to agencies; but while this may be mostly true of the federal doctrine (and state doctrines that are similar), the nondelegation doctrine—at least when it comes to private delegates—may have more teeth in certain states, like Texas. Some lower federal courts have likewise interpreted the nondelegation doctrine to apply more stringently to private delegations.

Let's examine our examples under hypothetical state doctrines that are equivalent to the federal one. The North Carolina dental board authorizes regulation of dentistry "in the public interest"—a general, but nonetheless intelligible principle. The Mississippi Board of Pharmacy, however, seems to lack an intelligible principle for licensing pharmacy benefit managers.

Mississippi's nondelegation doctrine is about as loose as the federal doctrine, but even by loose standards, it's hard to find an intelligible principle in the requirement that pharmacy benefit managers have to provide *any* (non-proprietary) information about their operations that the Board might require.

If that were all, it would appear that the nondelegation doctrine isn't all that stringent. But two additional factors combine to make it potentially more stringent: at the state level, strong private nondelegation doctrines like that of Texas; and at the federal level, a private nondelegation doctrine recently applied by the D.C. Circuit.

In *Texas Boll Weevil Eradication Foundation v. Lewellen* (1997), the Texas Supreme Court invalidated the Texas legislature's delegation of regulatory power to a boll weevil eradication foundation. The foundation operates weevil eradication programs and charges growers for the costs. Growers in an area can elect with a 2/3 vote to establish eradication zones, entitling the foundation to make assessments and enter the subject properties without the owners' permission. First, the Texas Supreme Court found that the statute "delegate[d] authoritative power to private interested parties," which made this delegation different than usual delegations to public agencies. Then, it devised a multi-factor test for whether a private delegation was valid. The factors included whether the private delegate's actions were supervised by the government, whether affected people were adequately represented, whether the delegate had adjudicative in addition to rulemaking power, whether it had a pecuniary bias, whether it could impose criminal sanctions, how broad the delegation was, whether the delegate had special qualifications, and whether the legislature provided sufficient standards. (The last factor coincides with the federal "intelligible principle" standard; the pecuniary bias factor sounds more like the test for due process.) Enough of these factors cut against the foundation that the Court concluded that the delegation was unconstitutional.[8]

The cases of the North Carolina dental examiners and the Mississippi Board of Pharmacy would be questionable were they subject to the Texas rule, since the regulated parties aren't represented in the process, the organizations apply rules to particular individuals, the organizations are peopled with practitioners with a pecuniary bias against their competitors, the extent of the delegation is broad, and the legislature hasn't provided detailed standards. (As to these standards, general guidance like the dental examiners' "public interest" may be enough for the federal doctrine, but the Texas rule is more demanding.)

Which brings us to the D.C. Circuit's doctrine against private federal delegations. In *Ass'n of American Railroads v. DOT* (2013), the D.C. Circuit held that Amtrak was private and that therefore a statute delegating regulatory power to it violated the federal nondelegation doctrine. The court wrote that, while generally an "intelligible principle" is enough to save a federal delegation, this isn't enough when the delegate is private. To complete the reasoning, the D.C. Circuit had to establish that Amtrak is indeed private. Such an approach could be problematic in light of previous case law holding that Amtrak is a state actor. No problem, said the D.C. Circuit—one can be governmental for purposes of the state action doctrine but private for purposes of the nondelegation doctrine. And here, said the court, the purposes of the nondelegation doctrine—accountability and disinterestedness—suggest that Amtrak should be considered private, since the statute setting it up as an independent, profit-making corporation makes it both unaccountable and self-interested. The end result was that the statute delegated regulatory power to a private party and was therefore invalid.

Under the D.C. Circuit's approach—if it comes to be adopted at the state level—our two examples might still be valid. The North Carolina dental examiners' board and the Mississippi pharmacists' board aren't like Amtrak in that they hold themselves out as regulatory bodies rather than profit-making enterprises, though predicting how the D.C. Circuit would apply its doctrine in these cases involves some amount of guesswork.

In sum, the current nondelegation doctrine at the federal level (and in states that follow the federal doctrine's lead) is not likely to be a highly effective avenue of attack against private regulatory agencies. The doctrine in states with more stringent rules against private delegations, like Texas, is likely to be much more effective, and the private delegation doctrine developed by the D.C. Circuit, if adopted by states, might also play a somewhat constraining role.

4. Federal Antitrust Law

As mentioned above, industry self-regulation raises the possibility that incumbents will anti-competitively regulate potential entrants or current competitors.

A state board accused of anti-competitive behavior will always argue, as an initial matter, that its behavior is "state action" and therefore exempt from antitrust law.[9] State-action antitrust immunity has a three-part structure: (1) The acts of state governments *themselves*—for instance, a state legislature—aren't regulated by federal antitrust law at all.[10] (2) Municipalities and state agencies are immune from antitrust challenge if they show that they're acting according to a clearly articulated state policy.[11] (3) But private actors aren't immune unless they *in addition* show that they're actively supervised by the state.[12]

The question for state boards is thus whether they're public (as their labeling as state agencies suggests) and fall into the second category—or whether they're actually private (because they're composed of self-interested industry members) and fall into the more vulnerable third category.

The federal circuits have taken different approaches to this question. The Fifth and Tenth Circuits have said state boards were public based on a very cursory analysis, and the Second Circuit has (dubiously) suggested that an agency is public if it's "by statute a political subdivision of the state."[13] The First, Ninth and Eleventh Circuits take an intermediate view: whether an agency is public depends on what attributes of government power it has (this involves looking at a laundry list of factors like whether it has eminent domain power, rulemaking authority, or tax-exempt status) and how involved private members are in its operation.[14]

The Federal Trade Commission, in its enforcement actions, takes the strongest view. Rather than a "laundry list of attributes" approach, the FTC focuses on one aspect: the extent to which the bodies are driven by private self-interest.

In 2011, the FTC examined the case of North Carolina's Board of Dental Examiners, which had driven non-dentists out of the state market for teeth-whitening services. The FTC's position was that the Board should be treated as private because it was dominated by self-interested market participants.[15] The FTC partly convinced the Fourth Circuit—at least in this case, where the Board was not only dominated by dentists but also only elected by (and therefore accountable to) dentists.[16] The Supreme Court will review this case in its 2014–15 term, so presumably it will endorse one of these approaches and disapprove the rest.

The Mississippi Board of Pharmacy would probably be vulnerable under both the FTC's and the Fourth Circuit's approaches. There's no antitrust problem with the statute requiring pharmacy benefit managers to disclose their financial statements to the state Board of Pharmacy—that's the act of the legislature, which is absolutely immune. But the Board also has a delegated power to require additional financial information, so these additional items could still be challenged. And the fiduciary duty requirement for pharmacy benefit managers, had it been adopted, could be challenged because it would have come entirely from the Board.

The Mississippi Board of Pharmacy is appointed by the governor from lists submitted by the Mississippi Pharmacy Association with input from other pharmacist organizations. All members must be licensed pharmacists and have at least five years' experience practicing pharmacy in Mississippi. That would probably be enough to make it private for purposes of state action immunity under the FTC's approach. The Fourth Circuit's approach would in addition require accountability to market actors. At first sight this seems lacking, since the governor appoints and removes the Board members. But on the other hand, Board members can only be removed for cause and with procedural protections, so the governor can't remove a Board member for purely policy reasons, and the governor is also constrained to appoint members suggested by pharmacist associations. So it's plausible that the pharmacists on the Board are primarily accountable to other pharmacists, which could be enough to satisfy the Fourth Circuit's approach to finding the Board private for purposes of state action immunity as well.

Whether a state agency like the Mississippi Board of Pharmacy will be able to benefit from state action immunity from federal antitrust law will thus depend on the circuit, and how strictly the circuit analyzes the agency's structure for signs of privateness. A challenger who can show that an agency is dominated by and accountable to market participants is certainly well off in the Fourth Circuit, though such characteristics may also make the difference in "laundry list" circuits like the First, Ninth and Eleventh.

Of course, showing state-action immunity from antitrust law isn't enough: a challenger won't win unless he also shows an antitrust violation.

In the dental examiners' case, the FTC and Fourth Circuit didn't have much trouble showing an antitrust violation: the Board was excluding lower-cost competitors, and the offered pro-competitive justifications were found to be insufficient. In other cases—for instance, if a regulatory-looking board is promulgating or enforcing apparently "reasonable" regulations—the analysis would be more complicated. The strength of a challenger's case would then probably depend on whether he and the board members are competitors (and, more generally, whether the board members have a financial interest in the outcome), whether they're in vertically related or collateral markets, and whether they're in the same geographic market.[17]

The Mississippi Board of Pharmacy thus seems vulnerable. Once state action immunity is overcome, the competitive relation between pharmacists and pharmacy benefit managers can create a strong presumption of a substantive antitrust violation. Establishing the anticompetitive effect will still take some proof, but one can at least imagine how such a challenge would proceed, since knowing one's adversaries' financial information would help one compete against them and could also facilitate collusion among pharmacists. Imposing a fiduciary duty on one's competitors reduces their profits and reduces entry into their line of work, which should also contribute greatly to the self-interest of pharmacists. In any event, the structural considerations should make a challenge that much easier.

Once an antitrust violation is found, the result could be treble damages and attorney's fees for those who are found to have conspired to restrain trade. Some state agencies may be considered "arms of the state" and share the state's sovereign immunity from damages for purposes of the Eleventh Amendment, but other agencies and boards won't. The inquiry is complex; whether the state is obligated to pay the agency's debts is an important consideration, but not the only one.[18] It isn't possible to be definitive, but it looks as if the North Carolina dental board does share the state's sovereign immunity, while the Mississippi Board of Pharmacy is a tougher case and may be subject to treble damages (if found in violation of antitrust law). In the case of the Mississippi Board of Pharmacy, the Board's regulatory function cuts in favor of immunity, but its relative independence and lack of political accountability cut against immunity—and these are only some of the factors that courts would consider.[19]

Regardless, any suit—whether or not damages are available, and whether or not it even asks for damages—will still require defendants to pay the costs of litigation, as well as the plaintiff's costs if he prevails. Similarly, even if damages are not available, the boards would still be subject to injunctions.

Putting the conclusions on state action immunity, substantive antitrust violations, and liability together: The North Carolina dental board was found to lack state-action immunity in the Fourth Circuit and may be found non-immune in the intermediate circuits. It's in violation of antitrust law; but it probably has sovereign immunity, so it only has to worry about injunctions. The Mississippi pharmacy board's state-action antitrust immunity likewise depends on the circuit; it may be found in violation, depending on the anticompetitive effect of its activities; and it may not have sovereign immunity, so it has to worry both about injunctions and about paying damages.

5. Conclusion

Let's now put everything together, with the understanding that what's potentially invalid may not be the organization itself but simply the particular challenged actions described in the text.

	Due Process	Nondelegation Doctrine	Antitrust
North Carolina Board of Dental Examiners' sending cease-and-desist letters to non-dentist teeth whiteners	No violation	Probably invalid under a Texas-like doctrine	Possible antitrust violation, no state-action immunity under Fourth Circuit approach, probable sovereign immunity
Mississippi Board of Pharmacy's demanding pharmacy benefit managers' financial information or imposing fiduciary duties	Possible violation by Board-generated rules	Possibly invalid under federal or Mississippi doctrine, probably invalid under Texas doctrine	Possible antitrust violation, no state-action immunity under Fourth Circuit approach, possibly no sovereign immunity

Neither of these organizations necessarily violates all of the doctrines described in the text, and showing violations in some cases will require gathering extra facts and overcoming some plausible defenses. The moral here, though, is modest: courts are willing to subject coercive power held by private organizations to (possibly increasing) scrutiny. Some organizations that think of themselves as governmental may in fact be held to be private under the tests advanced in some states or federal circuits. Even organizations that survive challenges can expect to be sued and have to pay their attorneys' fees. And, if found to violate some of these doctrines, the remedy might just be an injunction, or might be personal damages and attorney fees for board members or even treble antitrust damages.

Legislators should think twice before empowering self-interested parties to regulate their competitors. Existing private regulators should be advised to tread carefully. And regulators who consider themselves public but participate in the business they're regulating might consider looking in the mirror: the private regulator about to be sued might be them.

About the Author

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Professor Volokh earned his BS from UCLA and his JD and PhD in economics from Harvard University. He clerked for Judge Alex Kozinski of the Ninth Circuit and for Supreme Court Justices Sandra Day O'Connor and Samuel Alito. Before coming to Emory, he was a visiting associate professor at Georgetown University Law Center and a visiting assistant professor at University of Houston Law Center. His academic work has been published in the *Harvard Law Review*, *Stanford Law Review*, *NYU Law Review, University of Pennsylvania Law Review*, *Michigan Law Review*, *American Law and Economics Review* and *International Review of Law and Economics*, among other places.

His interests include law and economics, administrative law and the regulatory process, privatization, corrections, antitrust and regulated industries, environmental law and policy, and legal history.

Endnotes

1 *N.C. State Bd. of Dental Examiners v. FTC*, 717 F.3d 359 (4th Cir. 2013).

2 Joanna Shepherd Bailey, "The Fox Guarding the Henhouse: The Regulation of Pharmacy Benefit Managers by a Market Adversary," *Northwestern Journal of Law and Social Policy,* Vol. 9, Issue 1 (2013).

3 226 U.S. 137 (1912).

4 298 U.S. 238, 311 (1936) (emphasis added).

5 411 U.S. 564 (1973).

6 *J.W. Hampton, Jr. & Co. v. United States*, 276 U.S. 394 (1928).

[7] *Am. Power & Light Co. v. SEC*, 329 U.S. 90, 105 (1946).

[8] 952 S.W.2d 454 (Tex. 1997).

[9] This sort of antitrust "state action" is unrelated to the (misleadingly) identically named "state action" doctrine in the context of constitutional rights.

[10] *Parker v. Brown*, 317 U.S. 341 (1943).

[11] *Town of Hallie v. City of Eau Claire*, 471 U.S. 34, 46 (1985).

[12] *Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc*., 445 U.S. 97 (1980).

[13] *Earles v. State Bd. of CPAs of La.,* 139 F.3d 1033 (5th Cir. 1998); *Porter Testing Lab. v. Bd. of Regents for Okla. Ag. & Mech. Colleges*, 993 F.2d 768 (10th Cir. 1993); *Cine 42nd St. Theater Corp. v. Nederlander Org., Inc*., 790 F.2d 1032 (2d Cir. 1986).

[14] *Interface Group, Inc. v. Mass. Port Auth.,* 816 F.2d 9 (1st Cir. 1987); *Hass v. Or. State Bar*, 883 F.2d 1453 (9th Cir. 1989); *Bankers Ins. Co. v. Fla. Res. Pty. & Cas. Joint Underwriting Ass'n*, 137 F.3d 1293 (11th Cir. 1998).

[15] In re *N.C. Bd. of Dental Examiners*, 151 F.T.C. 607 (2011).

[16] *N.C. State Bd. of Dental Examiners v. FTC*, 717 F.3d 359 (4th Cir. 2013).

[17] See 1A, Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law: An Analysis of Antitrust Principles and their Application* ¶ 228b, at 214 n.15 (3d ed. 2006); 13 Herbert Hovenkamp, *Antitrust Law: An Analysis of Antitrust Principles and their Application* ¶ 2232d3, at 457 (3d ed. 2012).

[18] See, e.g., *Hess v. Port Auth. Trans-Hudson Corp.,* 513 U.S. 30, 48–51 (1994).

[19] That the Board supports itself from fees may cut against immunity.