

# **LITIGATING REGULATION: CORPORATE STRATEGY IN TELECOMMUNICATIONS**

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## **ABSTRACT**

Using a Federal Communications Commission (FCC) dataset, this paper demonstrates firms are strategic in the regulatory cases they bring to court. They are increasingly likely to bring cases as the ideological distance between the FCC and the Court increases. Judges then vote ideologically as the firms' actions predict they will.

## **INTRODUCTION**

A firm's ability to change the regulatory environment can have a large impact on the company's profitability and overall strategic position in the marketplace. One way that the firm can alter the competitive conditions it faces is to strategically challenge governmental regulations in the courts to delay implementation of potentially harmful rules or to eliminate those rules altogether. Frequently, firms turn to litigation to reach those goals--protecting profitable markets, raising rivals' costs, and affecting market entry patterns. The purpose of this paper is to demonstrate how firms strategically engage in litigation to overturn potentially harmful regulations passed by federal administrative agencies and to show how ideologically motivated judges in the courts can affect the litigation strategy of the firm and the outcomes of trials.

Although non-market strategy has received increasing prominence in the strategic management literature (Baron, 1998; Hillman, 1999; Schuler, 1996), the role of strategic litigation has gone all but unnoticed. Scholars of political science have a robust theory of ideological judges (Segal 1997), but have not considered how strategic litigants would affect their analysis. The law and economics literature has considered strategic litigants (Priest and Klein 1984), but has yet to consider judicial ideology explicitly in its statistical empirical models (without inference from win rates). This paper attempts to bring together these three disparate literatures in examining corporate non-market strategy.

In particular, this paper empirically considers the decisions of firms to challenge Federal Communications Commission (FCC) regulations in the courts and the outcomes of those cases. The focus of the paper is the political and ideological factors that account for case outcomes in regulatory proceedings. It argues that judges are politically motivated and vote, in particular, on regulatory cases in a somewhat predictable way. Republican (conservative) judges are more likely

to overturn Democratic (liberal) agencies than they are to overturn Republican agencies, with which they have more ideological congruence, and vice versa. Firms, anticipating judges to vote in this way, select regulatory cases for litigation to exploit this ideological divide. Fortunately, the transition of the FCC from a majority-Republican to a majority-Democratic commissioners during this time period allows for a natural experiment in the data. Moreover, shifts in the make-up of the Court allow the econometric models to be identified.

## **THE FRAMEWORK AND THEORY**

The FCC has been granted administrative regulatory powers in telephone and wireless communication services, radio, television broadcast, emerging communications technologies. Administrative rules and orders are generally generated by the FCC bureaus, after extensive public comment, and then sent to the Commission for approval. A firm may appeal the FCC order to the judicial branch of government. Approximately 91% of all FCC order challenges are heard in the DC Circuit. Thus, the remainder of this discussion will focus on the D.C. Circuit.

The D.C. Circuit is structured similarly to other appellate courts and has 12 permanent judgeships assigned to it. A firm that challenges a FCC order in court becomes the plaintiff (appellant) and the FCC is always the defendant (appellee). Only after a case is filed in the court, a three-judge panel, selected randomly from the banc of 12 judges, hears the case. Once in court, the case usually moves expeditiously, with concise motions, briefs, and other filings. Thus, unlike other forms of civil litigation in the federal courts, FCC order challenges are relatively inexpensive and are carried out swiftly, often within the same judicial term. After all arguments are heard, the three judge panel takes a vote on whether to uphold the order, vacate the order, or remand it back to the FCC for further consideration.

There exists a two-stage problem. In the first stage, firms must make a decision of whether to litigate or not. In the second stage, a set of factors will determine whether the firm wins or loses at trial, given it has decided to litigate. We examine each of these stages in turn.

We are interested in understanding to what extent judges are ideologically motivated and to what extent the litigants take this into account. Why might judges vote ideologically? We assume that judges have some set of preferences over case outcomes (Segal, 1997; Spiller and Gely, 1992; de Figueiredo and Tiller, 1996). In regulatory cases, these may be ideological or political preferences. Because the judge's ruling is binding (until overruled), the judge is able to put his or her preferences or ideological imprint on regulatory outcomes.

If judges vote ideologically, then firms should select cases that take advantage of the ideology of the court. That is, firms should bring cases that are more likely to win in court based on the judges they expect to get. In regulatory litigation, when appeals go to the D.C. Circuit, firms do not know at the time of case filing, which judge will receive the case. Rather, they have a measure of the ideological make-up of the bench -- the political affiliation of each judge. This will be a measure of the make-up of the banc of judges. Firms can then make a probability-estimation

about the outcome of the case, based on the probability that they will obtain a certain panel of judges. As the agency ruling becomes ideologically farther apart from the ideology of the judges who sit on the bench, firms will be more likely to bring cases to the court for litigation. After filing, a set of judges is randomly selected and impaneled to hear the case. If judges vote ideologically, then one would expect that they would vote in a way that is consistent with their ideology, and firm expectations. That is, the draw of three judges from the banc of 12 judges should vote to overturn cases that are far, ideologically, from their own views.

A relevant question is why the agency and firm don't settle after filing of cases, once the panel is announced. Practically, it is difficult for the agency to change its ruling. Common law dictates that once a case has been filed, the agency cannot change its ruling without the permission of the court (*Greater Boston TV Corp v. FCC* 1971). Moreover, changes in rulings would have to be introduced into the internal bureaucratic and entire rulemaking process to insure the agency is not arbitrary and capricious. Indeed, interviews at the FCC suggest that the litigation division of the FCC rarely discusses opportunities for settlement with the Bureaus. For the firm, the incremental cost of litigating, once a case has been filed and panel announced, is relatively small. Thus, we expect to see observed judicial politics correlating with actual politics in judicial decision-making provided a) panels are selected randomly after filing, and b) there are limitations to the settlement. Another concern is that the agency may behave strategically as well. Although in theory this is true, in practice, it is costly and time-consuming for the agency to act strategically in each of the 1400 orders it issues in every year. Statistical tests confirm this intuition.

In order to operationalize elements of the theory, we need to consider how the politics of the bench will enter into the probability assessment of the firm at two levels. If judges are ideological, then the decision to litigate or not will be affected by the firm's ex ante belief of winning. Specifically, a firm that disputes a Democratic agency order will examine the political make-up of the banc of judges on the court. If that banc is made up largely of Republicans (Democrats), and the firm believes the bench is politically motivated so that it is likely to overturn Democratic (Republican) agency decisions, the firm will be more likely to bring a case against the agency rather than not litigate. However, politics will enter at the second stage as well—winning or losing in litigation—if judges are indeed ideological. This is because the ideologically motivated panels are likely to be the realization of a probability estimation of the political makeup of the bench that the firm makes at the time of settlement. Specifically, in an ideological world, Republican-oriented panels should be more prone to overturning Democratic agency orders and vice versa, controlling for selection.

Thus, if judges are ideological and firms recognize this, two outcomes should result. First, firms have a higher probability of bringing cases to the appellate court the farther the ideology of the agency relative to the banc of judges. Second, judges who are opposed to the agency ideology are more likely to overturn the agency than to uphold the agency, as the firms expect.

## EMPIRICAL TEST

In order to test the propositions in the previous section, a dataset of two parts has been compiled. The first part contains 234 litigated cases, which includes what I believe to be every case brought to the D.C. Circuit from 1990-1995 where a FCC order or ruling is challenged. The second part of the data set includes cases that are not litigated. A random sample of 234 firm-specific FCC rulings that were disputed from 1990-95 but did not reach the litigation stage was collected.

The dependent variable in the litigation equation is equal to one if an order was challenged in the Circuit Court, and is equal to zero otherwise. In the trial equation, the dependent variable is equal to one if the firm wins in the D.C. Circuit, and is equal to zero otherwise. In the current sample of cases, the agency wins 67% of the time. There are two sets of independent variables. We first discuss the independent variables of the selection equation.

The first and second independent variables of interest are REPUBLICAN AGENCY \*BANC IDEOLOGY (abbreviated RABI) and DEMOCRATIC AGENCY\*BANC IDEOLOGY (abbreviated DABI). These variables are designed to pick up the information about politics entering into judicial decision-making, with a focus on the D.C. Circuit. An ideology score is assigned to each judge that sits on the D.C. Circuit. The ideology score is a weighted measure of appointing President (2/3) and the confirming Senate (1/3). Republicans are given a value of 1, Democrats 0. Table 1 provides a sample of the ideology scores of the judges.

When the firm is deciding whether to litigate or not, it does not know the composition of the panel, only the composition of the banc of judges from which the panel will be drawn. For RABI (DABI), a dummy variable is created that is the political partisanship of the agency (measured by the President's party) at the time of case filing. It is equal to 1 for Republicans and 0 for Democrats. It is multiplied by the average ideology score of the banc to obtain RABI (DABI). In order to take advantage of the natural experiment in the data and examine if the ideological behavior the court and the response of the firm crosses political parties, we bifurcate the sample for the statistical analysis. We create one subset of the data to include all orders issued, and litigation initiated 1990-1992 during a Republican administration, and second sub-sample for 1993-1995, during a Democratic administration. The fundamental argument being posed here is that Democratic-oriented panels are likely to overturn Republican-controlled agencies, and vice versa. The best information the firm has about the panel it will draw at the time it must decide whether to litigate or not is the make-up of the banc of judges from which the panel will be drawn. Thus, if firms expect to exploit the ideological divide, we should see higher probabilities for firms bringing cases to court when an order is issued by an agency of a different political affiliation from that of the banc. Therefore, we would expect RABI to have a negative coefficient and DABI to have a positive coefficient.

A number of other case characteristics, firm characteristics, and industry control variables are included. Case controls included are for high stakes cases, adjudicated cases, antitrust and fraud

TABLE 1: SAMPLE OF JUDGES OF THE D.C. CIRCUIT, 1985-1995

<u>Judge</u>	<u>Year Appointed</u>	<u>President</u>	<u>President's Party</u>	<u>Senate</u>	<u>Ideology Score</u>
Bork, Robert H.	1982	Reagan	R	R	1
Ginsburg, Ruth B.	1980	Carter	D	D	0
Henderson, Karen L.	1990	Bush	R	D	0.66
Robinson, Spottswood W.	1966	Johnson	D	D	0
Scalia, Antonin	1982	Reagan	R	R	1
Sentelle, David B.	1987	Reagan	R	D	0.66
Starr, Kenneth W.	1983	Reagan	R	R	1
Tatel, David	1994	Clinton	D	D	0
Wald, Patricia M	1979	Carter	D	D	0

A number of other case characteristics, firm characteristics, and industry control variables are included. Case controls included are for high stakes cases, adjudicated cases, antitrust and fraud cases, and license cases. Firm controls include variables for firm size, regional Bell operating companies, and case experience in litigation. Finally, industry controls are added to the regression equations. de Figueiredo (2000) presents a full empirical description.

In the trial equation, most of these independent variables carry over. Two additional variables are created to focus on the politics of judicial decision-making on the D.C. Circuit, REPUBLICAN AGENCY\*PANEL IDEOLOGY (abbreviated RAPI) and DEMOCRATIC AGENCY\*PANEL IDEOLOGY (abbreviated DAPI). These variables are constructed in a very similar way as DABI and RABI, except they include the ideology score of the opinion writer (or the median justice, if no opinion is written). That is, when there is a Democratic agency decision and a tendency toward a Republican panel, firms should be more likely to win, and vice versa, if the judges which are randomly selected, do vote ideologically.

We estimate this model using a bivariate probit with adjustment for sample selection bias (Van de Ven 1981). The trial equation observations are present only when the firm has chosen to litigate. Thus, we allow for the possibility that the error terms in the two equations are correlated. Note that the matched sampling method used yields consistent estimates for all parameters except the constant. The constant is a biased estimate. This sampling technique was used to economize on the data collection because so few cases are litigated relative to the number of cases that are not.

The maximum likelihood coefficients for the political variables are reported in Table 2, with their standard errors in parenthesis. For a full reporting of the results, see de Figueiredo (2000). Model 1 covers the sample for cases that are decided by the FCC or filed in court during Republican administrations; Model 2 covers those cases during Democratic administrations. Models 1 and 2 correctly predict 73% and 76% of the cases, respectively.

RABI has a negative and significant coefficient and DABI has a positive and significant coefficient. These coefficients have the signs predicted. The coefficient on RABI suggests that companies are more likely to bring cases to the court when the political make up of the D.C. Circuit is increasingly Democratic and the FCC is issuing orders from Republican

TABLE 2: SELECTED RESULTS OF BIVARIATE PROBIT MODELS

Variable	Model 1	Model 2
LITIGATION EQUATION		
Republican Agency * Banc Ideology (RABI)	-47.417** (14.558)	
Democratic Agency * Banc Ideology (DABI)		22.794** (7.855)
TRIAL EQUATION		
Republican Agency * Panel Ideology (RAPI)	-0.585** (.290)	
Democratic Agency * Panel Ideology (DAPI)		.771* (.468)

All significance tests are for two-tailed t-statistics; \* significant at 10% level, \*\* significant at 5% level

Commissioners. The coefficient on DABI suggests, conversely, that firms are more likely to bring cases to the court when the make up of the D.C. Circuit is increasingly Republican and the FCC's orders are issued by Democratic Commissioners.

The lower half of Table 2 also shows that judges vote in a partially ideological way, as firms predict. RAPI has a negative and statistically significant coefficient, and DAPI has a positive coefficient that is statistically significant at the 90% level of confidence. Republican panels tend to overturn Democratic agency decisions, but not Republican agency decisions, and vice versa.

If we convert the coefficients into shifts in probabilities, and hold all other values of the variables at their mean values, we realize the large shifts in behavior that these political variables cause. If George Bush, in 1992, had replaced a Democratic-appointed judge with a Republican-appointed judge, firms would be 47% less likely to bring cases to court. Likewise, for an additional judge appointed by Clinton in his first term as President, replacing a Republican retiree, the firms are 46% less likely to litigate. On the litigation side, a Republican opinion writer is 12% more likely to support a Republican agency decision than a Democratic agency decision. A Democratic opinion writer for the court is 20% more likely to support a Democratic agency decision than a Republican agency decision.

## CONCLUSION

Companies can often choose to challenge unfavorable agency regulations in the court. In an examination of FCC rulings from 1990 to 1995, this paper has demonstrated that politics and ideology enters into judicial decision-making in telecommunications regulatory cases on the D.C. Circuit. Judicial panels, created after cases are filed, seem to vote in politically predictable ways. However, firms, react to these politics by bringing cases to exploit the politics of the bench in FCC decisions, and thus enhance the possibility of overturning the agency rulings. More broadly, the ability of firms to influence the regulatory process, whether through administrative or judicial means, offers the firm an important tool to mold its regulatory environment.

*References available from the author.*