Rethinking Federalism:
The Case for Preemption in the Information Age

By Solveig Singleton[1]

Executive Summary

Federal preemption of state law is a huge topic, with battles ongoing over the wisdom of preemption at the Federal Communications Commission and in the Fair Credit Reporting Act. This analysis reviews and assesses the case for preemption generally and examines the case of the FCRA and in the FCC's Triennial Review proceeding in more detail.

The various arguments are explored through a fictional dialogue between Ms. Scellfone, a representative of Estuff Corporation, and Dr. Freeman Tweedy, an economist. Ms. Scellfone argues that business support for preemption in finance and telecommunications is not merely a short-term strategy of the businesss community, but that it reflects a long-term need of markets for reasonably certain, uniform law. Dr. Freedom notes out that enlarging federal power is a road to uniformity fraught with peril, but agrees that state action in finance and telecommunications make increasingly little sense, to say nothing of Internet commerce.

The analysis concludes:

- Uniformity over a fairly large scale is a very desirable feature of healthy commercial law systems; preemption is one legitimate road to this goal, but not the only road.
- Clear choice of law rules that minimize legal overlap (like an origin-based choice of law rule for web sites) can reduce the need for uniformity and scale, but not eliminate it.
- Competition between different states and nations does increase the quality of some laws and regulations, but it is no guarantee, and it is worth exploring other accountability mechanisms.
- FCRA preemption should be continued by legislation.

- State involvement in telecommunications and electronic commerce should decrease, through legislation and court action. The FCC's decision to hand the states authority over telecommunications networks was a grave error.

Faced with the evolution of the federal system in response to the changing scale of the economy, we can only go forward, though, to paraphrase Frodo Baggins, we do not see the way.

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Federal preemption of state law is a huge topic, with battles ongoing over the wisdom of preemption at the Federal Communications Commission and in the Fair Credit Reporting Act, to say nothing of the insurance industry or E-commerce. The debates' outcome will partly turn on factors peculiar to each market having little to do with federalism. But these are increasingly national or even international markets, and it would be strange if a discussion of preemption did not raise issues pertinent to all the sectors. This analysis reviews and assesses the case for preemption generally and examines the case of the FCRA, telecommunications, and Internet taxation in more detail.

Some scholars are skeptical of federal preemption and prefer competition among the states. But many real-world players in the banking and telecommunications industry support national over state regulation. Although historically insurance has been a special case (if for no other reason than it has always been a special case) there are supporters of a federal charter among insurance companies as well. To the casual observer, this looks like a contradiction. How can something be (arguably) good for markets but (apparently) bad for business? Perhaps the scholars are operating at too great a level of abstraction. Or perhaps the business interests are taking too short-run a view.

This analysis concludes that each side has something to learn from the other, but that the case for "states' rights" in the telecommunications and financial sectors is weak—except in the area of taxation.

Preemption and Federalism: A Dialogue

This section outlines arguments brought to bear in disputes about preemption. Note: the characters introduced below are fictional, and if they remind you of anyone, its entirely coincidental, though perhaps surprising, as they both have a lot of time on their hands, and are more congenial than might be expected.

Ms. Serena Scellfone, Vice President of Important Affairs, Estuff Corporation:
Markets need uniformity and certainty. Markets work better when the rules of the game are laid out clearly. If we have to deal with fifty different state laws, the liability risks and costs of tailoring different products to different places are probably not be worth it. So there are some products we will not offer at all, and when we do offer a product it will have to be designed to avoid liability in the most restrictive state.

Dr. Tweedy Tweedy, Author of *One Hundred Things You Haven't Read*:
So why is it that businesses don't seem to have issues with state common law rules of property or contract, or corporation law?

Ms. Scellfone: Well, the common law started out relatively uniform across the different states—it all came from England.[2] And when differences did begin to cause problems, we developed the Uniform Commercial Code. Finally, common law courts usually enforced choice of law rules. And, with corporate law, the choice of law that is applied is state-of-origin—only the law of one state will be applied. Under these circumstances, sure, businesses can deal with 50 state regimes.

But modern regulations and statutes just don't look like this. When it comes to consumer protection laws, especially, the courts are not keen on letting corporations choose the law they are governed by. So your point is well taken, but it has nothing to do with current regulatory issues in telecommunications or finance.

Dr. Tweedy: Then the best answer is to restore freedom of contract and choice of law rules. Especially with the Internet, some kind of return to origin-based choice of law and jurisdictional rules would be extremely helpful. Otherwise we will continue to have courts in France and Australia trying to impose their defamation law or other restrictions on speech on U.S.-based web sites.

Ms. Scellfone: But that's going to be a hard sell for statutes or laws that are seen as protecting consumers. And if one is going to solve the problem with choice of law or jurisdictional rules—don't you need to do that *first* before giving the states free rein here? Otherwise you're really going to confuse consumers, among other things, not to mention the liability risks and other costs business will bear.

Bottom line: the jurisdictional and choice of law solution that you talk about is just not a reality nor is it likely to become one. So what is supposed to happen in the meantime?

Dr. Tweedy: It is a big mistake to give up on the federalist system for that immediate strategic advantage. I recognize that businesses are in a difficult position; if a business doesn't seek every near-term advantage it can in dealing with regulators, its competitors will, and it will be left out in the cold. And its easier and cheaper for you to lobby a single federal government than 50 state governments. But that has nothing to do with the well-being of markets generally.

Ms. Scellfone: Okay, I know that businesses can get caught up in lobbying for inside-the-Beltway favors. They start out forming associations to defend themselves from a bad law, and the next thing you know they are asking regulators to crack down on their competitors—and everyone does it because everyone else does it.

But that is *not* what is going on when telecommunications companies or banks ask for federal preemption to put a check on a crazy-quilt of state laws. Let me explain. I'll start with a question: What are laws for? Basically, from a business standpoint, they are there

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[2] As an aside, most of you lawyers will be familiar with the Supreme Court's great pronouncment that "there is no federal common law." What many do not know is that until late in the nineteenth century, common law was not considered federal law—but it was not thought of as "state" law, either. It was just "common law."

to provide ground rules so that we can make decisions without getting into wasteful litigation. They are there for conflict resolution and certainty. And uniformity across whatever the size of the market in question is is an important part of that.

And *national markets need this certainty.* It's not just a tactical advantage for individual businesses. Look at history for a second. All of the great systems of commercial law—Admiralty Law, the Uniform Commercial Code—have been relatively uniform across a wide geographic range.

Dr. Tweedy: Okay. That's a good point. Of course, neither Admiralty Law nor the Uniform Commercial Code are federal statutes…

Ms. Scellfone: But you concede my point about uniformity being an important aspect of certainty for systems of commercial law.

Dr. Tweedy: Um, yes. However, my point about Admiralty and the UCC not being federal statutes is not just a side issue. I'm going to step out of character for an academic and insert a dose of realism here: How likely are all the combined efforts of various businesses and trade associations to lobby for federal preemption on any given issue to result in law that is actually uniform? There are certainly plenty of examples where federal legislators have passed statutes in response to business lobbying that have *not* preempted state law. The Gramm-Leach Bliley Act's privacy provisions are a key example.

Ms. Scellfone: While federal legislation may not be a perfect solution to the uniformity problem, it is more likely to succeed than, say, solving the problem by restoring the idea of freedom of contract in choice of law rules—your earlier suggestion.

In general, I think we get higher quality legislation from federal lawmakers than state lawmakers. There is a particular problem with state legislation on telecommunications and E-commerce issues, which may be very technical and very novel, but it also effects banking and credit. This problem is worse states with term limits—short term legislators may be both less educated by our people about issues, and more populist.

Dr. Tweedy: But in the long run, you get higher quality legislation in federalist countries than in centrist ones. Look at federalist systems around the world, nations within which there is competition between different political jurisdictions, their tax rates are lower. They have less regulation. Compare France and Switzerland.[3] The bottom line is this:

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[3] Defenders of regulation express concerns that competition among the states will produce a "race to the bottom" in which beneficial laws are swept aside to attract business to the state. State (and national) governments are most concerned with this issue in the area of taxation; competition among states is seen to prevent their capturing what they feel is their share of tax revenues. The "race to the bottom," though, is a myth—problematic in theory, but not at all in practice. In practice, the forces that operate on governments to regulate and tax too much

Competition between different states is a powerful force for disciplining governments. And such forces are few and far between. That is a major strength of the American constitutional system.

Ms. Scellfone: Hold on. What you've just implied is that a lack of federal action would cause movement towards more sensible regulatory policies. Yet we see in a number of areas that this is not true. It has not been the case for alcohol regulation, for example, where the states have free reign because of the Twenty-first Amendment. It has not been the case within Europe with respect to rules for data protection; the stricter rule became the norm instead, although it is contrary to the interests of businesses and consumers.

I'll grant that competition among the states is a fairly force in some areas, such as taxation, where the records of federal systems like the United States and Switzerland are clearly much better. But for regulation generally? I'm not so sure. Switzerland looks better than France, yes, but does Germany (another federal system) look that much better than France? Or that much worse than, say, Ireland or New Zealand?

Basically, the strength of competition among states (or nations) as a force depends on mobility. If citizens (or companies) are relatively free to choose their jurisdiction—and bother to do so—it works. So it works for really important things, like taxation. But generally it will be a pretty weak force, because few people can just pick up and move for every little issue.

So, given a choice between a weak force that tends to support open markets, and going for uniformity that lowers our costs directly, I will take uniformity, thanks very much.

Dr. Tweedy: May I ask, then, where do you stop? Why stop with ending competition between states? Why not do away with competition between nations, as well, and have a uniform international law for everything?

Ms. Scellfone: Well, there is some support for that approach. But that goes way too far in the other direction. There's several reasons. First, generally, smaller political jurisidictions are more accountable. It's no accident, for example, that one saw real deregulation in places like New Zealand and Ireland, for example, more so even than in the U.S.

Second, international law is a mess. It has to be divorced from any particular culture or legal history, and that makes it very vague, so you may get uniformity but you still don't get certainty.

(special interest groups) seem to be far more powerful than the weaker forces of inter-jurisidictional competition. Some of the reasons those forces are week are discussed by Ms. Tweedy above in comment ___.

Third, international decision-making processes are dominated by some very strange politics. And its likely to get even stranger. International law may look okay to U.S. firms today, but what is it going to look like when Chinese or Indian or South American players dominate the process a decade or so from now? It might be better for markets, but it might be worse.

Now, I have a question for you. Where do *you* stop? If competition among the states is such a great thing, why not encourage even more competition by moving the bulk of lawmaking tasks to the municipal or county level? Then we would have competition with a vengeance.

Dr. Tweedy: I think we can concede that that would strike the balance in the wrong place for most issues, certainly for telecommunications and banking. Maybe not for pothole repair. We're defending the American system of government, not some other hypothetical system.

Ms. Scellfone: You admit that the size and number of jurisdictions is relevant after all. Well, how do we know that the states are the right number and size? There wasn't some kind of grand calculation made when the Constitution was set up how big the states should be, or how many. The size of the states more or less corresponds to how far you could ride in a day on horseback. That might have been fine for business in the nineteenth century, but telecommunications and banking today take place on a much larger scale.

Here's a heretical idea: for a lot of business purposes today, the states are too small, and there are too many of them. Constitutional federalism was great, but it needs to change over time. It needs to adjust.

Dr. Tweedy: I would respond that the scale of the states has worked very well for a long time; let's not mess with it. We are not likely to do better.

But let me offer another answer to your question, of where do we stop. My answer is, that the authority of the states should stop where their accountability stops. That is, states can use regulation to gain benefits for their citizens at the expense of residents or other states. Perhaps the most obvious simple example would be taxes on imports from other states. A more controversial example: Attempts to make out-of-state companies collect taxes on out-of-state sales to in-state consumers—because this is much politically easier for the state than enforcing use tax laws collected directly from the consumers. States' rights in these cases is misplaced.

So I will ultimately agree with you that the states should not play much of a role in regulating telecommunications, electronic commerce, or, increasingly, financial markets as well. Those are national markets, and the cost of restrictive state regulation will be borne by national consumers, not just by the voters in the state that passes the rules. The courts agree with this approach, and have been willing to strike down state regulation of the Internet under the "dormant commerce clause."

Even so, I must say that we have learned a great deal from state "experiments" in regulation in telecommunications, banking, credit, and insurance. And that still might be very valuable on new issues like identity theft, for example.

Ms. Scellfone: Well, yes, experimentation is valuable, but when have we learned enough? When a regulatory experiment has been tried or debated at length, may we not safely say, "enough" at some point? Local and state regulation of cable television, for example, resulted in widespread monopoly franchising, high franchise fees, and increasingly corrupt franchising processes. With the 1984 Cable Act, federal legislators had learnt enough about *that* to come up with some federal limits. And, frankly, I'm not at all sure that legislators should be encouraged to look upon markets as guinea pigs. I think that metaphor may do more harm than good.

Dr. Tweedy: Do you by chance have time for lunch?

Ms. Scellfone: No, I have to take this call.

Federalism, Twenty-First Century Style

What are we to make of this nicely balanced arguments? Taken together, the business case and the scholar's case add up to the following:

- Markets need both certainty (which often means some reasonable degree of uniformity) and freedom.

- The first-best situation is one in which both state and federal lawmakers keep their hands off except when absolutely necessary. The less regulators at the state or federal level impinge themselves upon the daily processes of a business, the less acute the problem of 50 jurisdictions is. This helps explain why the differences between contract law and property law regimes across the states have been tolerable, but why more baroque regulations might not be.

- Another solution is to deal with the problem of many jurisdictions with choice of law rules that allow participants in the market to predict and control the level of risk they assume, including contractual choice of law provisions and origin-based jurisdictional rules.

- Preemption is one of several solutions to the problem of multiple jurisdictions—not the best solution, but not the worst, either. But it is also, perhaps the most readily politically acceptable immediate solution.

- Other avenues to more uniform laws are worth exploring, including model state laws (like the Uniform Commercial Code), and challenges to overly restrictive state laws under the commerce clause of the U.S. constitution.

- Preemption is most appropriate in the case of national markets like telecommunications and, increasingly, banking and insurance (as a general observation, this will not be news to anyone).

Some Easy Cases: Some Hard Cases

Taking these factors into consideration, let us consider some of the areas where federal preemption has become a pressing issue.

1). A strong case for continued preemption: The Fair Credit Reporting Act. The Fair Credit Reporting Act preempts state action in seven areas. This leaves the states free to do some interesting things, like pass specific laws addressing identity theft, for example.

Had the FCRA preemption not expired by its own terms, there would have been no earthly reason to disturb it. The market for consumer credit is now a highly competitive national market, and nor would there have been any reason to disturb that. A change in legal regime at this point would simply impose unnecessary costs on the economy and bring more lawyers into play. The most sensible thing to do would be to simply extend the preemption.

The real reason that FCRA preemption is an issue this session has to do with the desire of some advocates and lawmakers to trade preemption for opt-in. It is unfortunate that some legislators have made the leap from the fact that they *do* this kind of "policy trade" to thinking that this is what they *should* do. But if preemption is to be abandoned or continued, it should be on its own defects or merits; because it is the right thing to do to preserve an open market for consumers and businesses. Lawmakers should not use economic need to blackmail participants in the legislative process into accepting regulations that are otherwise unnecessary, costly to consumers, and excessive.

2) A very strong case for preemption: telecommunications. In large part, deregulation of telecommunications has come about at the federal level, aided substantially by preemption. Both Congress and the FCC have taken steps to preempt state laws that protect monopolies in cable television and traditional telephone service. If any business is largely "interstate" in nature, it is telecommunications. The division that has been maintained between state and federal telephone service is increasingly impossible and awkward to justify.

The most recent furor over preemption in telecommunications is in the FCC's Trienniel Review proceeding, in which the agency considered which network elements are now sufficiently competitive to be freed from the heavily regulatory unbundling regime. The FCC rules at issue concern the "unbundling" of parts of local phone networks, such as switches, network fiber, and DSL services. The FCC's first attempt to craft rules under the Telecommunications Act of 1996 went too far with forced sharing at discounted prices. The great weight of the evidence developed in the FCC's Triennial Review proceeding showed that this strict regime of price regulation discouraged investment in new networks by new entrants and incumbents alike. The regulations needs to be scaled back—and quickly, before more harm is done to the fast-moving tech economy.

Several conservative organizations and state public utility commissions insist that states be given the right to tailor their own "unbundling" regime. This approach is also

supported by Commissioner Martin. This was a grave error. Given that telecommunications is largely interstate in character—and more so every day—it should come as no surprise that federal preemption has played a very large role in deregulation. Federal legislators have preempted state laws that have restricted mobile phone competition, cable price regulation, and so on. While some limited experimentation by the states has been valuable in the past, markets are more valuable and less easily replaced than guinea pigs. Once a better course of action to restore markets is known, there was little reason not to take it.

The argument for "states' rights" is that state regulators are more familiar with local market conditions. However, markets in telephony simply do not correspond with state boundaries. And no state regulator knows local markets simply by virtue of living in a state—they must get their data from local divisions of the phone companies like anyone else, and there is no reason that same data could not be interpreted by the FCC. Telecommunications is a large-scale business where investors might be substantially discouraged by divergent and inconsistent regulatory approaches. With the states each crafting their own unbundling rules, there was little point in passing a federal telecommunications law at all, or even having a federal communications commission.

The best hope for the future of the FCC's most recent venture is that it likely to be struck down by the court, as there is no statutory basis for the decision.

The lesson to be learned from all this is that Dr. Tweedy's point that federal action will not necessarily give businesses the uniform rules they hope for was a fair one. Other approaches to opening markets and deregulation other than increases in federal power are vital.

4) Regulation of Electronic Commerce: A strong case for no state regulation, but a weaker case for federal action. As with telecommunications, state regulation of the Internet is likely to have extremely confusing consequences, in the absence of strong, clear choice of law rules or contractual provisions. But the courts are quite likely to strike down state regulation of the Internet as a violation of the dormant commerce clause. For this reason, it would be premature to call for federal regulation of electronic commerce in the vast majority of areas. Federal legislation at this stage promises to be just as capricious and unnecessary as much of the state regulation.

Summary & Final Recommendations

The arguments raised by Ms. Scellfone and Dr. Tweedy in their debate concerning federalism point to the following guidelines:

1) Explore all roads to uniformity of state laws, not just preemption.

- Understand how reasonably uniform common-law rules can be adapted to electronic commerce and other new contexts, without further displacement by statute.

- Support the adoption of model state laws.
- Support dormant commerce clause challenges to state laws that impede national markets as a first resort.

2) Support clear choice of law rules that minimize legal overlap,
- Defend freedom of contract, including the enforcement of choice of law clauses.
- Support origin-based choice of law rules for web sites.

3) Advance legal and regulatory reform at the state and federal level, advocating for open markets directly, because constitutional mechanisms like interstate competition are weak. At a minimum, this should include attention to:

- Accountability for state and federal regulators to the courts.
- Tort reform.

4) Continue FCRA preemption by legislation.

5) Decrease state involvement in telecommunications and electronic commerce, through legislation and court action.

Faced with the evolution of the federal system in response to the changing scale of the economy, we can only go forward, though, to paraphrase Frodo Baggins, we do not see the way. We cannot go back.