

# Data Security and the FTC's UnCommon Law

*Justin (Gus) Hurwitz\**

*ABSTRACT: There were more data breaches in 2014 than any prior year, including the well-publicized attacks on Sony, Target, JPMorgan, and Home Depot—and uncountably more on individuals and smaller companies. This pace continued into 2015, with attacks against Anthem BCBS, Hacking Team, eBay, Trump Hotels, and Ashley Madison, and with a notable expansion into attacks on government targets, including major breaches from OPM and the IRS. Over the past 15 years, and in response to the lack of any comprehensive legal framework for addressing data security concerns, the FTC has acted as the primary regulator of data security practices in the United States. In this role, the FTC has used ad-hoc enforcement of its statutory “unfair acts and practices” authority to develop a “common law” of data security.*

*This Article raises concerns that the FTC's self-styled “common-law” approach to data security regulation is yielding an unsound body of law. It argues that the FTC's approach lacks critical features of the common law that are necessary for the development of jurisprudentially legitimate rules, and also that this approach raises jurisdictional and due process concerns. It builds on these critiques to recommend an alternative approach for the FTC to consider: treating a firm's lack of an affirmative data security policy as an unfair practice.*

*In so doing, this Article makes contributions to ongoing pressing discussions about how the law and regulators should respond to data security issues. It also makes contributions to ongoing scholarly discussions of agency choice of procedure and due process, both of which are of active and increasing interest in the administrative and regulatory law communities.*

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\* Assistant Professor of Law, University of Nebraska College of Law, J.D., University of Chicago Law School; M.A., Economics, George Mason University; B.A., St. John's College. With thanks to participants at the George Mason University Law and Economics Center Roundtable on Data Security, IPSC 2014, workshop participants at the Universities of Nebraska, Oklahoma, and Indiana-Bloomington, and in particular to Berin Szoka, Woody Hartzog, and Dan Solove, as well as Jane Bambauer, Eric Berger, Derek Bambauer, James Cooper, Margaret Hu, Bruce Kobayashi, Steve Willborn, and Todd Zywicki, among others. This Article resulted from an earlier project co-authored with Berin Szoka.

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## I. INTRODUCTION

According to Federal Bureau of Investigation (“FBI”) Director James Comey, “There are two kinds of big companies in the United States. There are those who’ve been hacked . . . and those who don’t know they’ve been hacked . . . .”<sup>1</sup> Indeed, a recent report estimates that 43% of companies experienced data breaches in 2014.<sup>2</sup> In recent years, these breaches affected some of the largest, most sophisticated firms in the world, including Sony, Target, eBay, JPMorgan, Home Depot, Anthem BCBS, Hacking Team, Ashley Madison, and CHS Community Health Systems—as well as government targets such as OPM and the IRS.<sup>3</sup> These and other attacks result from a broad range of motivations, including politics, espionage, theft of financial or personal information, and simple vandalism. Yet, we have no effective—let alone comprehensive—legal framework to prevent or respond to these attacks.

Over the past 15 years, the Federal Trade Commission (“FTC”) has attempted to fill this void, acting as the primary regulator of online privacy and data security in the United States. This Article questions both the jurisdiction and efficacy of the FTC’s role in addressing data security concerns. The Commission has come into this role largely because of the breadth and ill-defined boundaries of its authorizing statute, read in conjunction with some limited authority to regulate narrow privacy and data security issues under cognate statutes.<sup>4</sup> Since the advent of the consumer Internet, there has been a palpable regulatory vacuum in these areas. But regulation abhors a vacuum, and—though ill-suited to the task—the FTC has been quick to fill it.

The FTC has brought over 50 enforcement actions relating to online data security over the past decade (and over another 100 privacy actions).<sup>5</sup> In its data security cases, the FTC generally takes action against firms whose computers have been compromised by hackers seeking access to customer

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1. James Cook, *FBI Director: China Has Hacked Every Big US Company*, BUS. INSIDER (Oct. 6, 2014, 6:24 AM), <http://www.businessinsider.com/fbi-director-china-has-hacked-every-big-us-company-2014-10> (quoting James Comey, FBI Director).

2. PONEMON INST. LLC, *IS YOUR COMPANY READY FOR A BIG DATA BREACH?: THE SECOND ANNUAL STUDY ON DATA BREACH PREPAREDNESS 1* (2014), <http://www.experian.com/assets/data-breach/brochures/2014-ponemon-2nd-annual-preparedness.pdf>.

3. See, e.g., PONEMON INST. LLC, *2014: A YEAR OF MEGA BREACHES 1* (2015), [http://www.ponemon.org/local/upload/file/2014%20The%20Year%20of%20the%20Mega%20Breach%20FINAL\\_3.pdf](http://www.ponemon.org/local/upload/file/2014%20The%20Year%20of%20the%20Mega%20Breach%20FINAL_3.pdf).

4. For instance, the FTC has some authority to regulate disclosures of information about consumers of financial products under the Gramm–Leach–Bliley Act, 15 U.S.C. §§ 6801–6809 (2012), and has authority to regulate privacy issues relating to children’s use of the Internet through the Children’s Online Privacy Protection Act (“COPPA”), 15 U.S.C. §§ 6501–6506 (2012).

5. See FED. TRADE COMM’N, *2014 PRIVACY AND DATA SECURITY UPDATE* (2014), [http://www.ftc.gov/system/files/documents/reports/privacy-data-security-update-2014/privacydatasecurityupdate\\_2014.pdf](http://www.ftc.gov/system/files/documents/reports/privacy-data-security-update-2014/privacydatasecurityupdate_2014.pdf).

information such as credit cards or social security numbers. Because there is no specific statutory framework relating to data security in the United States, the FTC brings these cases under its unfair and deceptive acts and practices (“UDAP”) authority.<sup>6</sup> For myriad reasons, these cases almost always settle prior to litigation, with the firm whose computers were breached agreeing to decades of ongoing monitoring and security audits and the threat of substantial fines for future breaches.<sup>7</sup> Only two cases to date have failed to settle, *FTC v. Wyndham Worldwide Corp.* and *LabMD, Inc. v. FTC*, both of which are currently in litigation.<sup>8</sup> A central question in these cases is whether the FTC’s past settlements form a common-law-like body of precedent sufficient to give firms notice of the FTC’s data security standards.

The Commission has been quick to defend its efforts. This defensive attitude has increased in recent years, largely in response to three related issues. First, the two cases currently pending have for the first time subjected the FTC’s practices to judicial scrutiny. Second, Congress is actively considering the need for privacy and data security legislation; the FTC seeks to defend its record both to preserve its existing power and to capture greater power through any new legislation. And third, the Commission is seeking legitimacy for the enforcement actions that it has already taken over the past decade.

This Article challenges the FTC’s approach to regulating data security and related issues. In particular, it raises concerns over the Commission’s self-styled “common law” approach to developing legal norms. While the Commission’s approach—based on case-by-case enforcement actions—does bear some resemblance to that of common-law courts, it also bears important differences that render the comparison inapposite. Perhaps most important, common-law courts shape legal norms because, and only where, they are required to do so. The FTC, on the other hand, has the option to develop legal norms using either quasi-judicial enforcement actions or quasi-legislative rulemaking processes. These different institutional designs lead to important differences in both the substance and legitimacy of the resulting rules.

This Article also raises concerns about the FTC’s jurisdictional claims. In recent years, the Commission has aggressively sought to expand the scope of its authority under section 5 of the FTC Act. Its data security efforts are part of this effort. In the data security context, the Commission is pushing the

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6. *Id.*; see also *infra* Part III.A.

7. See *infra* Part III.B.

8. These cases are discussed in detail in Part II.D. As this Article is being prepared to go to press there have been important updates in both of these cases: Wyndham has settled with the FTC, see *Wyndham Settles FTC Charges It Unfairly Placed Consumers’ Payment Card Information at Risk*, FED. TRADE COMMISSION (Dec. 9, 2015), <https://www.ftc.gov/news-events/press-releases/2015/12/wyndham-settles-ftc-charges-it-unfairly-placed-consumers-payment>; and the ALJ hearing the FTC’s case against LabMD dismissed all of the FTC’s claims. Both of these developments—which by and large support the arguments made in this Article—are discussed in the Afterword to this Article.

limits of its so-called unfairness authority. As argued here, the Commission's efforts raise constitutional due process concerns—in particular, the Commission has failed to provide parties sufficient notice to satisfy basic principles of fair notice. These principles are required both to ensure that regulated parties understand the rules to which they are subject, and are also able to constrain agencies and protect regulated parties from discriminatory enforcement. The FTC's efforts fail on both fronts. Moreover, the FTC purports that its efforts extend to the data security practices of any firm subject to the FTC Act—that is, to every business in the country, no matter how large, how sophisticated, or otherwise regulated. Supreme Court precedent—reaffirmed in each of the Supreme Court's last two terms—reminds us of the skepticism with which we should view such claims of previously “unheralded power to regulate ‘a significant portion of the American economy.’”<sup>9</sup>

While the few scholars that have considered the FTC's efforts have been supportive of them, recent developments suggest the challenges raised in this Article are meritorious. At one hearing in the pending *LabMD* case, Judge William S. Duffey, Jr. excoriated FTC counsel as “completely unreasonable,” and “not willing to accept any responsibility.”<sup>10</sup> He criticized the agency's approach to developing legal norms by saying that the agency “ought to give [regulated parties] some guidance as to what you do and do not expect, what is or is not required. You are a regulatory agency. I suspect you can do that.”<sup>11</sup> More recently, at the closing arguments of the FTC's administrative hearing, FTC Chief Administrative Law Judge Michael Chappell expressed similar concerns, asking FTC counsel “where is the fairness in that, Counselor? If you're a company, you're a corporation, where is the fairness in a standard of what the law is being issued or published after the case is brought?”<sup>12</sup> In *Wyndham*, District Court Judge Esther Salas recognized that the FTC's authority over, and appropriateness of, its approach to addressing data breaches was sufficiently uncertain that she took the unusual step of certifying the question to the Third Circuit on interlocutory appeal.<sup>13</sup> In its recent opinion on the matter, the Third Circuit affirmed the FTC's authority in the context of the *Wyndham* litigation, but did so in a way that potentially undermines the Commission's broader efforts to regulate data security practices and expressed concern that the FTC had not, *inter alia*, “informed the public that it needs to look at complaints and consent decrees for

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9. *Util. Air Regulatory Grp. v. Envtl. Prot. Agency*, 134 S. Ct. 2427, 2444 (2014) (quoting *Food & Drug Admin. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 159 (2000)); see also *King v. Burwell*, 135 S. Ct. 2480, 2489 (2015) (quoting *Util. Air Regulatory Grp.*, 134 S. Ct. 2427).

10. Transcript of Proceedings at 91, *LabMD, Inc. v. Fed. Trade Comm'n*, No. 1:14-CV-810-WSD, 2014 WL 1908716 (N.D. Ga. May 7, 2014).

11. *Id.* at 95.

12. Closing Arguments at 8, *LabMD, Inc.*, No. 9357 (F.T.C. Sept. 16, 2015).

13. Memorandum Opinion and Order at 9–10, *Fed. Trade Comm'n v. Wyndham Worldwide Corp.*, 10 F. Supp. 3d 602 (D.N.J. 2014) (No. 13-1887).

guidance.”<sup>14</sup> Looking beyond these pending cases, recent Supreme Court decisions raise serious concerns about the FTC’s claimed authority over data security. Furthermore, the House Oversight Committee has recently initiated an investigation into the relationship between the FTC and a private security firm that has been integral to the FTC’s data security efforts.<sup>15</sup>

This Article’s critique is framed both by the FTC’s recent history of enforcement actions, and also by Solove & Hartzog’s work. Their recent articles, *The FTC and the New Common Law of Privacy*<sup>16</sup> and *The Scope and Potential of FTC Data Protection*<sup>17</sup> are the seminal works in the field. The first of these articles argues that the FTC’s approach to data security has yielded a coherent body of precedent;<sup>18</sup> the second argues that it is possible for agencies to develop legal principles in settings such as data security through case-by-case adjudication.<sup>19</sup> Together, these articles argue for more expansive efforts by the Commission. This Article disagrees with this optimism—it argues that, while the FTC undoubtedly can develop and has developed a body of data security law, the specific approach that the Commission has taken raises grave concerns about the soundness of that body of law. But this critique is made with the hope that our disagreement can lead to better and more sound approaches to dealing with what are undoubtedly some of the most important issues facing the online economy.

An additional observation about Solove and Hartzog’s work bears prefatory note. They observe that the FTC’s evolving jurisprudence has not been well studied by legal scholars, and that this is problematic. This concern is echoed in other recent work. For instance, recent scholarship raises concerns about the SEC that parallel the concerns raised in this Article.<sup>20</sup> And Davidson & Leib’s recent work on “Regleprudence” raises general concerns that the legal academy has failed to seriously study administrative decision-making.<sup>21</sup> This Article agrees wholeheartedly with, and amplifies, these concerns. Indeed, the importance of understanding administrative jurisprudence in traditionally non-administrative areas of law (especially

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14. See *Fed. Trade Comm’n v. Wyndham Worldwide Corp.*, 799 F.3d 236, 240, 257 n.23 (3d Cir. 2015); see also *infra* Part II.D (discussing the *Wyndham* interlocutory appeal opinion in detail).

15. See *The Federal Trade Commission and Its Section 5 Authority: Prosecutor, Judge, and Jury: Hearing Before the H. Comm. on Oversight & Gov’t Reform*, 113th Cong. 2 (2014).

16. Daniel J. Solove & Woodrow Hartzog, *The FTC and the New Common Law of Privacy*, 114 COLUM. L. REV. 583 (2014).

17. Woodrow Hartzog & Daniel J. Solove, *The Scope and Potential of FTC Data Protection*, 83 GEO. WASH. L. REV. 2230 (2015).

18. See Solove & Hartzog, *supra* note 16, at 588, 619.

19. See generally Hartzog & Solove, *supra* note 17.

20. See, e.g., William F. Johnson & Amelia R. Medina, *SEC’s Administrative Enforcement Intensifies Fairness Debate*, 252 N.Y. L.J., Nov. 6, 2014; Connor Raso, *Agency Avoidance of Rulemaking Procedures*, 67 ADMIN. L. REV. 65 (2015).

21. See generally Nestor M. Davidson & Ethan J. Leib, *Regleprudence—at OIRA and Beyond*, 103 GEO. L.J. 259 (2015).

antitrust) is a theme central to my own recent work.<sup>22</sup> I cannot agree more emphatically with Solove and Hartzog, and the few others raising this concern, that this is a set of issues to which legal scholars must turn their attention.

The core concerns raised by this Article are procedural—even if the FTC has managed to craft a coherent set of rules through a common law-like approach, this does not mean that those rules are sound. The process by which rules are created gives legitimacy to the substance of those rules. It gives notice to relevant stakeholders, and ensures that the proper stakeholders are subject to those rules. It ensures that other regulating entities—e.g., Congress, the courts, and other agencies—are able to participate in the process, and that regulatory responsibility is properly apportioned between them. And, more generally, even if the result of the FTC's process in the data security context is sound, permitting use of an illegitimate process in this context gives legitimacy to the use of flawed processes in other contexts.

Several solutions are proposed in response to these concerns. Among these responses, this Article draws from principles of modern administrative law to advocate a different approach to developing a data security jurisprudence that will not run afoul of constitutional due process requirements. Key among the insights offered here is that the agency's efforts are largely problematic because it has proceeded with the mentality of an enforcement agency—as it purports to be working to develop legal norms, it would be better advised to adopt the mentality of a rulemaking agency. In practice, this means that, where the agency investigates firms' data security practices, it should do so solely to identify good and bad practices to inform itself and the broader community about these practices. And, to the extent that it is acting to develop legal norms, the FTC should expressly not seek damages, censure, or other punitive action against firms. This Article also argues that, to the extent the agency does need to operate in an enforcement capacity, or is working to develop legal norms through enforcement actions, it should pursue those efforts through litigation in Article III courts rather than relying on administrative adjudication. Finally, it argues that the FTC may have viable unfairness claims—as opposed to the deception claims it brings today—against firms operating at a national scale that do not have affirmative data security policies and are not otherwise subject to data security regulation. This more modest jurisdictional claim is both legally sounder, more likely to yield more meaningful data security norms, offer consumers meaningful data security protections, and overall help in the ongoing development of better data security practices and protections.

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22. See, e.g., Justin (Gus) Hurwitz, *Administrative Antitrust*, 21 GEO. MASON L. REV. 1191 (2014) [hereinafter Hurwitz, *Administrative Antitrust*]; Justin (Gus) Hurwitz, *Chevron and the Limits of Administrative Antitrust*, 76 U. PITT. L. REV. 209 (2014) [hereinafter Hurwitz, *Chevron and the Limits*].

This Article proceeds as follows. Part II describes the FTC's approach to developing legal norms to govern data security—the FTC's so-called “common law” approach—by distilling what the FTC and other commentators mean when they refer to the FTC's “common law.” Part III turns to consider the mechanisms by which the common law is ordinarily understood to work, and why these mechanisms are thought to be sound.

Part IV situates this discussion in the broader debate about agency choice of procedure. The relative merits of quasi-legislative rulemaking and case-to-case adjudication have been a central issue in administrative law for more than 60 years, dating at least to *SEC v. Chenery* (1947) (“*Chenery I*”).<sup>23</sup> Relating to issues familiar to most legal scholars from debates over rules versus standards, in *Chenery II* the Supreme Court gave agencies broad latitude in deciding whether to formulate rules through legislation-like rulemaking processes or to take a more standards-like approach to developing legal norms through common-law-like adjudicative processes.<sup>24</sup> *Chenery II* is still good law today. But administrative law scholars have long expressed concern about *Chenery II* and over the past decade the Supreme Court has arguably begun to rein in this discretion, largely due to the very sort of jurisprudential concerns raised by the FTC's “common law” approach.

As Solove and Hartzog discuss, legal scholars generally—and in this field in particular—have paid little attention to the administrative aspects to the FTC's approach. This doesn't mean that these questions have not been studied and do not have serious implications for the FTC's approach. It is unfortunate that some scholars and regulators are flippant about these

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23. Sec. & Exch. Comm'n v. *Chenery Corp.*, 332 U.S. 194 (1947).

24. See *infra* Part IV.A.



issues.<sup>25</sup> The Supreme Court is not<sup>26</sup>—if the FTC does not act with a sound jurisprudential theory backing its processes, decisions resulting from those processes may well not be long for this world.

Part V situates the FTC's "common law" approach in the broader context of current and historic administrative law debates. It then offers a critique of the FTC's approach, arguing both that the jurisprudential value of its approach falls well below that of judicial common law and that its approach runs contrary to contemporary trends in administrative law.

Despite this Article's criticisms, the FTC is likely to continue to develop legal norms through adjudication—and this adjudicatory approach is appropriate in many cases. Part VI looks at the circumstances under which such an approach may or may not be reasonable. It then explains how the FTC uses adjudication in ways that capture the virtuous aspects of the common law method while avoiding the jurisprudential concerns raised earlier.

## II. THE FTC'S "COMMON" LAW

Section 5 of the FTC Act gives the FTC authority to proscribe "[u]nfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices . . . ."<sup>27</sup> This Part explains the meaning of this statutory

25. To be clear, this is not a charge levied against Solove and Hartzog. Others, however, have been implicitly or explicitly dismissive of these concerns. Chairwoman Ramirez's characterization of the common law is undertheorized, demonstrating little concern for the jurisprudential task that is her charge. See Edith Ramirez, Chairwoman, FTC, *Unfair Methods and the Competitive Process: Enforcement Principles for the Federal Trade Commission's Next Century*, Keynote Address at the George Mason University School of Law 17th Annual Antitrust Symposium: The FTC: 100 Years of Antitrust and Competition Policy (Feb. 13, 2014), [http://www.ftc.gov/system/files/documents/public\\_statements/314631/140213section5.pdf](http://www.ftc.gov/system/files/documents/public_statements/314631/140213section5.pdf). And in recent congressional testimony, Paul Ohm has described these concerns as a "side show." *Hearing Before the Subcomm. on Commerce, Mfg., & Trade of the H. Comm. on Energy & Commerce*, 113th Cong. 94 (2014) (statement of Professor Paul Ohm, Associate Professor, University of Colorado Law School; Faculty Director, Silicon Flatirons Center for Law, Technology, and Entrepreneurship), <http://docs.house.gov/meetings/IF/IF17/20140228/101812/HHRG-113-IF17-Wstate-OhmP-20140228.pdf> [hereinafter Ohm, House E&C Testimony]. That view is not unfamiliar. But as procedure scholars often note, procedure is at least as important as substance. Or, as Rep. John Dingell more colorfully said, "I'll let you write the substance . . . you let me write the procedure, and I'll screw you every time." *Regulatory Reform Act: Hearing on H.R. 2327 Before the Subcomm. on Admin. Law & Governmental Relations of the H. Comm. on the Judiciary*, 98th Cong. 312 (1983) (statement of Hon. John D. Dingell, Chairman, House Committee on Energy and Commerce); see also *Wisconsin v. Constantineau*, 400 U.S. 433, 436 (1971) ("[I]t is procedure that marks much of the difference between rule by law and rule by fiat.").

26. In recent years, the Court has shocked the Tax and Immigration worlds by rejecting their long-standing, field-specific, practices in favor of normalizing them with the Court's administrative jurisprudence. See Kristin E. Hickman, *The Need for Mead: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537, 1619 (2006); see also Hurwitz, *Administrative Antitrust*, *supra* note 22, at 1207–11 (discussing the Court's recent cases addressing "tax exceptionalism" and "immigration exceptionalism").

27. 15 U.S.C. § 45(a)(1) (2012 & Supp. 2014).

authority, how the FTC has developed the “unfair or deceptive acts or practices” branch over time and how it has adopted what it calls a “common law” approach in recent years, and criticisms of that approach.

A. *THE FTC’S “UNFAIRNESS” PHOENIX*

The Commission’s authority is generally divided between its antitrust mission (“unfair methods of competition”) and its consumer protection mission (“unfair or deceptive acts or practices”). Under the consumer protection branch, there are different standards for “unfair” and “deceptive” conduct. The Commission’s data security jurisprudence has generally been developed under the “unfair . . . acts or practices” branch, which is generally referred to as the Commission’s “unfairness” authority.<sup>28</sup>

This authority was added to the FTC Act in 1938, but the Commission used the authority only sparingly into the 1970s.<sup>29</sup> All of the FTC’s power under section 5 is broad, intended to ensure that the FTC can protect consumers and competition under a wide range of potentially changing circumstances.<sup>30</sup> Its unfairness authority is the broadest portion of the Commission’s statutory authority, initially unconstrained by any statutory definition of “unfair.” Unsurprisingly, this lack of statutory constraint proved to be problematic. The breaking point for the FTC’s early development of its “unfairness” authority came with the Commission’s effort to ban all advertising directed at children.<sup>31</sup> Public reaction to these rules was swift and negative, captured famously by a Washington Post editorial labeling the FTC the “National Nanny.”<sup>32</sup>

Congressional response was also swift. Congress reversed the FTC advertising rule, and even shut the Commission down for a period. In 1980, Congress passed the FTC Improvements Act of 1980, which, among other things, imposed heightened procedural requirements on the Commission’s unfairness-related rulemaking and prohibited the Commission from regulating certain industries.<sup>33</sup> The Commission also adopted a policy

28. See J. Howard Beales, Former Dir., Fed. Trade Comm’n, *The FTC’s Use of Unfairness Authority: Its Rise, Fall, and Resurrection*, at the Marketing and Public Policy Conference (May 30, 2003), <http://www.ftc.gov/public-statements/2003/05/ftcs-use-unfairness-authority-its-rise-fall-and-resurrection>.

29. *Id.*

30. See Neil W. Averitt, *The Meaning of “Unfair Methods of Competition” in Section 5 of the Federal Trade Commission Act*, 21 B.C. L. REV. 227, 230–38 (1980) (discussing the history and purpose of section 5); Hurwitz, *Chevron and the Limits*, *supra* note 22, at 227–29 (same).

31. Beales, *supra* note 28.

32. *Id.*; see also *The FTC as National Nanny*, WASH. POST (Mar. 1, 1978), <https://www.washingtonpost.com/archive/politics/1978/03/01/the-ftc-as-national-nanny/69f778f5-8407-4dfo-b0e9-7f1f8e826b3b>.

33. See generally Federal Trade Commission Improvements Act of 1980, Pub. L. No. 96–252, 94 Stat. 374 (1980) (codified at 15 U.S.C. § 57a (2012)).

statement to define its “unfairness” authority.<sup>34</sup> This policy statement guided the Commission’s use of its unfairness authority through the 1980s. It was codified as section 5(n) of the FTC Act in the 1994 reauthorization of the Commission.<sup>35</sup> Section 5(n) provides that

[t]he Commission shall have no authority . . . to declare unlawful an act or practice on the grounds that such act or practice is unfair unless the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition.<sup>36</sup>

This is generally understood to impose three requirements on the Commission’s unfairness authority: To be unfair, conduct must (1) cause substantial injury; (2) without offsetting benefits; which (3) consumers cannot reasonably avoid.<sup>37</sup> Properly applied, section 5(n) defines meaningful contours around this authority, allowing it to be meaningfully used while also providing necessary checks on the Commission’s authority.<sup>38</sup>

Through the 1990s, the Commission began to reassert its unfairness authority in a number of contexts—often with important and lauded success. For instance, the Commission has used its authority against unauthorized billing practices, harmful telemarketing practices, and abusive Internet practices such as the sending of forged spam e-mails.<sup>39</sup> It was, nonetheless, a disfavored approach, used only where stronger legal authority was lacking.<sup>40</sup>

Following these early successes in unfairness cases in the mid- to late-90s, the Commission was increasingly eager to plumb the depths of this immense well of authority. Starting in the early 2000s, the FTC developed a renewed interest in using its statutory authority to proscribe unfair and deceptive acts and practices.<sup>41</sup> This interest developed largely in response to online privacy and data-security concerns.<sup>42</sup> Its initial cases focused on deception—cases in which a firm failed to follow its stated privacy policies.<sup>43</sup> As the FTC grew

34. Letter from Michael Pertschuk et al., Chairman, Fed. Trade Comm’n, to Hon. Wendell H. Ford, Chairman, Consumer Subcomm., Comm. on Commerce, Sci., & Transp., and Hon. John C. Danforth, Ranking Minority Member, Consumer Subcomm., Comm. on Commerce, Sci., & Transp. (Dec. 17, 1980), <http://www.ftc.gov/public-statements/1980/12/ftc-policy-statement-unfairness>.

35. Federal Trade Commission Act Amendments of 1994, Pub. L. No 103-312, 108 Stat. 1691, 1695 (1994) (codified at 15 U.S.C. § 45n (2012)).

36. *Id.*

37. *Id.*

38. For a more comprehensive discussion of these requirements see Beales, *supra* note 28.

39. *Id.*

40. *Id.* (“[I]n the 1990’s, the Commission almost entirely avoided the use of unfairness. It became the theory of last resort.”).

41. *Id.*; see also *infra* note 44.

42. See *infra* note 44.

43. See, e.g., *infra* note 58 and accompanying text.

comfortable enforcing firms' stated policies, it also grew concerned about the conduct of firms not governed by stated policies. During Jon Leibowitz's term as Chairman, this concern grew into the Commission's current desire to enforce legally binding data-security standards, which the Commission began referring to as its "common law" of data security.

*B. WHAT IS THE FTC'S "COMMON LAW"?*

Section 5(n) of the FTC Act provides general guidance for the application of the Commission's unfairness authority; it doesn't provide specific guidance for how that authority is likely to be applied in any given case, or class of cases. In recent years, the Commission has begun referring to its consumer protection efforts—especially those based in its unfairness authority and those relating to privacy and data security—as developing a "common law" body of rules. The first such reference came in an April 2012 speech by Commissioner Julie Brill, citing back to academic work from 2010 and 2011.<sup>44</sup>

While the FTC has not presented a well-developed jurisprudential theory of its "common law" approach, it appears to be defined by a few essential characteristics: a case-by-case approach that addresses individual cases, producing memorialized outcomes (e.g., complaints, settlements, etc.) from which other parties can infer rules that the FTC will apply to them in the future.

FTC Chairwoman Edith Ramirez recently explained that the "common law is best understood by reading and analyzing the leading case decisions . . . . At the FTC, that means the decisions, complaints, statements, and analyses associated with our enforcement actions."<sup>45</sup> Similarly, Paul Ohm, a Professor of Law and former Senior Policy Advisor in the Commission's Office of Policy Planning, has explained that, "[w]ith every settlement, the FTC approves and publishes a complaint, a consent order, and a press release, which lay out in some detail the theory of the FTC case. . . . What makes [the

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44. Julie Brill, Comm'r, Fed. Trade Comm'n, "Privacy, Consumer Protection, and Competition," Address at the 12th Annual Loyola Antitrust Colloquium (Apr. 27, 2012), [http://www.ftc.gov/sites/default/files/documents/public\\_statements/privacy-consumer-protection-and-competition/120427loyolasymposium.pdf](http://www.ftc.gov/sites/default/files/documents/public_statements/privacy-consumer-protection-and-competition/120427loyolasymposium.pdf). Her footnote bears repetition here in full:

*See* Christopher Wolf, *Targeted Enforcement and Shared Lawmaking Authority As Catalysts for Data Protection in the United States*, BNA Privacy and Security Law Report, Oct. 25, 2010, (FTC consent decrees have "created a 'common law of consent decrees,' producing a set of data protection rules for businesses to follow") and *see* Kenneth A. Bamberger & Deirdre K. Mulligan, *Privacy on the Books and on the Ground*, 63 STAN. L. REV. Vol. 63, January 2011, (discussing how chief privacy officers reported that "state-of-the-art privacy practices" need to reflect both established black letter law, as well as FTC cases and best practices, including FTC enforcement actions and FTC guidance).

*Id.* at 1 n.1.

45. Ramirez, *supra* note 25, at 7–8.

FTC's common-law approach] work . . . is the cadre of [lawyers scrutinizing these documents]."<sup>46</sup>

Solove and Hartzog identify similar characteristics, though to their credit they take a more nuanced view. They describe the FTC approach as the "functional equivalent of common law," and note that the analogy "has its limits."<sup>47</sup> In addition to recognizing the same characteristics—case-by-case adjudication with published outcomes that provide notice and some level of precedent<sup>48</sup>—they make two additional observations. First, they explain that, "[i]n the most traditional form of common law, judges develop the legal rules."<sup>49</sup> While these rules may later be codified into statutes, treatises, restatements, etc., they are developed in the first instance by judges. We will return to this point—it is an important difference between judicial and FTC common law—for now, it is important to recognize it as a characteristic of the FTC's approach.<sup>50</sup> Second, they recognize that FTC adjudications are not strictly precedential: The Commission is not bound to be consistent in its construction of the law, though as a practical matter (over the short period during which it has developed this body of law) it has attempted to be consistent.<sup>51</sup>

Solove and Hartzog are right to dub this a "functional equivalent" of common law and to recognize that the analogy is limited. But, as taken up below, even calling it the "functional equivalent" goes too far. There are fundamental differences between what the FTC is doing and the judicial common-law approach. These differences call into question the basic jurisprudential legitimacy of the FTC's approach.

### C. THE GENESIS OF THE FTC'S "COMMON LAW"

The Commission's turn to the rhetoric of common law is of relatively recent vintage. The underlying jurisprudential approach, however, is anything but new, dating in the modern U.S. tradition to at least 1947. We will turn to the jurisprudential history in a moment.<sup>52</sup> A brief discussion of the Commission's recent use of the "common law" terminology is helpful in placing that FTC's current approach in the broader jurisprudential history.

46. Ohm, House E&C Testimony, *supra* note 25, at 5 (citing Solove & Hartzog, *supra* note 16, at 620–25).

47. Solove & Hartzog, *supra* note 16, at 619.

48. *Id.*; see also Hartzog & Solove, *supra* note 17 ("In a common law system—or any system where matters are decided case-by-case . . . there is an attempt at maintaining consistency across decisions . . .").

49. Solove & Hartzog, *supra* note 16, at 619.

50. *Id.*; see also Ramirez, *supra* note 25, at 8 ("Of course, it is useful to compile a Restatement. And it is helpful to have good law review articles and treatises. But the real guidance rests with the primary sources.").

51. Solove & Hartzog, *supra* note 16, at 620.

52. See *infra* Part III.B.

Fundamentally, the FTC is, and always has been, engaged in a process of developing legal rules and norms. This is one of many functions played by administrative agencies—and it is a function that can be carried out through many means. These various means each offer (or require) different levels of formality, and in turn offer (or require) different levels of discretion or judicial review.<sup>53</sup>

A series of high-profile losses, both in courts of law and of public (and congressional) opinion, prompted the Commission in the 1970s to largely retreat from its norm-setting role.<sup>54</sup> Instead, it focused on enforcement of well-understood legal norms.<sup>55</sup> In the mid-1990s, however, the Commission began playing an informal role in online privacy issues. This role evolved organically, both in scope and formality. The Commission had relevant, if discrete, statutory authority in cognate areas,<sup>56</sup> which made it a natural host for a series of privacy-related workshops.<sup>57</sup> And it has used its authority over “unfair or deceptive acts and practices” to take action against firms that failed to follow their stated privacy policies.<sup>58</sup>

During this early period, the FTC did not characterize its role in establishing legal norms relating to privacy in common-law terms. Rather, the Commission was viewed (and viewed itself) as participating in the traditional administrative back-and-forth of information gathering and dissemination through informal processes, punctuated by enforcement actions in extreme cases. Internet law in general was yet young, and its trajectory uncertain—the

53. For an outstanding recent treatment of these issues, see generally Randy J. Kozel & Jeffrey A. Pojanowski, *Administrative Change*, 59 UCLA L. REV. 112 (2011).

54. See generally Hurwitz, *Chevron and the Limits*, *supra* note 22 (discussing the response to FTC’s Trade Regulation Rules and advertising rules in the 1970s, and subsequent history).

55. See Beales, *supra* note 28 (discussing the FTC’s 1980 *Unfairness Policy Statement* and subsequent codification of 15 U.S.C. § 45(n)).

56. See, e.g., Children’s Online Privacy Protection Act of 1998, Pub. L. No. 105-277, 112 Stat. 2681-728, 728-35 (1998) (codified as amended at 15 U.S.C. §§ 6501-6506 (2006)); Gramm-Leach-Bliley Act, Pub. L. No. 106-102, §§ 501-510, 113 Stat. 1338, 1436-45 (1999) (codified as amended at 15 U.S.C. §§ 6801-6809 (2006)).

57. See, e.g., *Consumer Privacy on the Global Information Infrastructure*, FED. TRADE COMMISSION (June 4-5, 1996), <http://www.ftc.gov/news-events/events-calendar/1996/06/consumer-privacy-global-information-infrastructure>; *Consumer Protection and the Global Information Infrastructure*, FED. TRADE COMMISSION (Apr. 10, 1995), <http://www.ftc.gov/news-events/events-calendar/1995/04/consumer-protection-global-information-infrastructure>; *Online Profiling Public Workshop*, FED. TRADE COMMISSION (Nov. 8, 1999), <http://www.ftc.gov/news-events/events-calendar/1999/11/online-profiling-public-workshop>.

58. See, e.g., *In re JetBlue Airways Corp.*, 379 F. Supp. 2d 299, 315 (E.D.N.Y. 2005). Courts have generally declined to enforce web sites’ privacy policies in civil actions due to the difficulty of demonstrating harm. The seminal case is *In re JetBlue*, in which Jet Blue voluntarily provided its passenger information to the Federal Government following the events of 9/11. *Id.* at 305. This was in direct violation of JetBlue’s privacy policies. While consumers were unable to recover anything from JetBlue, the FTC found that JetBlue had deceived consumers by not following its stated privacy policies and fined the firm for this “deceptive act[.]” *Id.* at 315.

Commission had no expectation at that time that it was taking upon itself the twin role of privacy legislator and enforcer.

Rather, the general focus was on the need for congressional action to address evolving privacy concerns. In 1998, the Commission issued a report to Congress concluding that “[t]he federal government currently has limited authority over the collection and dissemination of personal data collected online.”<sup>59</sup> The Report recommended that Congress pass legislation specific to children’s privacy, setting in motion what became the Children’s Online Privacy Protection Act.<sup>60</sup> But even as it concluded that “industry has had only limited success in implementing fair information practices and adopting self-regulatory regimes with respect to the online collection, use, and dissemination of personal information,” the FTC declined to recommend broader legislative changes.<sup>61</sup> In 2000, the Commission *did* call for broader legislative authority.<sup>62</sup> When Congress declined to pass such legislation, the Commission began bringing enforcement actions regarding data security. Its initial cases focused on deception, where companies failed to live up to their stated security policies.<sup>63</sup> By 2005, the Commission expanded its legal theory to include cases premised on unfairness, in which the FTC took action against companies that failed to live up to what the FTC deemed to be reasonable security standards.<sup>64</sup>

Here, as with privacy, the central concern related to how online intermediaries—firms hosting or handling sensitive consumer information—protected consumer interests. The FTC deemed existing laws, both federal and state, insufficient to the task of protecting consumers against lax data security practices. But, as with privacy, the FTC’s authority to proscribe unfair and deceptive acts and practices appeared to offer the breadth and flexibility needed to reach data security concerns.

The Commission’s approach to data security was more forceful than its approach to privacy issues had been. In its prior work with privacy concerns, the Commission had declined to take enforcement action except against firms that had violated their clearly stated privacy policies. Where this was not the case, the Commission had focused on information gathering and dissemination. It had held workshops, issued reports, and advised Congress

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59. FED. TRADE COMM’N, *PRIVACY ONLINE: A REPORT TO CONGRESS* 40 (1998), [http://www.ftc.gov/sites/default/files/documents/public\\_events/exploring-privacy-roundtable-series/priv-23a.pdf](http://www.ftc.gov/sites/default/files/documents/public_events/exploring-privacy-roundtable-series/priv-23a.pdf).

60. *Id.* at 42.

61. *Id.* at 43.

62. *See* FED. TRADE COMM’N, *PRIVACY ONLINE: FAIR INFORMATION PRACTICES IN THE ELECTRONIC MARKETPLACE: A REPORT TO CONGRESS* 36 (2000), <http://www.ftc.gov/sites/default/files/documents/reports/privacy-online-fair-information-practices-electronic-marketplace-federal-trade-commission-report/privacy2000.pdf>.

63. *See generally* David Alan Zetony, *The 10 Year Anniversary of the FTC’s Data Security Program: Has the Commission Finally Gotten Too Big for Its Breaches?*, 2011 STAN. TECH. L. REV. 12.

64. Michael D. Scott, *The FTC, the Unfairness Doctrine, and Data Security Breach Litigation: Has the Commission Gone Too Far?*, 60 ADMIN. L. REV. 127, 129, 147 (2008).

on potential legislation. Its approach to data security relied instead on adjudicatory enforcement actions rather than information gathering and dissemination. This was in part because the Commission's authority and expertise in the area was buttressed by its experience as privacy regulator, and in part because data security concerns presented a greater specter of consumer harm—hackers are scary—than mundane privacy cases.

By mid-decade, concern was beginning to foment about the FTC's approach.<sup>65</sup> It was becoming clear that the Commission was developing a substantial new area of law in the shadow of its unfairness and deceptive acts authority. These concerns, however, were overshadowed for most by the pressing need to address data security concerns—even for those concerned by the FTC's approach, uncertainty over how to proceed justified some reliance on the FTC's approach as a stopgap measure.

By the turn of the decade, these concerns were beginning to spill over from the bar into policy debates, and from there into the academic debates that we are beginning to have today. As Solove and Hartzog note, the Commission's activity in this area proceeded with minimal academic attention for 10 to 15 years.<sup>66</sup>

In this same timeframe, many Commissioners and commentators have begun pressing for the Commission to embrace a broader understanding of its authority to proscribe “unfair methods of competition” (“UMC”).<sup>67</sup> This urged expansion results from the perceived inadequacy of the (judicially-defined) antitrust laws to address a range of competition-related concerns.<sup>68</sup> The Commission's UMC authority is widely understood to embrace, but be broader than, the antitrust laws.<sup>69</sup> In the decades prior to 2010, the Commission had been reluctant to push its UMC authority beyond the scope of the antitrust laws, but this reluctance has been giving way<sup>70</sup>—at least in the Commission's rhetoric—to the FTC's general willingness to more aggressively set, and push, the boundaries of existing legal norms.

This changing understanding of its UMC authority tracks the Commission's embrace of its “common law” role. This is perhaps best captured in remarks by Chairwoman Ramirez, in which she articulated that the Commission's UMC authority is well-established to be broader than the

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65. See, e.g., *id.* at 144. See generally Zetoon, *supra* note 63.

66. Solove & Hartzog, *supra* note 16, at 598–99.

67. See Hurwitz, *Chevron and the Limits*, *supra* note 22, at 243; Joshua D. Wright, Comm'r, Fed. Trade Comm'n, Proposed Policy Statement Regarding Unfair Methods of Competition Under Section 5 of the Federal Trade Commission Act 4–5 (June 19, 2013), [https://www.ftc.gov/sites/default/files/documents/public\\_statements/statement-commissioner-joshua-d.wright/130619umcpolicystatement.pdf](https://www.ftc.gov/sites/default/files/documents/public_statements/statement-commissioner-joshua-d.wright/130619umcpolicystatement.pdf).

68. See Wright, *supra* note 67, at 9.

69. *Id.*; see also *Fed. Trade Comm'n v. Sperry & Hutchinson Co.*, 405 U.S. 233, 239–40 (1972).

70. See Hurwitz, *Chevron and the Limits*, *supra* note 22, at 237–41; see also *id.* at 227–29 (discussing the history of the FTC's UMC authority).



traditional antitrust laws and that she favors a common law approach to developing that authority.<sup>71</sup>

Today, Commissioners and commentators increasingly describe the Commission's approach to all three areas—privacy, data security, and UMC—in common law terms.<sup>72</sup> This rhetorical device has evolved along with criticism of the Commission's approach to developing legal norms. It is not entirely unwarranted—courts and scholars have long described agency use of case-by-case adjudication as common-law-like. But that language is generally used by those explaining the mechanical process of agency decisionmaking, not the underlying jurisprudential theory. And, indeed, mechanically, agency adjudication *is* similar to common law in the sense that individual matters are decided on a case-by-case basis by an adjudicator, sometimes with the effect of producing new binding legal norms.<sup>73</sup>

But while the FTC's approach is indeed similar, it is not the *same* as common law. Rather, the Commission's self-styled description of what it is doing as “common-law” is a rhetorical flourish. As will be seen in the next two Parts of this Article, there are important differences between the FTC's approach and the common law approach, and these differences suggest the FTC's approach is jurisprudentially deficient. The Commission's increasingly common allusions to the common law are not based on a well-theorized jurisprudential understanding of the common law or the differences between administrative adjudication and the common law. Rather, the Commission is free riding on the reputational legitimacy of the common law in the judicial context in a (likely unintentional) effort to avoid confronting questions of the jurisprudential legitimacy of its approach by analogizing it to something understood to be jurisprudentially sound.

#### D. EARLY JUDICIAL RESPONSES TO THE FTC'S APPROACH TO DATA SECURITY

The most notable aspect of the FTC's approach to developing data security norms is that it is based in discrete enforcement actions. These actions generally result in settlements—typically requiring, at minimum, that firms agree to 20 years of ongoing security monitoring and audits—which are made public in the form of consent decrees. To date, the FTC has brought

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71. Ramirez, *supra* note 25, at 6 (“This brings me to the second topic I would like to address today: the process the Commission uses to develop Section 5 doctrine. I favor the common law approach, which has been a mainstay of American antitrust policy since the turn of the twentieth century.”).

72. *Id.* See generally Solove & Hartzog, *supra* note 16.

73. See Cass R. Sunstein, *Is Tobacco a Drug? Administrative Agencies as Common Law Courts*, 47 DUKE L.J. 1013, 1019 (1998) (“A general claim underlies this conclusion: without much fanfare, agencies have become modern America's common law courts, and properly so.”). *But see* Lars Noah, *Interpreting Agency Enabling Acts: Misplaced Metaphors in Administrative Law*, 41 WM. & MARY L. REV. 1463, 1506 (2000) (“As a descriptive thesis, therefore, Professor Sunstein's common law metaphor seems over-stated. It fares even less well as a normative claim.”).

more than 50 data security actions;<sup>74</sup> all but two of these actions have settled. The two cases that have not settled—*Wyndham* and *LabMD*—are currently in litigation.<sup>75</sup>

Both *Wyndham* and *LabMD* have argued that the FTC's approach to developing data security norms is an improper way for an administrative agency to develop binding legal norms. They argue that the FTC has failed to provide notice or otherwise promulgate any data security standards, such that the Commission's enforcement actions violate constitutional due process guarantees.<sup>76</sup> The Commission responds that its past enforcement actions are well known within the bar and result in published consent decrees that provide notice of its data security expectations.<sup>77</sup>

Due to certain nuances of how the FTC can enforce section 5 of the FTC Act, it will be helpful to explain aspects of the procedural history of the *Wyndham* and *LabMD* cases. In both cases, the FTC is asserting the same basic claim that the respective firms' data security practices were insufficient to protect their customers' data, such that the data was potentially obtained by unknown third parties which causes or is substantially likely to cause harm to the firms' customers.<sup>78</sup> The FTC alleges that practices that results in such actual or likely harms are unfair practices under section 5 of the FTC Act.<sup>79</sup> But while the basic claims are the same, the FTC has elected to prosecute its enforcement action differently in each case. The Commission has the option of pursuing enforcement actions either on an administrative basis or directly in federal district court. In *LabMD*, the Commission is proceeding through administrative adjudication;<sup>80</sup> in *Wyndham*, the Commission commenced its enforcement action in federal court in the District of New Jersey.<sup>81</sup> In both

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74. See *supra* note 5 and accompanying text.

75. Since this Article entered the final editing stages, there have been important developments in both cases—developments which tend to support the arguments made in this Article. A brief discussion of these developments is offered in the Afterword to this Article.

76. This argument applies where a firm has not affirmatively indicated to consumers that it abides by specific data security standards. Where such statements are made, the FTC can proceed under its deception authority—and there is little question that such enforcement actions are appropriate. Where, however, no affirmative assurances have been made, the FTC proceeds under an unfairness theory.

77. See Brill, *supra* note 44, at 1, 3; *supra* Part II.B; see also Brief for the Federal Trade Commission pt. II.B.1, at 45–49, Fed. Trade Comm'n v. *Wyndham Worldwide Corp.*, 799 F.3d 236 (3d Cir. 2015) (No. 14-3514), [https://www.ftc.gov/system/files/documents/cases/141105wyndham\\_3cir\\_ftcbrief.pdf](https://www.ftc.gov/system/files/documents/cases/141105wyndham_3cir_ftcbrief.pdf).

78. See *LabMD, Inc. v. Fed. Trade Comm'n*, No. 1:14-cv-00810-WSD, 2014 WL 1908716, at \*1 (N.D. Ga. May 12, 2014); Fed. Trade Comm'n v. *Wyndham Worldwide Corp.*, 10 F. Supp. 3d 602, 607 (D.N.J. 2014), *aff'd*, 799 F.3d 236 (3d Cir. 2015). In *Wyndham*, the FTC also asserts additional claims, not asserted in *LabMD*, based upon its authority to proscribe deceptive acts and practices. See *Wyndham Worldwide Corp.*, 10 F. Supp. 3d at 626.

79. *LabMD, Inc.*, 2014 WL 1908716, at \*1; *Wyndham Worldwide Corp.*, 10 F. Supp. 3d at 607.

80. See *LabMD, Inc.*, 2014 WL 1908716, at \*1 (showing that the Commission proceeded by filing an Administrative Complaint against *LabMD*).

81. *Wyndham Worldwide Corp.*, 10 F. Supp. 3d at 609.

cases, the parties responded by filing motions to dismiss for failure to state a claim.<sup>82</sup> In *Wyndham*, this motion was heard and decided by the presiding federal judge.<sup>83</sup> In *LabMD*, however, such motions are heard on an administrative basis and are appealable to the Commission, not the Article III courts. As such, *LabMD*'s motion to dismiss was ultimately heard—and dismissed—by the FTC Commissioners (the same Commissioners who have given life to the underlying legal theory of the case).<sup>84</sup> *LabMD* subsequently sought review of the denial of its motion to dismiss in federal district court. The judge in this case, Judge Duffey of the District of Georgia, denied this review on procedural grounds because the issue was not ripe.<sup>85</sup>

*Wyndham* and *LabMD* have proceeded independently but in parallel in their respective venues. Both cases, starting with their respective motions to dismiss, bear discussion. The FTC's approach appeared vindicated in April 2014 when Judge Salas of the United States District Court for the District of New Jersey rejected *Wyndham*'s motion to dismiss.<sup>86</sup> In denying this motion, Judge Salas explained that “the contour of an unfairness claim in the data-security context, like any other, is necessarily ‘flexible’ such that the FTC can apply section 5 ‘to the facts of particular cases arising out of unprecedented situations.’”<sup>87</sup> In other words, the Judge found that it was appropriate for the FTC to pursue section 5 claims relating to data security standards through case-by-case adjudication.

Most commentators viewed this as a strong affirmation of the FTC's authority and approach to developing data security norms.

Shortly after Judge Salas issued her opinion denying *Wyndham*'s motion, *LabMD* sought review in federal court of the FTC's denial of its motion to dismiss in the *LabMD* litigation. In defending its denial of this motion, the FTC was quick to cite Judge Salas's opinion, citing cursorily to the holding without any discussion in asserting “the adequacy of the Commission's jurisdiction over and notice regarding data security standards.”<sup>88</sup> But the judge reviewing the *LabMD* motion to dismiss was not so blasé about the issue, especially in the administrative context.

It was at this stage that the FTC received its first substantial judicial push-back. During a hearing to consider *LabMD*'s motion, Judge William S. Duffey, Jr., addressed FTC counsel:

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82. *LabMD, Inc.*, 2014 WL 1908716, at \*1; *Wyndham Worldwide Corp.*, 10 F. Supp. 3d at 607.

83. See generally *Wyndham Worldwide Corp.*, 10 F. Supp. 3d 602.

84. *LabMD, Inc.*, 2014 WL 1908716, at \*1.

85. *Id.* at \*6.

86. *Wyndham Worldwide Corp.*, 10 F. Supp. 3d at 631.

87. *Id.* at 620.

88. Complaint Counsel's Pre-Trial Brief at 61, *LabMD, Inc.*, No. 9357 (F.T.C. May 6, 2014).

No wonder you can't get this resolved, because if [a 20-year consent order is] the opening salvo, even I would be outraged, or at least I wouldn't be very receptive to it if that's the opening bid.

....

You have been completely unreasonable about this. And even today you are not willing to accept any responsibility . . . .

....

. . . I think that you will admit that there are no security standards from the FTC. You kind of take them as they come and decide whether somebody's practices were or were not within what's permissible from your eyes.

. . . [H]ow does any company in the United States operate when . . . [it] says, well, tell me exactly what we are supposed to do, and you say, well, all we can say is you are not supposed to do what you did.

. . . [Y]ou ought to give them some guidance as to what you do and do not expect, what is or is not required. You are a regulatory agency. I suspect you can do that.<sup>89</sup>

Judge Duffey ultimately denied LabMD's motion on procedural grounds, holding that because the FTC's administrative enforcement action against LabMD was ongoing, the challenge to the agency action in federal court was unripe.<sup>90</sup>

Judge Duffey's opinion, issued in May 2014, sent the case back to the FTC for resumption of the Commission's administrative enforcement action. At this point, the *Wyndham* case seemed poised to continue apace in the District of New Jersey and the *LabMD* case to continue before the FTC's administrative law judge. Before either case could continue, however, each took its own surprising turn: Judge Salas certified portions of her motion to dismiss opinion in *Wyndham* to the Third Circuit Court of Appeals on interlocutory appeal,<sup>91</sup> and the FTC's *LabMD* investigation became the subject of a congressional inquiry. As a result, further proceedings in both cases were effectively delayed by more than a year, only resuming again in force in recent months.

Starting with recent activity in *Wyndham*: While many commentators had read Judge Salas's motion to dismiss opinion in *Wyndham* as vindication of the FTC's practices—and the FTC represented the opinion's holding without qualification to the court in the *LabMD* hearing—Judge Salas offered a more cautious understanding, explaining in her certification of *Wyndham*'s

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89. Transcript of Proceedings at 91, 94–95, *LabMD, Inc. v. Fed. Trade Comm'n*, No. 1:14-CV-810-WSD, 2014 WL 1908716 (N.D. Ga. May 7, 2014).

90. *LabMD, Inc.*, 2014 WL 1908716, at \*6.

91. *Wyndham Worldwide Corp.*, 10 F. Supp. 3d at 636.

interlocutory appeal that Wyndham's "statutory authority and fair-notice challenges confront this Court with novel, complex statutory interpretation issues that give rise to a substantial ground for difference of opinion."<sup>92</sup>

Roughly a year and a half after Judge Salas's initial opinion on Wyndham's motion to dismiss, the Third Circuit issued its own opinion upholding her rejection of the motion to dismiss.<sup>93</sup> While this opinion has been—once again—overwhelmingly characterized by commentators as affirming the FTC's authority to regulate firms' data security practices, such a reading is really far too broad. Indeed, it is likely more accurate to characterize the opinion as raising serious questions about the FTC's efforts to develop a common law of data security.

The Third Circuit's opinion rewards careful reading.<sup>94</sup> To start, we need to understand what question the court was answering and what its answer was. The court finds that it is possible that a firm's data security practices possibly can constitute unfair practices under section 5 of the FTC Act.<sup>95</sup> Contrary to how the opinion is typically characterized, it is not about the FTC's authority to regulate data security practices—it is about whether specific practices may fall within the FTC's unfairness authority. Further, the court was reviewing a motion to dismiss—it therefore was required to assume all facts to be found in the Commission's favor. With this understanding, the opinion is incredibly unremarkable: It effectively holds that there are circumstances under which a firm's data security practices—just like any other practices a firm may engage in—may constitute unfair practices under section 5.

What does make the court's opinion remarkable, however, is how it reaches this obvious conclusion: Its decision ignores, and arguably rejects, the FTC's contention that it has developed a common law of data security. The importance of the *Wyndham* case is not what it says about the FTC's argument that bad practices can be unfair practices—it is what it says about the FTC's claims that it has developed binding legal norms identifying what security practices constitute bad, and therefore unfair, practices. As the FTC argues in no uncertain terms in supplemental briefing requested by the Third Circuit, "the FTC *has* acted under its procedures to establish that unreasonable data security practices that harm consumers are indeed unfair within the meaning of Section 5."<sup>96</sup> But the court, in its consideration of Wyndham's due process

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92. *Id.* at 634. There have been further important updates in the Wyndham case as this Article goes to print. For a discussion of these updates, see Afterword, *infra*.

93. Fed. Trade Comm'n v. Wyndham Worldwide Corp., 799 F.3d 236, 259 (3d Cir. 2015).

94. Portions of the following discussion are based on an earlier analysis of the Third Circuit Wyndham opinion published at TechPolicyDaily.com. See Gus Hurwitz, *In Wyndham, the FTC Won a Battle but Perhaps Lost Its Data Security War*, TECHPOLICYDAILY.COM (Aug. 27, 2015, 6:00 AM), <http://www.techpolicydaily.com/technology/wyndham-ftc-data-security-war>.

95. *Wyndham Worldwide Corp.*, 799 F.3d at 247.

96. Supplemental Memorandum of the Fed. Trade Comm'n at 2, Fed. Trade Comm'n v. Wyndham Worldwide Corp., 799 F.3d 236 (3d Cir. 2015) (No. 14-3514), <https://www.ftc.gov/system/files/documents/cases/150327wyndhamsuppbrief.pdf>.

and fair notice arguments, accepts Wyndham's argument that the FTC has not developed such a law.<sup>97</sup> This is central to the court's opinion, because different standards apply to interpretations of laws that are developed by courts as opposed to those that are developed by agencies. The court outlines these standards, explaining that "[a] higher standard of fair notice applies [in the context of agency rules] than in the typical civil statutory interpretation case because agencies engage in interpretation differently than courts."<sup>98</sup> The court goes on to find that Wyndham had sufficient notice of the requirements of section 5 *under the standard that applies to judicial interpretations of statutes*.<sup>99</sup> And it expressly notes that, should the district court decide that the higher standard applies—that is, if the court agrees to apply the general law of data security that the FTC has tried to develop in recent years—the court will need to reevaluate whether the FTC's rules meet constitutional muster.<sup>100</sup> That review would be subject to the tougher standard applied to agency interpretations of statutes.

The fact that the court elected to evaluate the FTC's unfairness claims under the standard applicable to judicial interpretations of law does not necessarily bear ill portents for the FTC. Indeed, under the standard of review applicable to motions to dismiss, under which all facts are to be interpreted in the light most favorable to the Commission, it may simply be necessary to apply the standard most favorable to the Commission's claims in the instant case. But there is nonetheless reason to think that the court may have proceeded under the more favorable standard because doing so was necessary for the Commission to prevail: The Third Circuit's opinion bears ill portents for review under the heightened standard applicable to review of agency rules. In the court's opinion, the Circuit judges note that they "agree with Wyndham that the [FTC's] guidebook could not, on its own, provide 'ascertainable certainty' of the FTC's interpretation of what specific cybersecurity practices fail [section 5]."<sup>101</sup> And they "agree with Wyndham that the [FTC's prior] consent orders, which admit no liability and which focus on prospective requirements on the defendant, were of little use to it in trying to understand the specific requirements imposed by [section 5]."<sup>102</sup> They "recognize it may be unfair to expect private parties back in 2008 to have examined FTC

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97. *Wyndham Worldwide Corp.*, 799 F.3d at 252–53, 255 (“[Wyndham] has contended repeatedly . . . that there is no FTC rule or adjudication about cybersecurity that merits deference here. The necessary implication . . . is that federal courts are to interpret § 45(a) in the first instance to decide whether Wyndham’s conduct was unfair. . . . [W]e accept Wyndham’s forceful contention that we are interpreting the FTC Act.”).

98. *Id.* at 251–52.

99. *Id.* at 253–59.

100. *Id.* at 255 (“If later proceedings in this case develop such that the proper resolution is to defer to an agency interpretation that gives rise to Wyndham’s liability, we leave to that time a fuller exploration of the level of notice required.”).

101. *Id.* at 256 n.21.

102. *Id.* at 257 n.22.

complaints or consent decrees. Indeed, these may not be the kinds of legal documents they typically consulted.”<sup>103</sup> And they noted that the FTC had failed to explain how it had “informed the public that it needs to look at complaints and consent decrees for guidance.”<sup>104</sup>

All of these comments are offered by the court in footnotes near the end of its opinion. It is curious to consider why the court bothered to include them at all, especially having relegated them to footnotes. They are only relevant to the counterfactual evaluation of the Commission’s claims under the Commission’s own articulation of its unfairness standards—because the court does not proceed under this standard, these observations have no bearing on the court’s analysis of *Wyndham*’s motion to dismiss.

Rather than treat the court’s comments as unnecessary and irrelevant asides, it seems more reasonable to read them as a substantive critique of the FTC’s asserted development of a “common law of data security.” The court seems to reject nearly every element of the FTC’s common law approach. While it is unquestionably the case that any of a firm’s practices, including its data security practices, may under certain facts constitute unfair practices—and, therefore, it is almost necessary that a complaint alleging such facts survive a motion to dismiss—the court is aware that the FTC’s efforts in the data security sphere are broader than the facts at issue in *Wyndham* and is using dicta to provide both lower courts and the Commission cautionary guidance about the potential jurisprudential infirmities in the FTC’s common law approach.

Turning now to recent activity in *LabMD*:<sup>105</sup> following Judge Duffey’s May 2014 order, activity in *LabMD* was largely suspended pending a congressional investigation relating to the FTC’s investigation of LabMD. The full details of this investigation need not be presented for the purposes of this discussion. Generally, starting in the summer of 2014, the House Oversight Committee began investigating concerns about the relationship between the FTC and a security firm, Tiversa, with which the FTC worked to identify and pursue its case against LabMD and a number of other firms.<sup>106</sup> The impetus for these concerns are claims by a former employee of Tiversa that the company fabricated evidence of data breaches and threatened to report the fabricated

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103. *Id.* at 257 n.23.

104. *Id.* (citation omitted).

105. For discussion of the most recent development in the *LabMD* litigation, see Afterword, *infra*.

106. See Letter from Honorable Darrell E. Issa, Chairman, House Comm. on Oversight & Gov’t Reform, to Honorable Edith Ramirez, Chairwoman, Fed. Trade Comm’n 1 (Dec. 1, 2014), <http://pathologyblawg.com/wp-content/uploads/2015/02/House-Oversight-Letter-Dec-2014.pdf> (“The Committee on Oversight and Government Reform has been investigating the activities of Tiversa, Inc. . . . The Federal Trade Commission has relied on Tiversa as a source of information in its enforcement action against LabMD, Inc. . . . The Committee has obtained documents and information indicating Tiversa failed to provide full and complete information about work it performed . . . In fact, it appears that, in responding to an FTC subpoena . . . , Tiversa withheld responsive information that contradicted other information it did provide about [LabMD].”).

breaches to the FTC if the firm did not employ its security consulting services—and further that the FTC, in its eagerness to develop its common law of data security, embraced Tiversa’s falsified reports without further investigation, and that FTC Commissioners lied to Congress about the LabMD investigation. While salacious and intriguing—and still pending resolution—the Congressional investigation’s key relevance to the *LabMD* litigation is that the former employee at the center of these allegations is also a witness in the *LabMD* case. His participation was both contentious and delayed due to his whistleblower status.

After a lengthy delay—first due to LabMD’s motion to dismiss heard in the District of Georgia and then due to issues surrounding the congressional investigation—the FTC’s administrative hearing before the administrative law judge assigned to the case resumed. Closing arguments were heard in September 2015, and the parties are now awaiting the administrative law judge’s opinion. While this opinion is still pending and although it is a foregone conclusion that this opinion will be appealed, first to the full Commission and then to the Article III courts, no matter its outcome, it is nonetheless worth it to look briefly at the closing arguments, as they offer a fourth judicial perspective on the FTC’s efforts to develop a common law of data security.

At closing arguments, FTC Chief Administrative Law Judge Chappell spent nearly the entirety of his time with FTC counsel pressing to understand the legal authority on which the Commission based its legal theory of the case. The Commission’s central argument is that, when a firm experiences a data breach that puts customer data in the hands of unknown individuals, there is a substantial likelihood that that data will then be used in a way that harm those customers, and that this is sufficient to satisfy section 5(n)’s requirement that an unfair practice causes or substantially likely causes injury to consumers.<sup>107</sup> Prior to *LabMD*, however, that legal theory had never been adjudicated in court; the first time the theory was considered by a judge was in the motion to dismiss, which was only filed after the complaint against LabMD was filed. Early in the arguments, Judge Chappell focused on roughly the same issue that had previously alarmed Judge Duffey, asking FTC counsel “where is the fairness in that, Counselor? If you’re a company, . . . where is the fairness in a standard of what the law is being issued or published after the case is brought?”<sup>108</sup> The judge’s exasperation is at times palpable even through the transcript as he pushed FTC counsel to provide him with support for the Commission’s legal theory beyond the Commission’s own construction of the statute: “And I’ve asked you again, what authority do you have, what other case do you have that says that’s the law . . . I asked for cases. Cases.

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107. Closing Arguments at 6, 10, 16–17, *LabMD, Inc.*, No. 9357 (F.T.C. Sept. 16, 2015).

108. *Id.* at 8.



No. I've read *International Harvester*.<sup>109</sup> It does not say that. . . . It's like you're citing headnotes to me here."<sup>110</sup> The judge returns to this issue again near the end of FTC counsel's arguments:

Excuse me. Law of the case? . . . How's that? . . . A ruling on a motion to dismiss becomes law of the case? . . . Did I get that right? . . . But you haven't cited any Court of Appeals case that agrees with that, have you? . . . And again, I'm going to give you another opportunity to cite any authority to me other than that [motion to dismiss] opinion. . . . I'm asking you to cite any authority to me, any case law, other than the ruling on a motion to dismiss in this case, that says a mere breach is sufficient harm to sustain a violation of section 5.<sup>111</sup>

As discussed further in the Afterword to this Article, shortly before this Article went to press, Judge Chappell issued his Initial Opinion. As the discussion above suggested he would, the Judge rejected the FTC's claims against LabMD, finding amongst other things that the FTC failed to demonstrate sufficiently likely harm stemming from LabMD's conduct, and finding that the FTC's theory of the case—under which the fact of a data breach demonstrates a likelihood of consumer harm—"would not provide the required constitutional notice of what is prohibited."<sup>112</sup>

Comments such as those offered by Judges Chappell, Duffey, and the judges of the Third Circuit suggest serious judicial concern about the FTC's approach to developing its common law of data security. At the same time, the Commission has consistently prevailed in these cases on procedural grounds. As Judge Salas recognizes, agencies have substantial flexibility in developing and applying their statutes on a case-by-case basis;<sup>113</sup> and, as the judges of the Third Circuit recognized, bad security practices surely *can* constitute unfair practices under section 5.<sup>114</sup> Where things get difficult is where agencies seek to develop a new body of legal rules using this case-by-case method—and this is exactly what the Commission argues it has done. As Judge Chappell asks, "where is the fairness in that?"<sup>115</sup> As the judges on the Third Circuit opine, the FTC failed to explain to them how it had "informed the public that it needs to look at complaints and consent decrees for guidance."<sup>116</sup> This is in contrast to Judge Duffey's view that the FTC "ought to

109. *International Harvester* was the case the FTC counsel suggested. *See id.* at 17.

110. *Id.*

111. *Id.* at 57–59.

112. Initial Decision, 2015 WL 7575033, at \*64 (F.T.C. Nov. 13, 2015); *see also* Afterword, *infra*.

113. *See* Fed. Trade Comm'n v. Wyndham Worldwide Corp., 10 F. Supp. 3d 602, 620 (D.N.J. 2014).

114. *See* Fed. Trade Comm'n v. Wyndham Worldwide Corp., 799 F.3d 236, 247 (3d Cir. 2015).

115. Closing Arguments at 8, LabMD, Inc., No. 9357 (F.T.C. Sept. 16, 2015).

116. *Wyndham Worldwide Corp.*, 799 F.3d at 257 n.23.

give them some guidance as to what you do and do not expect.”<sup>117</sup> Concerns such as these take us to the FTC’s underlying jurisprudential theory, that it is developing its body of data security law through something resembling a “common law” process.

### III. THE FTC’S “COMMON LAW” IS NOT COMMON LAW

The FTC’s “common law” approach described above bears some resemblance to common-law rulemaking—but it also is different in important ways. This Part starts with a brief discussion of the theory underlying the common law—a subject that has been sorely lacking in prior presentations of the FTC’s “common law” approach. This background provides a benchmark against which we can more rigorously compare the FTC’s approach to the traditional understanding of the common law. Finally, treating the FTC’s “common law” moniker as a shorthand substitute for case-by-case adjudication, this Part critiques the Commission’s preference for adjudication and presents the contrary argument—which has been largely lacking from scholarly and policy discussion—that the Commission should rely primarily on rulemaking over adjudication.

#### A. WHAT IS COMMON LAW?

Those advocating for the FTC’s “common law” approach analogize this approach to the common law primarily because the Commission is engaging in a series of case-by-case adjudications that produce various forms of semi-precedential documents (complaints, settlement, statements by Commissioners, aids for public comment, press releases, etc.). But the common law results from more than just a series of semi-precedential public opinions. The common law operates in a domain of convergence: Over time, the decisions of common-law judges will tend to converge to a common set of principles.<sup>118</sup> Common law will not yield satisfactory results where the resulting rules will not converge over time to a stable set of principles.

But while the common law operates in a domain of convergence, it does not assume that it is converging on any specific outcome.<sup>119</sup> Early theories of the common law posited that judges were not *making* law—rather, judges were dipping into a great reservoir of legal and practical knowledge to discover and apply objectively identifiable principles. They were discovering and *declaring* the law as it existed independent of them.<sup>120</sup> Modern understandings of

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117. Transcript of Proceedings at 95, *LabMD, Inc. v. Fed. Trade Comm’n*, No. 1:14-CV-810-WSD, 2014 WL 1908716 (N.D. Ga. May 7, 2014).

118. See generally George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65 (1977); Paul H. Rubin, *Why Is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977).

119. See, e.g., Priest, *supra* note 118; Maxwell L. Stearns, *Standing Back from the Forest: Justiciability and Social Choice*, 83 CALIF. L. REV. 1309, 1331 (1995).

120. For contemporary discussions, see Allan Beever, *The Declaratory Theory of Law*, 33 OXFORD J. LEGAL STUD. 421 (2013); Michael Sinclair, *Precedent, Super-Precedent*, 14 GEO. MASON

common law tend to eschew this declaratory theory for more realist understandings of the law and role of precedent.<sup>121</sup>

Whatever the theory, both declaratory and more recent theories of common law create—and, to some extent, value—a stable body of precedent.<sup>122</sup> This is captured in the well-known idea of *stare decisis*.<sup>123</sup> Under a declaratory theory, stability of the law is a consequence: Judges are merely announcing the externally defined, objectively understood, law.<sup>124</sup> Precedent will change as we perfect our understanding of that law, but the law itself is stable. More recent theories tend to value stability as a goal.<sup>125</sup> Therefore, they value precedent to avoid the mischief that unnecessary change may cause.<sup>126</sup>

Importantly, while contemporary understandings of the common law recognize that judges do in fact “make” law, they do not embrace this function warmly.<sup>127</sup> Rather, it results from the realist understanding that cases are brought to the court because there is an otherwise irreconcilable conflict.<sup>128</sup> It is the judge’s job to reconcile this conflict, even where the law offers no clear answer. It is for this reason that various rules exist—statutory, constitutional, and customary—that restrict the scope of a judge’s discretion.<sup>129</sup> Judges do not select cases to hear: They take the cases that come to them;<sup>130</sup> judges cannot hear any case: The parties must have standing, the case must represent an actual case or controversy, and the issues must be

L. REV. 363 (2007). One standard exposition was offered in *Willis v. Baddeley*: “There is, in fact, no such thing as judge-made law, for the judges do not make the law, though they frequently have to apply existing law to circumstances as to which it has not previously been authoritatively laid down that such law is applicable.” *Willis & Co. v. Baddeley* [1892] 2 QB 324, 326 (Eng.).

121. LORD RADCLIFFE, NOT IN FEATHER BEDS 215 (1968) (“[T]here was never a more sterile controversy than that upon the question whether a judge makes law. Of course he does. How can he help it?”).

122. See generally GUIDO CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES (1982); Paul H. Rubin, *Common Law and Statute Law*, 11 J. LEGAL STUD. 205 (1982).

123. For a discussion of *stare decisis* in both the judicial and administrative context, see generally Kozel & Pojanowski, *supra* note 53.

124. Importantly, and somewhat curiously, judges operating under this theory would not hesitate to reject prior decisions were they to be ill-suited to a new case. The prior decisions, being flawed are not actually law, and therefore are not entitled to any precedential value. Under the declaratory model, *stare decisis* is a result of the declaratory process, not one of its mechanisms.

125. See *Immigration & Naturalization Serv. v. Chadha*, 462 U.S. 919, 975–78 (1983) (White, J., dissenting).

126. See, e.g., ALEXANDER M. BICKEL, THE LEAST DANGEROUS BRANCH: THE SUPREME COURT AT THE BAR OF POLITICS (1962) [hereinafter BICKEL, THE LEAST DANGEROUS BRANCH]; CALABRESI, *supra* note 122, at 16–30; Alexander M. Bickel, *The Supreme Court 1960 Term—Foreword: The Passive Virtues*, 75 HARV. L. REV. 40 (1961) [hereinafter Bickel, *The Supreme Court*].

127. See *supra* note 121 and accompanying text.

128. See Frederick Schauer, *Do Cases Make Bad Law?*, 73 U. CHI. L. REV. 883, 884 (2006). See generally BICKEL, THE LEAST DANGEROUS BRANCH, *supra* note 126.

129. See Heather Elliott, *The Functions of Standing*, 61 STAN. L. REV. 459, 478 (2008); Schauer, *supra* note 128, at 893; Stearns, *supra* note 119, at 1388–89.

130. See Anthony Niblett, *Case-by-Case Adjudication and the Path of the Law*, 42 J. LEGAL STUD. 303, 305 (2013); Stearns, *supra* note 119, at 1351.

ripe;<sup>131</sup> and judges should decide cases narrowly: Decisions are generally limited to the facts of the case and to the legal issues needed to address the case or controversy.<sup>132</sup>

These restraints highlight the role of the adjudicator in common law. Common law cases are heard by an adjudicator who is independent from the facts and parties and who must take cases and render decisions upon them. Each of these aspects is necessary to the common law mechanism—especially under modern understandings. Under a declaratory theory, case selection, decision, and independence are of less concern (provided that judges can be disciplined for clear improprieties). But where we understand that judges do make law, involving the adjudicator in the case selection process implicitly influences the outcome of that process.<sup>133</sup> The reason for this is that case selection drives the issues addressed by the common law process. If the judge (or any other party) is responsible for case selection decisions, their selection directly influences the path in which the law evolves.<sup>134</sup>

This brings us to a final factor to consider: the value of a multiplicity of cases being decided both in sequence and in parallel.<sup>135</sup> The value of this approach is familiar to those in the U.S. system: Appellate courts are most likely to hear cases that present conflicts between lower courts. Cases and controversies fuel the common law system—and cases and controversies arise at the margin of existing doctrine, where new facts challenge existing precedent or multiple precedents apply to existing facts.<sup>136</sup> A case or controversy does not exist between neighbors; a case or controversy exists between legal principles. The common law works to make clear what those legal principles are, such that neighbors do not need to bring their disputes to court. The hierarchical structure of our judicial system uses lower courts as

131. Elliott, *supra* note 129, at 465.

132. William M. Landes & Richard A. Posner, *Legal Precedent: A Theoretical and Empirical Analysis*, 19 J.L. & ECON. 249, 250 (1976) (“[F]or it is only from a series of decisions, each determining the legal significance of a slightly different set of facts, that a rule applicable to a situation common or general enough to be likely to recur in the future can be inferred.”).

133. See generally *Immigration & Naturalization Serv. v. Chadha*, 462 U.S. 919 (1983) (discussing separation of powers between legislative and adjudicative functions of government); *id.* at 960–62 (Powell, J., concurring) (“One abuse that was prevalent during the Confederation was the exercise of judicial power by the state legislatures. The Framers were well acquainted with the danger of subjecting the determination of the rights of one person to the ‘tyranny of shifting majorities.’ . . . It was to prevent the recurrence of such abuses that the Framers vested the executive, legislative, and judicial powers in separate branches. . . . [T]he separation-of-powers doctrine generally, reflect the Framers’ concern that trial by a legislature lacks the safeguards necessary to prevent the abuse of power.”); Stearns, *supra* note 119.

134. See generally Stearns, *supra* note 119.

135. See generally Rubin, *supra* note 118; Schauer, *supra* note 128; Stearns, *supra* note 119.

136. See generally George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984).

laboratories of jurisprudence, allowing appellate courts to identify—and clarify—conflicts between legal principles.<sup>137</sup>

Both the selection of which cases are brought and the order in which they are brought can have important effects on how the common law develops.<sup>138</sup> Using tools from the Social Choice literature, Max Stearns, for instance, has argued that while courts of appellate review should have control over their dockets, lower courts should be required to take cases as they come.<sup>139</sup> The purpose of this is to avoid path manipulation—the strategic use of easy cases to develop a body of precedent that will later make it easier to litigate hard cases. Unsurprisingly, these problems are particularly difficult where one party to litigation is a repeat player.

Cases—and the parties bringing them—play an even more important role in the development of the common law than the judges who adjudicate them. This is in part a simple function of volume. A well-known economic understanding of the common law mechanism results from simple multiplication.<sup>140</sup> Assuming that judges are, on average, more likely than not to decide any given case correctly, the process of deciding a large number of cases over time results in constant refinement and incremental development of increasingly “correct” laws.<sup>141</sup> The amazing thing about this understanding is that judges need only be more competent than the flip of a coin in their application of precedent to facts.

While judges play a surprisingly unimportant role in the development of the common law, cases and their litigants play an important role in this process: Development of the law is a public good.<sup>142</sup> Parties that litigate cases to a judicial decision generate a positive externality—a social benefit beyond that which is reflected in their private gains from litigation. Where the law is unsettled, private litigants’ incentives are aligned with the public’s interest in developing the law. The more cases that judges decide, subject to the constraint that the litigants’ incentives are aligned with this public benefit, the more the public benefits from these positive externalities.

But where settlement is possible, these private incentives are not aligned with the public’s larger interest in developing jurisprudence. If the law is sufficiently developed that settlement is possible, there is little social benefit

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137. See generally Stearns, *supra* note 119.

138. See *id.* at 1329–50; see also Niblett, *supra* note 130, at 316–17.

139. See generally Stearns, *supra* note 119.

140. See generally Priest, *supra* note 118; Rubin, *supra* note 118.

141. See generally Rubin, *supra* note 118. Note that this model does not assume the existence of an objectively “correct” body of law, but merely the possibility of a body of law that is stable as compared to its alternatives.

142. See generally Priest, *supra* note 118 (arguing that the common law tends to produce efficient results despite differing opinions between individual judges); Stearns, *supra* note 119 (arguing that standing doctrine helps preserve a beneficial distinction between judicial *stare decisis* and legislative lawmaking).

in having private litigants invest resources litigation. This explains both why the law prefers settlements and why settlements do not have precedential value—the settling parties’ incentives are not aligned with the socially beneficial further development of the law.

*B. THERE’S NOTHING COMMON ABOUT THE FTC’S “COMMON LAW”*

Once we move beyond the superficial understanding of the common law as being merely a series of semi-precedential decisions, it becomes difficult to maintain an analogy of the FTC’s approach to the common law. Most fundamentally, the FTC is not operating in a domain of convergence; it is operating in a domain of modal policies. This will be considered as part of the next Subpart’s treatment of the FTC’s approach as compared to rulemaking. But first, this Article considers separately the roles of adjudicator and litigant.

The FTC is not an independent adjudicator; it is a party to the enforcement actions it brings. And instead of taking and deciding whatever cases come to it, it has discretion to choose what cases it hears. Those familiar with the FTC’s process describe this as a benefit because it allows the Commission to use its case-selection prerogative to guide the development of the law.<sup>143</sup> Whatever the benefits of such an approach, it is a clear departure from the common law. Although in some cases, firms and individuals may be able to initiate their own action against the FTC,<sup>144</sup> it is unlikely that the FTC will take action in close cases—those in which we would say there is a case or controversy—when it can instead choose only to bring those cases that are most likely to advance its policy goals.<sup>145</sup>

While this may be advantageous to the FTC as it works to craft the rules that it wants to develop, such benefit accrues to the agency in its capacity as a rule-maker, not as a rule-enforcer. As discussed above, the common law approach works well where adjudicators hear a large number of cases that present issues at the margins of existing law. Indeed, easy cases may well make bad law.<sup>146</sup> Where the FTC selects cases that allow it to shape the broad contours of the law,<sup>147</sup> it is misusing the adjudicatory mechanism. Decisions

143. See generally Ohm, House E&C Testimony, *supra* note 25.

144. For instance, these may be initiated by seeking a declaratory action against an agency rule, or by challenging the procedures by which a given rule was adopted. But these approaches are difficult even where the agency has issued a rule through notice-and-comment rulemaking—courts often require parties to wait until an agency brings action against them before allowing a party to challenge an agency rule. This is to ensure that there is an actual case or controversy that is ripe for adjudication by a party with standing.

145. See Ohm, House E&C Testimony, *supra* note 25, at 3 n.1 (noting that the FTC selected cases from more than 2 million complaints received in 2012).

146. See generally Schauer, *supra* note 128 (arguing that simple cases in addition to hard cases make bad law).

147. Ohm, House E&C Testimony, *supra* note 25, at 3 (“The FTC’s wise use of its enforcement discretion is apparent in the cases it brings. Most of the cases the FTC brings each year are clear cut. It almost always brings cases in which the proof of deceptive or unfair conduct

that result from such a process will be overbroad, because they are made without the benefit of facts that would tend to be considered more seriously in a legislative or notice & comment rulemaking process.<sup>148</sup>

The contrast between this approach and that of a common law court is stark. Courts decide cases because they must, and in rendering decisions, they are careful to address only the relevant issues and do so narrowly. This is a central theme that cuts to the heart of the argument in favor of the FTC's approach: Agencies, unlike courts, can engage in quasi-legislative rulemaking. Recall that in *Chenery II* the Court started its analysis by saying that "[s]ince the Commission, unlike a court, does have the ability to make new law prospectively through the exercise of its rule-making powers, it has less reason to rely upon *ad hoc* adjudication to formulate new standards of conduct."<sup>149</sup>

With the agency wearing the hats of both litigant and adjudicator, it is also unsurprising that the Commission has an unprecedented success rate in its adjudications. This is well documented in recent literature: Until 2014, the FTC's complaint counsel (administrative prosecutor) hadn't lost a case adjudicated before the Commission (on appeal from the Administrative Law Judge) in nearly 20 years.<sup>150</sup> And, when one excludes cases in which the full

is undeniable, cases in which the defendant's conduct falls well below standards of reasonableness. This is not to say that these cases are easy; on the contrary, many are quite complex. But the FTC tends to focus on cases with a significant impact on consumer protection, avoiding marginal cases that push the envelope unnecessarily." (footnote omitted)); *see also* Solove & Hartzog, *supra* note 16, at 613.

148. Indeed, many of the safeguards of notice & comment rulemaking are intended to force precisely that kind of consideration, especially those added by the FTC's Magnuson-Moss authority beyond what the APA requires. *See* Hurwitz, *Chevron and the Limits*, *supra* note 22, at 233-35 (discussing the history of Magnuson-Moss). Magnuson-Moss imposed heightened procedural requirements on FTC rulemaking, in response to concerns about the quality and subject matter of rules the Commission developed in the 1970s. As discussed in Part IV, *infra*, agencies are largely free to develop new binding legal norms through either rulemaking or adjudication. However, one would expect that when Congress imposes heightened procedural requirements on either of these approaches, those heightened requirements would need to be respected when using the other. That is, the FTC should not be free to circumvent the heightened procedural requirements imposed by Magnuson-Moss by simply turning to adjudication for the development of new rules. There, however, has been little, if anything, written on this question. For a contrary view, *see* Maureen K. Ohlhausen, *The FCC's Knowledge Problem: How to Protect Consumers Online*, 67 FED. COMM. L.J. 203, 212 & n.46 (2015) (suggesting that "the FTC's process is enforcement-centric rather than rulemaking-centric" because Magnuson-Moss imposes higher procedural burdens on FTC rulemaking).

149. *Sec. & Exch. Comm'n v. Chenery Corp.*, 332 U.S. 194, 202 (1947).

150. *See* Joshua D. Wright, Comm'r, Fed. Trade Comm'n, *Judging Antitrust: Remarks at the Global Antitrust Institute Invitational Moot Court Competition 17-18* (Feb. 21, 2015), [https://www.ftc.gov/system/files/documents/public\\_statements/626231/150221judgingantitrust-1.pdf](https://www.ftc.gov/system/files/documents/public_statements/626231/150221judgingantitrust-1.pdf); *see also* David A. Balto, *The FTC at a Crossroads: Can It Be Both Prosecutor and Judge?*, 28 LEGAL BACKGROUNDER 1, 1 (2013) (noting that, as of 2013, the FTC counsel had not lost a case before the Commission in 18 years); Hurwitz, *Chevron and the Limits*, *supra* note 22, at 264-65 (discussing the FTC's multi-decade streak of winning administrative adjudication). These articles also offer background discussion of the relevant administrative process used by the FTC.

Commission dismissed some claims, that winning streak goes back 30 years.<sup>151</sup> This outstanding success rate is particularly remarkable given that FTC matters initially prosecuted before the Commission are more, not less, likely to be overturned by the courts of appeal than FTC matters initially prosecuted in district court.<sup>152</sup> This plain fact runs in the face of justifying deference to administrative agencies because of their supposedly greater expertise.<sup>153</sup>

These statistics raise clear questions about the FTC's impartiality as adjudicator, an important difference between the FTC's "common law" and judicial common law. They also highlight another important difference. The parties have more of a substantial reason to settle the cases due to the money and time costs of litigating a case before the Commission.<sup>154</sup> In addition, the parties face reputational damage if an FTC complaint does get adjudicated.<sup>155</sup> Settlement offers the opportunity to resolve complaints with minimal publicity as well as saving time and money.

But as discussed above, development of the common law is a positive externality that results from private litigants having an incentive to see cases through to decision. Where this is not the case, parties' private incentives do not align with the public development of the law. While the various public documents relating to an FTC enforcement action may provide some understanding of FTC policy, it is disingenuous to describe the resulting policy in common-law terms.<sup>156</sup>

The FTC's "common law" analogy also fails on multiplicity grounds. Multiplicity—especially of different adjudicators deciding similar cases—helps adjudicators find the margins along which the law needs to develop and to identify the directions in which it may develop. The FTC's approach—especially where the Commission proceeds by identifying high-impact cases that address broad issues—assumes the conclusion. Unlike the common law, the Commission begins knowing the direction in which it wants the law to develop, and selects cases that allow it to proceed along this path. This robs the Commission of the benefit offered by hearing many perspectives, and it

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151. See Hurwitz, *Chevron and the Limits*, *supra* note 22, at 237.

152. Joshua D. Wright & Angela M. Diveley, *Do Expert Agencies Outperform Generalist Judges? Some Preliminary Evidence from the Federal Trade Commission*, 1 J. ANTITRUST ENFORCEMENT 82, 96 (2013).

153. Importantly, this concern is generalizable. For instance, since 2010, when Dodd-Frank authorized the SEC to litigate its cases before an Administrative Law Judge instead of bringing them in federal court, the SEC has increasingly moved its cases to the administrative forum. The reason for this preference is clear: In recent years the SEC has lost the majority of its cases brought in federal court, but fares well in the administrative setting. Johnson & Medina, *supra* note 20.

154. Hurwitz, *Chevron and the Limits*, *supra* note 22, at 265.

155. Jim Rossi, *Bargaining in the Shadow of Administrative Procedure: The Public Interest in Rulemaking Settlement*, 51 DUKE L.J. 1015, 1057 n.147 (2001).

156. See generally *id.* (describing how mismatching incentives undermine the precedential value of settlements of administrative complaints).



robs the public of the better policies that such perspectives would allow the Commission to craft.<sup>157</sup>

A final difference between the Commission's approach and that of the common law is that there is no reason to believe that the Commission's jurisprudence will be stable over time. Administrative agencies are not bound by principles of *stare decisis*. They are largely free to change their policies, even to create direct conflicts with prior policies.<sup>158</sup> Indeed, agencies are even free to adopt policies that contradict previous judicial constructions of their statutes.<sup>159</sup> The primary constraint is that whatever policy they adopt must reasonably be within the ambit of the agency's statutory authority.<sup>160</sup> Simply stated: *Stare decisis* does not constrain administrative decision-making.

Many of the commentators who have discussed the Commission's "common law" approach have recognized this, at least to some extent.<sup>161</sup> They respond to concerns such as these by saying that the Commission has approached its development of the law with an eye to consistency.<sup>162</sup> While this may be historically true, it is a leap to compare 10–15 years of consistency from the FTC with the common law's hundreds of years of consistency. Institutional leadership changes, and tomorrow's leaders are not bound by either the procedural or substantive values of today's leaders.<sup>163</sup> The Commission has been developing these areas of law under the stewardship of only three Chairs, and only recently has the Commission begun thinking of itself as operating in a common-law-like manner. The FTC would not be the first agency whose jurisprudence become untethered from stable precedent, oscillating to match the political preference of whichever President appoints its chair.<sup>164</sup> Indeed, looking at the closing letters offered by the Commission in its data security investigations, it is apparent that the Commission is

157. Both of these are, of course, values that notice-and-comment rulemaking and formal adjudication are designed to protect.

158. See generally *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967 (2005).

159. *Id.* at 982.

160. See *Fed. Comm'n Comm'n v. Fox Television Stations, Inc. (Fox I)*, 556 U.S. 502, 514–15 (2009); *Motor Vehicle Mfrs. Ass'n of the U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 42–43 (1983).

161. See Solove & Hartzog, *supra* note 16, at 607.

162. See *id.* at 643.

163. For one well-known statement of this, see Policy Statement on Comparative Broad. Hearings, 1 F.C.C.2d 393, 393 (1965) ("Furthermore, membership on the Commission is not static and the views of individual Commissioners on the importance of particular factors may change. For these and other reasons, the Commission is not bound to deal with all cases at all times as it has dealt in the past with some that seem comparable . . . and changes of viewpoint, if reasonable, are recognized as both inescapable and proper.").

164. The textbook example of such an agency is the NLRB. See, e.g., Claire Tuck, Note, *Policy Formulation at the NLRB: A Viable Alternative to Notice and Comment Rulemaking*, 27 CARDOZO L. REV. 1117, 1122–23 n.40 (2005) (discussing this phenomenon and collecting examples); see also M. Elizabeth Magill, *Agency Choice of Policymaking Form*, 71 U. CHI. L. REV. 1383, 1399 n.48 (2004) (discussing the NLRB and FTC as examples of agencies that rely substantially on adjudication).

providing parties significantly less guidance under the stewardship of Chairwoman Ramirez than it did previously.<sup>165</sup>

#### IV. RULEMAKING VS. ADJUDICATION IN ADMINISTRATIVE LAW

The issues underlying concern about the FTC's "common law" approach are not new. Indeed, they tie into the separation of powers framework underlying our Constitution—concerns about consolidating the roles of rulemaking, enforcement, and adjudication—and the concerns that framework was meant to protect against. In the modern era, these concerns are central to basic questions about the legitimacy of and best practices for the administrative state. Judges and scholars have been debating the relative merits of administrative rulemaking compared to case-by-case adjudication for decades. These debates provide necessary context for understanding the appropriateness of the FTC's "common law" approach.

Roughly simultaneous with the FTC's development of its "common law" model, administrative law has been undergoing seismic shifts relating to agency discretion and choice of procedure.<sup>166</sup> While current precedent strongly supports granting deference to the FTC developing substantive legal norms through "common law"-like case-by-case adjudication rather than formal rulemaking, the Supreme Court's general trend has been increasingly hostile to this approach. The FTC's current approach is arguably the most aggressive use of adjudicatory procedures to develop a substantive area of law that any agency has embraced in the modern era of administrative law—which is, perhaps, unsurprising given the FTC's clash with Congress (then heavily Democratic), culminating in 1980.

To give a flavor of the Court's evolving sentiment, consider the following views expressed by leading administrative law scholars: Lisa Schultz Bressman explains that "[i]t should therefore come as no surprise . . . that the Supreme Court has recently begun to pare back the deference it accords to agency choice of procedures."<sup>167</sup> Elizabeth Magill similarly tells us that "courts appear

165. Copies of these letters were shared with the author after being obtained via Freedom of Information Act request. These letters show that, in cases closed in the mid-2000s, closing letters were formal, substantive, multi-page letters. In more recent cases, the Commission has merely informed parties that an investigation was being closed by informal means (e.g., the Commission responded to one e-mail from party counsel, asking: "A quick follow-up question. Will you be sending a closing letter?", with: "We do not plan to send a closing letter." In another instance, party counsel sent FTC counsel an e-mail stating "Thank you for your voicemail this morning advising me that the [FTC] had decided not to pursue any further action . . . and will be closing the investigation.").

166. See, e.g., 32 CHARLES ALAN WRIGHT & CHARLES H. KOCH, FEDERAL PRACTICE AND PROCEDURE: JUDICIAL REVIEW OF ADMINISTRATIVE ACTION § 8113 (2006) ("For over a decade, the US has experienced a reevaluation of the administrative state. Ironically, the recent attempts to rein-in the active government have increased the impact of the discipline. . . . The application of administrative law has at once become more complex and more fruitful.").

167. Lisa Schultz Bressman, *Beyond Accountability: Arbitrariness and Legitimacy in the Administrative State*, 78 N.Y.U. L. REV. 461, 536 (2003).

to be increasingly concerned about the oft-repeated charge that agencies are ‘regulating by guidance’—a category that includes unadjudicated enforcement actions.<sup>168</sup> John Manning offers a more skeptical take, arguing that it is jurisprudentially impractical for the Court to develop a strong preference for rulemaking over case-by-case adjudication.<sup>169</sup> But he does suggest that the Court may turn instead to other doctrines, such as fair notice, to meet the same end—and, indeed, the Court has since done just that.<sup>170</sup>

While perhaps not as engaging as the substantive concerns that the Commission seeks to address with its “common law” approach, one ignores these procedural and jurisprudential concerns at their own risk. It is a grave mistake to dismiss them as a “side show,”<sup>171</sup> or even just to proceed without an understanding of the broader historical—and shifting contemporary—context. The rest of this Part briefly sketches that context.

A. *THE BROAD CONTEXT OF AGENCY CHOICE OF PROCEDURE: RULEMAKING & ADJUDICATION*

Administrative agencies exist in an indeterminate place within our constitutional order.<sup>172</sup> They are created by congressionally enacted statute, and their power originates from Congress. And, like all law, it falls to the Executive to implement this congressionally created statute. But agencies are often given broad statutory authority by Congress—authority that implicitly or explicitly includes authority to develop legally binding norms.<sup>173</sup> Such norms, though developed by officers appointed by the Executive, may have the force of law, and therefore is the result of a legislative power.<sup>174</sup> And, where the agency is merely enforcing the law, it is typically acting in a judicial role, determining whether parties have complied with or violated congressional mandates, and taking appropriate action in response.<sup>175</sup> Agencies, therefore, both create and enforce law—they are said to have both quasi-judicial and quasi-legislative powers.

168. Magill, *supra* note 164, at 1441; *see also* J.B. Ruhl & James Salzman, *Mozart and the Red Queen: The Problem of Regulatory Accretion in the Administrative State*, 91 GEO. L.J. 757, 781 (2003).

169. John F. Manning, *Nonlegislative Rules*, 72 GEO. WASH. L. REV. 893, 909–10 (2004) (“Although scholars have also periodically tried to devise general standards for triggering rulemaking obligations, such efforts have not gained traction. Nor could they, in my view. Whatever one thinks of the relative merits of rulemaking versus adjudication, I think it safe to doubt the possibility of devising a judicially manageable standard for triggering mandatory rulemaking.” (footnote omitted)).

170. *Fed. Commc’ns Comm’n v. Fox Television Stations, Inc. (Fox II)*, 132 S. Ct. 2307, 2317 (2012) (“A fundamental principle in our legal system is that laws which regulate persons or entities must give fair notice of conduct that is forbidden or required.”).

171. *See* Ohm, House E&C Testimony, *supra* note 25, at 4.

172. *See, e.g., Immigration & Naturalization Serv. v. Chadha*, 462 U.S. 919 (1983).

173. *Id.* at 954.

174. *Id.* at 956–57.

175. *Id.* at 957 n.22.

Agencies generally have substantial discretion in how they use these powers. As discussed in the rest of this Part, they generally receive substantial deference to their choice of procedure—that is, whether they decide to act on a quasi-judicial, adjudicatory, basis in a given situation, or would rather act on a quasi-legislative basis to develop new rules.<sup>176</sup> It is often the case that there are good arguments for either approach. Quasi-judicial adjudication, for instance, generally renders decisions better suited to specific factual situations before the agency and is responsive to the concerns of individual regulated parties; quasi-legislative rulemaking, on the other hand, generally draws in a wider range of facts and can be more responsive to the overall regulated industry.

An agency's choice of procedure has implications for the legitimacy of any decisions the agency makes—and, ultimately, for the overall legitimacy of the agency. Legitimacy refers to “that quality of a rule which derives from a perception on the part of those to whom it is addressed that it has come into being in accordance with right process.”<sup>177</sup> A rule developed through a process that those subject to it do not recognize is an illegitimate rule; and an agency that promulgates rules through such processes is illegitimately exercising its power.

But, while it is easy to say that an agency that does not follow right process is not engaged in a legitimate exercise of power, it is difficult to operationalize this as a limit. The rest of this Part explores the Court's efforts to understand the limits on agency's choice of procedure.

#### B. CHENERY II AND AGENCY CHOICE OF PROCEDURE

All that follows is built on *Chenery II*, the 1947 case in which Supreme Court held that administrative agencies have broad discretion to choose whether to develop legal norms through either *ex ante* formal rulemaking or *ex post* informal case-by-case adjudication.<sup>178</sup> In this case, one of the cornerstones of American administrative law, the SEC had adopted a new interpretation of its statute in the course of an adjudication.<sup>179</sup> The Commission's decision was challenged on the grounds that new rules could only be promulgated through a rulemaking procedure.<sup>180</sup> The Court rejected this position in a passage that warrants quotation at length:

Since the Commission, unlike a court, does have the ability to make new law prospectively through the exercise of its rule-making

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176. See *Bi-Metallic Inv. Co. v. State Bd. of Equalization*, 239 U.S. 441, 445–46 (1915) (approving state quasi-legislative action); *Londoner v. Denver*, 210 U.S. 373, 384–85 (1908) (approving state quasi-judicial action). See generally 5 U.S.C. § 551 (2012 & Supp. II 2014).

177. Thomas M. Franck, *Legitimacy in the International System*, 82 AM. J. INT'L L. 705, 706 (1988) (emphasis omitted).

178. *Sec. & Exch. Comm'n v. Chenery Corp. (Chenery II)*, 332 U.S. 194, 209 (1947).

179. *Id.* at 197–99.

180. *Id.* at 199.

powers, it has less reason to rely upon *ad hoc* adjudication to formulate new standards of conduct within the framework of the Holding Company Act. The function of filling in the interstices of the Act should be performed, as much as possible, through this quasi-legislative promulgation of rules to be applied in the future. *But any rigid requirement to that effect would make the administrative process inflexible and incapable of dealing with many of the specialized problems which arise.* Not every principle essential to the effective administration of a statute can or should be cast immediately into the mold of a general rule. Some principles must await their own development, while others must be adjusted to meet particular, unforeseeable situations. *In performing its important functions in these respects, therefore, an administrative agency must be equipped to act either by general rule or by individual order. To insist upon one form of action to the exclusion of the other is to exalt form over necessity.*

In other words, problems may arise in a case which the administrative agency could not reasonably foresee, problems which must be solved despite the absence of a relevant general rule. Or the agency may not have had sufficient experience with a particular problem to warrant rigidifying its tentative judgment into a hard and fast rule. Or the problem may be so specialized and varying in nature as to be impossible of capture within the boundaries of a general rule. In those situations, the agency must retain power to deal with the problems on a case-to-case basis if the administrative process is to be effective. There is thus a very definite place for the case-by-case evolution of statutory standards. *And the choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency.*<sup>181</sup>

The italicized portions are the genesis of the modern rule that agencies have broad discretion in their choice of procedure, generally limited only by an abuse of discretion standard.<sup>182</sup> This full passage is the operative language continually used in the debate over agency choice of procedure; it is the basic rationale for adjudication that is routinely cited today, likely because it is appealing to those who favor the FTC's "common law" approach. We will return to this language in due course.

This standard is, on the Court's own terms, a bit puzzling: The Court says outright that *ex ante* rulemaking should be used "as much as possible."<sup>183</sup> This

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181. *Id.* at 202–03 (emphasis added) (citations omitted).

182. *See* Nat'l Labor Relations Bd. v. Bell Aerospace Co., Div. of Textron, Inc., 416 U.S. 267, 295 (1974).

183. *Chenery II*, 332 U.S. at 202.

view was commonly held at the time, and has been prominent since.<sup>184</sup> As captured by Justice Jackson's dissent:

The truth is that in this decision the Court approves the Commission's assertion of power to govern the matter *without* law. . . . The reasons which will lead it to take one course as against the other remain locked in its own breast, and it has not and apparently does not intend to commit them to any rule or regulation. This administrative authoritarianism, this power to decide without law, is what the Court seems to approve in so many words: "The absence of a general rule or regulation governing management trading during reorganization did not affect the Commission's duties. . . ." This seems to me to undervalue and to belittle the place of law, even in the system of administrative justice. It calls to mind Mr. Justice Cardozo's statement that "Law as a guide to conduct is reduced to the level of mere futility if it is unknown and unknowable."<sup>185</sup>

We will turn momentarily to consider these and other concerns about the Court's decision—and its subsequent history. But first, why did the Court adopt the approach that it did? In particular, why did it commit the decision of which procedure to use so fully to the agency's sole discretion? The answer, as unsatisfying as it has been persistent, is judicial administrability: Determining whether or when it is appropriate for an agency to use one procedure over another requires a court to assess factual gradations to a degree beyond the meaningful resolution of judicial process.<sup>186</sup>

184. Bressman summarizes many of the concerns with adjudication nicely:

Yet, adjudication, as a general matter, has serious shortcomings for formulating policy. It applies new rules retroactively to the parties in the case. It also excludes other affected parties in the development of policy applicable to them, unless included through the venues of intervention or amicus curiae filings. To the extent it excludes such parties, it also excludes the information and arguments necessary to define the stakes and educate the agency. It tends to approach broad policy questions from a narrow perspective—only as necessary to decide a case—which decreases the comprehensiveness of the resulting rule and increases the risk that bad facts will make bad law. Similarly, it elaborates policy in a narrow manner—on a case-by-case basis—which decreases predictability and opportunities for planning. It also announces policy in the form of an order rather than codifying it in the Federal Register, thus decreasing accessibility. And, it depends for all of this on the existence of circumstances that lead to the initiation of a proceeding or succession of proceedings.

Other methods for formulating general policy . . . fare even worse.

Bressman, *supra* note 167, at 542–43 (footnotes omitted).

185. *Chenery II*, 332 U.S. at 216–17 (Jackson, J., dissenting) (citations omitted).

186. See Manning, *supra* note 169, 909–14. This is unsatisfying to many because courts often are required to make such assessments. See, e.g., Bressman, *supra* note 167 (arguing for the development of such standards to determine choice of procedure questions).

C. WYMAN-GORDON, BELL-AEROSPACE, AND THE FAILED CHALLENGE TO  
DISCRETION

*Chenery II* prompted the development of a substantial and generally critical academic literature.<sup>187</sup> This literature found some allies on the Supreme and Circuit Courts in a short-lived revolt against *Chenery II*. In *Wyman-Gordon*, Justices Harlan and Douglas dissented from a plurality opinion concerning the NLRB's use of adjudication to issue a new rule.<sup>188</sup> In their dissents, both Justices argued that the NLRB should have been required to issue the new rule through a notice-and-comment process.<sup>189</sup> These dissents suggested that the Court might have had the appetite to revisit the strong holding in *Chenery II*. A few years later, the Second Circuit decided *Bell Aerospace*.<sup>190</sup> In his opinion, Judge Friendly, himself friendly to the argument that agencies should face a judicially enforced preference for rulemaking procedures, distilled from the plurality and dissents in *Wyman-Gordon* a test that would require new rules of general applicability to be announced through rulemaking procedures.<sup>191</sup> This approach was influenced by Professor Kenneth Culp Davis's—a strong critic of discretionary agency choice of procedure—work in the field.

Shortly thereafter, the D.C. Circuit decided another seminal case in modern administrative law: *National Petroleum Refiners Ass'n*.<sup>192</sup> In this case, the D.C. Circuit went to extraordinary lengths to find that the FTC Act gives the FTC substantive rulemaking authority,<sup>193</sup> explaining that:

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187. Magill, *supra* note 164, at 1403–04 n.69 (“There is an important, if now dated, literature focusing on agency choices between adjudication and rulemaking that develops a normative take on the choice between those two policymaking tools. Authors debated the relative merits of rulemaking and adjudication as policymaking tools and attempted to identify when an agency should pursue its goals through one or the other. . . . To say that there was a debate, however, implies more diversity of opinion than can be found in that literature. . . . [T]he drift of these articles was fairly uniform: agencies should use rulemaking more often than they did.” (citations omitted)). See generally KENNETH CULP DAVIS, ADMINISTRATIVE LAW TREATISE (2d ed. 1979); KENNETH CULP DAVIS, DISCRETIONARY JUSTICE: A PRELIMINARY INQUIRY (1969) [hereinafter DAVIS, DISCRETIONARY JUSTICE]; Daniel J. Gifford, *Discretionary Decisionmaking in the Regulatory Agencies: A Conceptual Framework*, 57 S. CAL. L. REV. 101 (1983).

188. See *Nat'l Labor Relations Bd. v. Wyman-Gordon Co.*, 394 U.S. 759, 775–83 (1969); Manning, *supra* note 169, at 906–07.

189. *Wyman-Gordon Co.*, 394 U.S. at 775 (Douglas, J., dissenting); *id.* at 780–81 (Harlan, J., dissenting); Manning, *supra* note 169, at 907.

190. *Bell Aerospace Co. Div. of Textron Inc. v. Nat'l Labor Relations Bd.*, 475 F.2d 485 (2d Cir. 1973), *aff'd in part, rev'd in part*, 416 U.S. 267 (1974).

191. See Manning, *supra* note 169, at 908.

192. *Nat'l Petroleum Refiners Ass'n v. Fed. Trade Comm'n*, 482 F.2d 672 (D.C. Cir. 1973), *cert. denied*, 415 U.S. 951 (1974).

193. For a discussion of the contortions of the *National Petroleum Refiners Ass'n* decision, see Thomas W. Merrill & Kathryn Tongue Watts, *Agency Rules with the Force of Law: The Original Convention*, 116 HARV. L. REV. 467, 554–57 (2002).

More than merely expediting the agency's job, use of substantive rule-making is increasingly felt to yield significant benefits to those the agency regulates. Increasingly, courts are recognizing that use of rule-making to make innovations in agency policy may actually be fairer to regulated parties than total reliance on case-by-case adjudication.<sup>194</sup>

The D.C. Circuit goes on to discuss *Chenery II*, and explains *Wyman-Gordon* as “a majority of the Supreme Court hint[ing] that there may be circumstances where agency policy innovations should be made *only* in rule-making proceedings.”<sup>195</sup> *Wyman-Gordon* and the Second Circuit's *Bell Aerospace* decision are characterized as a “judicial trend favoring rule-making over adjudication for development of new agency policy.”<sup>196</sup>

However, shortly after the D.C. Circuit decided *National Petroleum Refiners Ass'n*, the Supreme Court granted cert in Judge Friendly's test case, *Bell Aerospace*. In its opinion, the Court emphatically endorsed its own prior holding in *Chenery II*.<sup>197</sup> As explained by Manning, “*Bell Aerospace* thus decisively rebuffed the efforts of Justices Douglas and Harlan and Judge Friendly to devise a generally enforceable line between proper rules and improper adjudications.”<sup>198</sup> But while *Bell Aerospace* definitively settled the legal rule, the underlying concerns still remained, and have worked their way into administrative jurisprudence in various ways over the past 30 years—including, as we shall see below, as a factor in considering the deference an agency may receive from a reviewing court and as a matter of constitutional due process.

#### D. FROM CHEVRON TO MEAD

Following *Bell Aerospace*'s re-affirmation of *Chenery II* in 1974, concern over agency choice of procedure cooled and the focus of administrative law jurisprudence shifted from procedural to substantive discretion. This era began the explosive growth of the administrative state into its current form. This growth was driven in part by general regulatory attitudes—the growth, and concern over the growth, of the regulatory state in the 1970s;<sup>199</sup> it was

194. *Nat'l Petroleum Refiners Ass'n*, 482 F.2d at 681.

195. *Id.* at 682.

196. *Id.* at 683.

197. *Nat'l Labor Relations Bd. v. Bell Aerospace Co., Div. of Textron, Inc.*, 416 U.S. 267, 289–95 (1974); Manning, *supra* note 169, at 908.

198. Manning, *supra* note 169, at 908–09.

199. See, e.g., Thomas B. Leary, *A Suggestion for the Revival of Section 5*, ANTITRUST SOURCE, Feb. 2009, at 1, 6, [http://www.americanbar.org/content/dam/aba/publishing/antitrust\\_source/Febo9\\_Leary2\\_26f.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/publishing/antitrust_source/Febo9_Leary2_26f.authcheckdam.pdf) (“The 1970s were characterized not only by civil unrest over an unpopular war but also by the (hopefully) high-water mark of an intellectual movement that was profoundly skeptical about a market system driven by consumer sovereignty. This essentially paternalistic view, prominently associated with celebrities like John Galbraith and



also driven in part by the Court's administrative law jurisprudence, as exemplified by *Chenery II*.

In the earlier era, the courts had struggled with the basic questions of how agencies operate and the relationship between agencies and the courts.<sup>200</sup> Those questions largely settled, the courts now found themselves facing a new set of questions regarding the relationship between the agencies and the courts themselves.

These questions came along several dimensions. The best known, and most relevant for this Article, was addressed in *Chevron v. National Resources Defense Council*.<sup>201</sup> This case gave us the well-known *Chevron* doctrine, which requires courts to defer to reasonable agency constructions of ambiguous statutes.<sup>202</sup> One of the many questions that *Chevron* has raised over its 30 years is: What constitutes an agency construction of a statute? That is, is any agency statement interpreting an ambiguous statute entitled to *Chevron* deference, or is deference only afforded to constructions arrived at through more formal processes? And is this a binary question, such that an agency construction of a statute either is or is not entitled to deference; or is there a sliding scale, such that a construction of a statute arrived at through rulemaking is entitled to more deference than constructions arrived at through less formal processes such as adjudication?

These questions were addressed by the Court in *United States v. Mead*, a 2001 case considering whether “ruling letters” used by the Customs Service to set tariff classifications merit *Chevron* deference.<sup>203</sup> The Court held that they did not—that constructions of an ambiguous statute only receive *Chevron* deference if arrived at through procedures by which the agency is authorized to issue rules that have the force of law.<sup>204</sup> The Court found that the “ruling letters” at issue in *Mead* were not adopted through such procedures, and therefore were not entitled to *Chevron* deference.<sup>205</sup> But the impact of *Mead* was to expand the scope of agency action entitled to *Chevron* deference.

*Mead* ties the level of deference that an agency receives to the level of procedural formality used in interpreting statutes. This raises the obvious and, for the FTC, important question: Are agency determinations arrived at

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Ralph Nader, obviously had a strong influence on the leadership of the Federal Trade Commission at the time. . . . There was a perception that the Commission had been co-opted by the counter-culture, was out of control, and was suspicious of the private sector. Members of Congress were made aware of these concerns.”).

200. See, for example, *Motor Vehicle Manufacturers Ass'n of the U.S., Inc. v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983), and *Vermont Yankee Nuclear Power Corp. v. Natural Resources Defense Council, Inc.*, 435 U.S. 519 (1978), which consider the substantive and procedural requirements that courts can place on how agencies carry out their statutorily-mandated mission.

201. *Chevron U.S.A. Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

202. *Id.* at 866.

203. *United States v. Mead Corp.*, 533 U.S. 218, 222 (2001).

204. *Id.* at 231–32.

205. *Id.* at 234.

through adjudication entitled to the same level of deference as those arrived at through rulemaking?<sup>206</sup> *Mead* raises questions beyond this, but in the context of the relative merits of rulemaking and adjudication, *Mead* brings us full circle.

Bressman, arguing for greater accountability in agency choices of procedure, explains the significance of the decision: “*Mead* moves in the right direction. The case begins a partial weaning from *Chenery II* and unlimited choice of procedures.”<sup>206</sup>

Bressman’s views of agency choice of procedure—which largely echo the concerns of the pre-*Wyman-Gordon* era—are representative of current concerns about the FTC:

The place to start is with the advantages of notice-and-comment rulemaking for making general policy. . . .

Notice-and-comment rulemaking, by its nature, facilitates the participation of affected parties, the submission of relevant information, and the prospective application of resulting policy. As a result of the reasoned-decisionmaking requirement that accompanies it, notice-and-comment rulemaking fosters logical and thorough consideration of policy. To the extent notice-and-comment rulemaking issues general rules that rely for their enforcement on further proceedings, it also promotes predictability. At a minimum, it allows affected parties, who participate in the formulation of the rule, to anticipate the rule and plan accordingly.

Now compare formal adjudication. Agencies, like the NLRB, have shown that adjudication may serve as a policymaking tool. . . . Yet, adjudication, as a general matter, has serious shortcomings for formulating policy. . . .

Other methods for formulating general policy, whatever those might look like after *Mead*, fare even worse.<sup>207</sup>

For commentators like Bressman, *Mead* offers an appealing opportunity: to peg an agency’s substantive discretion inversely to its procedural discretion. The more stringent a process it uses to arrive at a given outcome, the more weight courts will give to that outcome. This comports with the view that “agencies must assume responsibility for those choices [of basic regulatory policy]. Otherwise, there is no assurance that they will exercise their authority in a manner that reflects reasonableness rather than arbitrariness. . . . Thus, agencies must supply the standards that discipline their discretion under delegating statutes . . . .”<sup>208</sup>

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206. Bressman, *supra* note 167, at 537.

207. *Id.* at 541–43 (footnotes omitted).

208. *Id.* at 533.

Writing in the period after *Mead*, others were not as optimistic that *Mead* marked an era of increased scrutiny over agency choice of procedure.<sup>209</sup> While the Court has not embraced Bressman's direct proposal, subsequent Supreme Court cases do suggest that the Justices are responsive to these concerns. Addressing a change in FCC policy relating to the broadcast of indecent material, the Court rejected claims brought by the FCC against Fox and other broadcasters. In *Fox I*, the Court noted that firms might have a viable challenge to new rules "when [the] prior policy has engendered serious reliance interests that must be taken into account."<sup>210</sup> In *Fox II* (decided on a second cert. after *Fox I* was remanded), the Court held that the FCC's changed policy could not be applied to conduct that occurred prior to that change on notice grounds: "A fundamental principle in our legal system is that laws which regulate persons or entities must give fair notice of conduct that is forbidden or required."<sup>211</sup>

Courts and scholars have long considered arguments such as these, as possible avenues to challenge an agency's inappropriate use of adjudication over rulemaking.<sup>212</sup> With these cases—especially *Fox II*—the court appears to have embraced this approach.

#### V. THE COMMISSION'S ADMINISTRATIVE JURISPRUDENCE

Under current administrative law, the FTC has broad discretion to proceed in an adjudicatory, common-law-like manner rather than using its rulemaking authority to issue formal *ex ante* rules under section 5. Moreover, it must be emphasized that the FTC has clear rulemaking authority for both UDAP and UMC.<sup>213</sup> Regardless, the FTC consistently relies on adjudication over rulemaking. It does so against the tide of the Court's recent jurisprudence, and therefore at its own risk. No matter the current state of

209. See, e.g., Manning, *supra* note 169, at 937–44.

210. Fed. Commc'ns Comm'n v. Fox Television Stations, Inc. (*Fox I*), 556 U.S. 502, 515 (2009).

211. Fed. Commc'ns Comm'n v. Fox Television Stations, Inc. (*Fox II*), 132 S. Ct. 2307, 2317 (2012).

212. See *supra* Part IV.C. For an *à propos* example demonstrating how longstanding these debates have been, see, e.g., Part 408—Unfair or Deceptive Advertising and Labeling of Cigarettes in Relation to the Health Hazards of Smoking: Statement of Basis and Purpose of Trade Regulation Rule, 29 Fed. Reg. 8324, 8365–69 (1964) ("We have indicated ten reasons why a formal rule-making proceeding may be preferable to an adjudicative proceeding, or series of adjudicative proceedings, from the standpoint both of government and the affected private parties, where the problem is one of fashioning a substantive standard to guide future conduct; and there are others. *It is not surprising that the Supreme Court, and critics of the administrative process, have urged the agencies to give greater emphasis to rule-making proceedings.*" (emphasis added)).

213. See generally Hurwitz, *Chevron and the Limits*, *supra* note 22 (discussing the FTC's rulemaking authority under section 5). Contrary to widespread view, the FTC has broad rulemaking authority under both its UMC and UDAP authorities. The Commission's authority to make UDAP rules faces heightened procedural requirements under Magnuson–Moss. See *id.* It is unclear how these requirements affect the jurisprudential value of decisions reached through adjudication.

precedent, the practical fact is that if the Commission acts too aggressively, it risks the ire of the courts or Congress.<sup>214</sup>

Adjudication is in many ways common law-like—and, as seen in *Chenery II*, the flexibility it offers is jurisprudentially valuable in circumstances where it is difficult to formulate specific rules *ex ante*. There are strong arguments for adjudication in fast-moving areas, such as privacy and data security. But there are also strong arguments for relying instead on, or in conjunction with, rulemaking. And, importantly, even where the FTC does take an adjudicatory approach, *how* it does so may matter as much as, or more than, the choice between adjudication and formal rulemaking: At one end of the spectrum, the FTC retains broad discretion to direct the development of the law with minimal concern about judicial oversight; at the other end, as in antitrust, the law evolves through an ongoing dialectic between the FTC and courts, forcing careful analysis of both law and the trade-offs, economic and otherwise, inherent in the FTC's statutory standards.

It is possible that describing the FTC's approach as common law-like is mere rhetorical flourish—that the FTC is just engaging in ordinary administrative adjudication and using the “common law” analogy as shorthand for those unfamiliar with administrative jurisprudence. As discussed above, this shorthand is inaccurate and amounts to free riding on the jurisprudential legitimacy of the common law instead of examining the jurisprudential merits of the FTC's adjudicatory approach. The discussion that follows applies the previous discussion of agency choice of procedure to the FTC's adjudicatory approach to developing its data security jurisprudence.

#### A. THE RULEMAKING VS. ADJUDICATORY MINDSETS

Rhetoric matters. The Commissioners' choice of rhetoric is a reflection of their regulatory mindset. The Commission has long viewed itself primarily as a law enforcement agency.<sup>215</sup> In such a role it is responsible for enforcing

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<sup>214</sup>. It is worth remembering—though it often seems that, as an institution, the Commission has largely forgotten—that its overreach brought Congress to shutter the agency in 1980, seriously damaged the agency's funding and reputation, and resulted in the Commission's statutory authority not being reauthorized for 14 years. See Beales, *supra* note 28 (“The breadth, overreaching, and lack of focus in the FTC's ambitious rulemaking agenda outraged many in business, Congress, and the media. Even the Washington Post editorialized that the FTC had become the ‘National Nanny.’ Most significantly, these concerns reverberated in Congress. At one point, Congress refused to provide the necessary funding, and simply shut down the FTC for several days.” (footnote omitted)).

<sup>215</sup>. This view was recently captured by Ohm: “Many employees of the FTC see the agency first and foremost as a civil law enforcement agency. Of course the agency also promulgates regulations and guidance and engages in research and consumer education, but these roles are second in priority for many at the FTC.” Ohm, House E&C Testimony, *supra* note 25, at 2; see also Brian Mahoney, *FTC Head Wants More Power to Penalize for Data Breaches*, LAW360 (Dec. 12, 2013, 6:33 PM), <http://www.law360.com/articles/495364/ftc-head-wants-more-power-to-penalize-for-data-breaches> (“FTC Chairwoman Edith Ramirez said at a privacy forum in Washington that she

legal norms, not setting them. The mindset of rule-maker is fundamentally different from that of rule-enforcer—the former focuses on means, the latter on ends. This is precisely why, in the common law system, the role of the two is separated, entrusting the role of rulemaking to a party whose interests are independent from the outcome of the case.

If the FTC is to have legitimacy as a rule-maker, it must view itself as a rule-maker—the development of legal norms cannot be secondary to its enforcement priorities.<sup>216</sup> This view must be held throughout the Commission, from the attorneys selecting and investigating cases to the Commissioners and Administrative Law Judges hearing them. Those involved with the Commission's rulemaking and enforcement functions should be separated—both institutionally and structurally—from those guiding its rulemaking processes.<sup>217</sup>

This holds truer for the FTC than for other agencies due to the sheer breadth of the Commission's statutory authority. No other agency has general authority to regulate commercial practices economy wide—no other agency has been described as the “second most powerful legislative body in the country.”<sup>218</sup> The breadth of the FTC's statutory authority makes both the potential for abuse and the potential consequences of such abuse particularly great. We should insist upon those wielding such power to have and to exercise the highest levels of discretion and sophistication.

But the concerns for the Commission's preference for adjudication over rulemaking (or rulemaking through adjudication) are more general than this. There are longstanding debates in administrative law over the propriety of agencies adjudicating matters when they have the power to develop and to issue rules instead. It is arguably incorrect to characterize this as a debate, so strong is the consensus that agencies should prefer rulemaking processes over adjudication wherever possible.<sup>219</sup>

To understand this, let's take a more general look at the jurisprudence of administrative adjudication.

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wants the commission to be seen as an ‘enforcer’ against companies that inadequately protect consumer data.”).

216. Ohm, House E&C Testimony, *supra* note 25, at 2 (describing rulemaking as “second in priority”).

217. See *supra* note 133 and accompanying text (discussing the role of the independent adjudicator in the common law process, and relating this to the separation of power).

218. See S. REP. NO. 96-500, at 59 (1979) (“In fact, the Federal Trade Commission may be the second most powerful legislature in the country.”); see also Timothy J. Muris, Former FTC Chairman, *Robert Pitofsky: Public Servant and Scholar*, FED. TRADE COMMISSION (June 12, 2001), <http://www.ftc.gov/public-statements/2001/06/robert-pitofsky-public-servant-and-scholar> (critiquing “rulemaking designed to maket [sic] the FTC our nation's second most powerful legislature”).

219. See *supra* Parts IV.C–D.

*B. THE FTC'S RULEMAKING DOMAIN*

Perhaps most fundamentally, whereas the common law operates in a domain of policy convergence, administrative law operates in a domain of policy modality.<sup>220</sup> Congress statutorily defines the policy-space in which an agency can operate, and the agency is empowered—indeed, expected—to say “what the law is” within this space.<sup>221</sup> As discussed above, there is no expectation of consistency over time—agencies are not bound by *stare decisis*.<sup>222</sup> Rather, courts recognize that the policy outcome is a political question—not a legal one—that is to be answered by political processes.<sup>223</sup>

This recalls one of the key aspects of the common law discussed above: Courts decide cases because they must.<sup>224</sup> A key reason administrative law allows agencies substantial discretion is because doing so provides an opportunity for courts to avoid deciding cases better decided through the political process. Where Congress has acted—either directly by passing a law or indirectly by empowering an agency to set legal norms—courts will not interpose the common law approach.

This suggests that Solove and Hartzog’s analogy is inapt where they say that “[t]he FTC has not been engaging in rulemaking in disguise any more than a court when interpreting a statute over time is engaging in judicial legislation.”<sup>225</sup> As discussed previously, given the availability of rulemaking, common law courts emphatically avoid engaging in common law.<sup>226</sup> So strong is this preference that courts will even decline to engage in common law adjudication where some regulatory agency has authority to issue rules but has not exercised that authority.<sup>227</sup>

An important, and reasonable, response to this is that Congress gave the FTC broad authority because Congress lacked the expertise and dedicated resources needed to regulate dynamic and fast-moving areas of the economy. Unlike most other agencies, Congress has defined the FTC’s policy space very broadly so that it will have the flexibility to develop legal norms that Congress is ill equipped to develop on its own. And an important reason for this delegation is that such legal norms are difficult to establish using *ex ante*, legislative-style, rulemaking processes—rather, any rules need to be developed with the flexibility and responsiveness afforded by case-by-case adjudication. To the extent that this is true—and it is to some extent true—it

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220. See *supra* Part III.A; see also *supra* Part III.B.

221. See *supra* Part III.B.

222. See *supra* Part III.B.

223. See *supra* Part III.B.

224. See *supra* Part III.A.

225. Hartzog & Solove, *supra* note 17.

226. See *supra* notes 126–32 and accompanying text.

227. See *Am. Elec. Power Co., Inc. v. Connecticut*, 131 S. Ct. 2527, 2537 (2011) (setting forth a broad standard of regulatory displacement of federal common law).

is responsive to the critique that agencies generally should prefer rulemaking to adjudication. The FTC, under this explanation, was created precisely because rulemaking proved inapt to the areas that the Commission was entrusted to regulate.<sup>228</sup>

But this understanding proves too much. If anything, the same concerns that drove Congress to create the FTC should give the FTC pause to be haphazard in its development of legal norms. While case-by-case adjudication may in some cases be necessary, and can serve as an input into more structured and deliberative rulemaking processes, the Commission should rely primarily on notice-and-comment rulemaking to develop legal norms.

The agency's history offers support for this view. Indeed, as initially envisioned, the FTC was to serve primarily an informational function: In its first instantiation, its primary power was to conduct investigations and prepare reports for (and at the behest of) Congress, the Department of Justice, and the President.<sup>229</sup> Its role was to provide information needed in order to develop legal norms to those expected to develop those norms. While the Commission was granted more power to bring civil actions and seek injunctions on its own over time, these were generally viewed as enforcement functions.<sup>230</sup> For most of its early history, the Commission was not thought of as having the power to develop legal norms, by itself or by others.<sup>231</sup>

In the 1960s and 70s, the Commission did undertake a substantial rulemaking role—and it was thoroughly rebuked for having done so. As a result, Congress enacted the Magnuson–Moss Act in 1975.<sup>232</sup> Among other things, this Act imposed cumbersome new procedural requirements on many of the Commission's rulemaking powers.<sup>233</sup> It requires, for instance, that rules developed under the Commission's unfairness and deceptive acts authorities be published in the Federal Register before they can go into effect.<sup>234</sup>

From an administrative law perspective, the Magnuson–Moss Act should have been damning to the Commission's efforts to develop legal norms relating to unfair or deceptive acts or practices through adjudication. Congress expressly imposed heightened procedural burdens on the FTC's rulemaking power. The Commission should not be able to avoid those burdens simply by turning to adjudication instead. Doing so avoids and negates congressional intent.

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228. See Averitt, *supra* note 30, at 231–32; Hurwitz, *Chevron and the Limits*, *supra* note 22, at 227.

229. Hurwitz, *Chevron and the Limits*, *supra* note 22, at 227.

230. *Id.* at 227–28.

231. *Id.* at 228.

232. *Id.* at 233–34.

233. See *supra* note 148.

234. See generally 15 U.S.C. § 57a (2012 & Supp. 2014).

C. OTHER CONCERNS: FAIR NOTICE & JURISDICTION

There are other, more general, reasons to be concerned about the Commission's choice of adjudication over rulemaking.

The best known of these concerns emanate from constitutional requirements that parties have fair notice of the laws that will apply to them.<sup>235</sup> Fair notice concerns over agency use of adjudication are not new, as courts and litigants have made use of them—with varying degrees of success—for decades.<sup>236</sup> In the aftermath of the short-lived *Wyman–Gordon* revolt against *Chenery II*, fair notice was raised as the remaining protection against agency abuse of discretion in preferring adjudication over rulemaking.<sup>237</sup>

Fair notice presents a facial challenge to a legal rule that imposes penalties upon regulated parties but that “fails to provide a person of ordinary intelligence fair notice of what is prohibited, or is so standardless that it authorizes or encourages seriously discriminatory enforcement.”<sup>238</sup> It is meant to protect against at least two types of harm: Failure to provide regulated parties notice of the rules to which they are subject, and ensuring that those making the rules “do not act in an arbitrary or discriminatory way.”<sup>239</sup> Critically, the standard is facial and objective: whether the entity establishing legal norms is doing so in a manner that provides sufficient notice to regulated parties, not whether a regulated party had actual knowledge of the regulation.<sup>240</sup> Fair notice is concerned with whether the regulator was conducting itself in a manner sufficient to meet basic constitutional principles of due process.<sup>241</sup>

The basic principles of fair notice have been long- and well-established.<sup>242</sup> How they apply in the administrative context, however, is an area still under development by the Court<sup>243</sup> and that raises a number of unanswered

235. As explained in *Fox II*, fair notice is related to constitutional due process requirements. *Fed. Comm'n's Comm'n v. Fox Television Stations (Fox II)*, 132 S. Ct. 2307, 2317 (2012). Fair notice concerns are raised where a regulation “fails to provide a person of ordinary intelligence fair notice of what is prohibited, or is so standardless that it authorizes or encourages seriously discriminatory enforcement.” *Id.* (citation omitted). It is meant to protect against at least two types of harm: providing regulated parties notice of the rules to which they are subject and ensuring that those making the rules “do not act in an arbitrary or discriminatory way.” *Id.*

236. See generally Manning, *supra* note 169.

237. *Id.* at 908.

238. *Fox II*, 132 S. Ct. at 2317 (quoting *United States v. Williams*, 553 U.S. 285, 304 (2008)).

239. *Id.*

240. See *Grayned v. City of Rockford*, 408 U.S. 104, 108–09 (1972); *Connally v. Gen. Constr. Co.*, 269 U.S. 385, 391 (1926).

241. Cf. *infra* notes 248–54; *supra* Part II.D; *infra* Afterword (discussing the *Wyndham* litigation, in which the FTC has argued that fair notice is a subjective standard, requires discovery as to a defendant's knowledge of legal requirements, and thus cannot be resolved at the motion to dismiss stage of litigation).

242. See *Fox II*, 132 S. Ct. at 2317 (“A fundamental principle in our legal system is that laws which regulate persons or entities must give fair notice of conduct that is forbidden or required.”).

243. See generally *supra* Part IV.



questions. For instance, fair notice only attaches where regulated parties face fines or other penalties for non-compliance. It is unclear how, or whether, courts will view reputational and regulatory compliance costs in the context of fair notice. This is particularly important in the context of the FTC, because the Commission has limited ability to assess fines for violation of its rules. Importantly, the FTC is actively seeking authority from Congress to assess civil fines in privacy and data security areas.<sup>244</sup>

Another open question, again of salience to the FTC's current efforts, is how compliance with industry norms affects the fair notice analysis.<sup>245</sup> Where a party is acting in accordance with industry customs or standards, courts are unlikely to find that a regulated party had fair notice of a regulation conflicting with those practices.<sup>246</sup> In the data security realm, the FTC is actively trying to develop new industry norms, shifting away from historically lax practices. While historic practices are certainly unsatisfactory, they are also widespread—the scale and scope of contemporary data security problems, including among extremely sophisticated and resource-rich parties—raises serious questions about the legitimacy of the Commission's efforts to shape industry norms through adjudication.

The response, such as that offered by Solove and Hartzog,<sup>247</sup> that privacy and data security practitioners are able to distill from the Commission's actions a coherent set of privacy and data security principles is unconvincing, especially in the data security realm. Almost every business in the U.S. maintains electronic records and is connected to the Internet—only a miniscule number of these businesses have the benefit of legal counsel, let alone of legal counsel with expertise in a subspecialty area of law. This is compounded by the existence of myriad federal and state privacy and data security laws. Where a business does have the sophistication necessary to seek out and comply with legal guidance for its electronic systems, it is more likely to turn to state law or industry specific regulators for guidance than to the FTC.

Recent judicial activity suggests weakness in Solove and Hartzog's argument. It is true that the FTC has prevailed in an extended series of judicial

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244. See, e.g., *Prepared Statement of the Federal Trade Commission on Data Breach on the Rise: Protecting Personal Information From Harm: Before the S. Comm. on Homeland Sec. & Governmental Affairs*, 113th Cong. 10 (2014) (statement of Edith Ramirez, Chairwoman, Federal Trade Commission), [http://www.ftc.gov/system/files/documents/public\\_statements/296011/140402datasecurity.pdf](http://www.ftc.gov/system/files/documents/public_statements/296011/140402datasecurity.pdf) ("Legislation in both areas—data security and breach notification—should give the FTC the ability to seek civil penalties . . ."); Mahoney, *supra* note 215 ("The head of the Federal Trade Commission on Thursday said she would continue to seek greater enforcement authority for the agency, including the power to impose civil penalties on companies arising from alleged data breach violations.").

245. Theodore J. Boutrous, Jr. & Blaine H. Evanson, Essay, *The Enduring and Universal Principle of "Fair Notice,"* 86 S. CAL. L. REV. 193, 199 (2013).

246. *Id.* at 199–200.

247. See generally Solove & Hartzog, *supra* note 16.

decisions—excepting the recent Initial Decision by the Administrative Law Judge in the *LabMD* case<sup>248</sup>—but these have all been decided on procedural grounds and in ways that have yet to touch on the FTC’s substantive decisions. The federal and administrative law judges reviewing these matters have consistently expressed concern about the FTC’s approach to developing data security norms—despite the procedural posture of the matters before them favoring the Commission’s position.<sup>249</sup> While Judge Salas in *Wyndham* initially rejected *Wyndham*’s facial fair notice challenge to the FTC’s data security jurisdiction—and despite the FTC’s subsequent representation of the opinion’s holding without qualification to the court in the *LabMD* hearing—she subsequently certified the question to the Third Circuit for interlocutory appeal; and the Third Circuit rejected the Commission’s preferred theory of the case—that it had developed a standalone common law of data security—in finding in favor of the Commission.<sup>250</sup> And, despite being required to assume all facts in favor of the Commission in its review of a motion to dismiss, the Third Circuit judges felt it appropriate to express substantial skepticism of the FTC’s “common law” approach in footnotes throughout the latter half of the opinion.<sup>251</sup> Similarly, despite consistently finding in favor of the Commission on procedural grounds in the *LabMD* case, judges have consistently expressed skepticism of the FTC’s substantive case against *LabMD*. District Court Judge Duffey reprimanded FTC counsel as “completely unreasonable,” and “unwilling to accept any responsibility,” telling counsel that the Commission “ought to give [regulated parties] some guidance as to what you do and do not expect, what is or is not required.”<sup>252</sup> And the FTC’s own Administrative Law Judge spent the entirety of the *LabMD* closing arguments with FTC counsel pushing counsel to explain “the fairness in a standard of what the law is being issued or published after the case is brought,” asking repeatedly and with increased frustration for FTC counsel to identify any judicial opinions to support its application of the Commission’s section 5 unfairness authority to data breaches.<sup>253</sup> As discussed in the Afterword to this Article, in his recent Initial Decision, the Administrative Law Judge found that the FTC’s theory in the *LabMD* case “would not provide the required constitutional notice of what is prohibited.”<sup>254</sup>

Also, in the meantime, the Supreme Court has provided important guidance relevant to the question of the FTC’s jurisdiction. In *Utility Air Regulatory Group v. Environmental Protection Agency*, the Court rejected an EPA effort to regulate greenhouse gasses, explaining that:

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248. See Afterword, *infra*.

249. See *supra* Part II.D.

250. See *supra* Part II.D.

251. See *supra* Part II.D.

252. See *supra* Part II.D.

253. See *supra* Part II.D.

254. Initial Decision, 2015 WL 7575033, at \*64 (F.T.C. Nov. 13, 2015); see also Afterword, *infra*.

When an agency claims to discover in a long-extant statute an unheralded power to regulate “a significant portion of the American economy,” we typically greet its announcement with a measure of skepticism. We expect Congress to speak clearly if it wishes to assign to an agency decisions of vast “economic and political significance.”<sup>255</sup>

This general theme—including the concern about agency action relating to “question[s] of deep ‘economic and political significance’”—was again repeated in *King v. Burwell*.<sup>256</sup> This speaks to the very concerns raised above, suggesting that the FTC’s efforts to establish broad data security norms should be met with skepticism. The FTC’s efforts would affect every business handling electronic consumer data in the country—effectively, that is, every business in the country. If ever there were a case for expecting Congress to speak clearly, this would be it.

It must be noted that there is an important difference between situations in which a business has a stated policy relating to privacy or data security and situations in which it does not. Where a stated policy is involved, the FTC can proceed under its deception authority instead of its unfairness authority.<sup>257</sup> In such cases, the Commission relies on its more clearly established body of deceptive acts precedent, and one that is more intuitively obvious to a person of ordinary intelligence. Fair notice issues are far more likely when the agency chooses, or needs, to act under its unfairness authority than under its deception authority.

There is one final aspect to be considered relating to the role of industry customs and standards in the FTC’s development of legal norms: While compliance with industry practices may buttress a fair notice claim against the Commission,<sup>258</sup> deviation from industry norms does not necessarily suffice to establish liability.

Consider *Pearson v. Shalala*, in which the D.C. Circuit rejected the FDA’s refusal to allow health claims for which there was not “significant scientific agreement.”<sup>259</sup> Although rejecting the challenger’s First Amendment arguments, the D.C. Circuit found that the FDA’s incorporation of a “significant scientific agreement” test to determine the permissibility of health

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255. *Util. Air Regulatory Grp. v. Envtl. Prot. Agency*, 134 S. Ct. 2427, 2444 (2014) (quoting *Food & Drug Admin. v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 159–60 (2000)).

256. *King v. Burwell*, 135 S. Ct. 2480, 2489 (2015) (quoting *Util. Air Regulatory Grp.*, 134 S. Ct. at 2444).

257. See, e.g., Brill, *supra* note 44, at 3–4; Scott, *supra* note 64, at 158–59 (quoting and discussing Commissioners Swindle and Leary’s dissents from the use of unfairness, but not deception, claims in the data security context, explaining that “injury in this case was caused by deception”).

258. But see *infra* notes 280–85 and accompanying text (discussing the *TJ Hooper*, 60 F.2d 737 (2d Cir. 1932)).

259. *Pearson v. Shalala*, 164 F.3d 650, 651 (D.C. Cir. 1999).

claims was insufficient to meet constitutional due process requirements. The court explains that that “proposition is squarely rooted in the prohibition under the APA that an agency not engage in arbitrary and capricious action”<sup>260</sup> and continues:

To be sure, Justice Stewart once said, in declining to define obscenity, “I know it when I see it,” which is basically the approach the FDA takes to the term “significant scientific agreement.” But the Supreme Court is not subject to the Administrative Procedure Act. Nor for that matter is the Congress. That is why we are quite unimpressed with the government’s argument that the agency is justified in employing this standard without definition . . . .<sup>261</sup>

Importantly, this case arose in the context of rulemaking, not adjudication. As the court noted:

That is not to say that the agency was necessarily required to define the term in its initial general regulation—or indeed that it is obliged to issue a comprehensive definition all at once. The agency is entitled to proceed case by case or, more accurately, sub-regulation by subregulation, but it must be possible for the regulated class to perceive the principles which are guiding agency action. Accordingly, on remand, the FDA must explain what it means by significant scientific agreement or, at minimum, what it does not mean.<sup>262</sup>

Thus we see that in the context of fair notice, use of an industry’s customs and standards is asymmetric. A party can use the fact of its compliance with such practices to argue that a regulator did not meet the constitutional requirements of fair notice—even if the party had actual notice of the regulations. But the regulator may not be able to use the fact of a party’s non-compliance with industry customs and standards to demonstrate that its regulation provided sufficient notice that such non-compliance was actionable.

#### D. OTHER CONCERNS: CONFLICTING INCENTIVES

A final set of concerns relate to the incentives faced by an agency and the parties it regulates. While it is certainly desired that agencies will be the faithful servants of Congress and the President, it is well understood that agencies—and the individuals that make up agencies—face their own incentives.<sup>263</sup> These incentives often conflict with those of Congress and the

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260. *Id.* at 660 (citation omitted).

261. *Id.* (citation omitted).

262. *Id.* at 661 (citation omitted).

263. *See generally* JAMES Q. WILSON, BUREAUCRACY: WHAT GOVERNMENT AGENCIES DO AND WHY THEY DO IT (1989).

President. There is substantial literature examining agencies' three key incentives: to acquire power, independence, and resources.<sup>264</sup> At times these incentives may be aligned with faithful execution of the law; at other times they are not. Regardless, all three have been on display in the FTC's recent discussions of need for privacy and data security legislation: According to the Commission, Congress should give it clear power to more forcefully use its discretion to develop legal norms relating to privacy and data security.<sup>265</sup>

Compare these with the incentives faced by the parties that the FTC investigates—the high costs of challenging an FTC investigation in terms of time and money, along with potential reputational harms from not silently accepting a consent agreement, create very strong incentives for parties to settle with the FTC.<sup>266</sup> The Commission touts its settlements both as a source of the agency's "common law," and also as a demonstration of the soundness of its approach.<sup>267</sup> But the incentives faced by both the parties and the Commission suggests that the meaning of this high settlement rate is, at best, indeterminate.<sup>268</sup> Really, all that it tells us is that the costs of settling for the parties is less than the expected cost of litigation. This is one of the reasons that settlements are not viewed as contributing to the development of the common law.<sup>269</sup> On the other hand, there is reason to suggest that the parties' incentives undermine the value of settlements.<sup>270</sup>

A final consideration related to incentives is based in the FTC's structure as an independent agency. Paul Ohm, however, argues that "[p]olitical accountability exerts [a] structural check on the agency's enforcement decisions."<sup>271</sup> If only this were the case! It would respond to many of the concerns over the Commission's incentives. But independent agencies are structured as they are precisely, or in order, to insulate them from political

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264. See *id.* at 50–55.

265. See *id.* at 247–50; see also *Prepared Statement of the Federal Trade Commission on Protecting Personal Consumer Information from Cyber Attacks and Data Breaches: Before the S. Comm. on Commerce, Sci., & Transp.*, 113th Cong. 10 & n.34 (2014) (statement of Edith Ramirez, Chairwoman, Federal Trade Commission), [https://www.ftc.gov/system/files/documents/public\\_statements/293861/140326datasecurity.pdf](https://www.ftc.gov/system/files/documents/public_statements/293861/140326datasecurity.pdf) (calling for greater authority for FTC and collecting prior FTC calls for the same).

266. See *supra* notes 154–55 and accompanying text (discussing party incentives to settle).

267. See, e.g., Ohm, House E&C Testimony, *supra* note 25, at 3 (“Another measure of the strength of these cases is the rate at which they are settled. In the history of the FTC’s work on online privacy, the number of cases that have not led to swift settlement can be counted on one hand.”).

268. Compare this with Judge Rakoff’s statement that “the Court of Appeals invites the SEC to avoid even the extremely modest review it leaves to the district court by proceeding on a solely administrative basis. . . . One might wonder: from where does the constitutional warrant for such unchecked and unbalanced administrative power derive?” *Sec. & Exch. Comm’n v. Citigroup Glob. Mkts. Inc.*, 34 F. Supp. 3d 379, 380 n.8 (S.D.N.Y. 2014).

269. See *supra* Part III.A.

270. See Rossi, *supra* note 155, at 1016.

271. Ohm, House E&C Testimony, *supra* note 25, at 3.

oversight.<sup>272</sup> It is the case that the political process does provide some check on the agency—particularly through congressional oversight. But it is this lack of political accountability that prompted then-Professor Kagan to argue for greater presidential control over agency decisionmaking;<sup>273</sup> and it is what has prompted scholars like Bressman to argue against *Chenery II*'s permissive approach to agency choice of procedure.<sup>274</sup>

## VI. THE ROLE OF FTC ADJUDICATION IN LAW MAKING AND DATA SECURITY

The discussion in the previous two Parts of this Article suggests that the FTC's preference to use adjudication instead of rulemaking to develop its data security jurisprudence is problematic. It is, however, the case that current precedent continues to give the agency broad discretion to adopt such a path. And, even to the extent that this is problematic—or that the winds of precedent may be changing direction—there surely are some cases where adjudication is an appropriate approach for the Commission to take. The discussion turns now to consider the circumstances in which this path may be more appropriate and how the Commission should be encouraged to proceed when charting such a course.

### A. THE NEED FOR AND CHALLENGE OF ADJUDICATION

As explained in *Chenery II*, the basic rationale for allowing agencies to develop rules through adjudication is that, in some instances, it is difficult to craft *ex ante* rules.<sup>275</sup> This may be the case, as explained by the Court, where an issue arises that an agency could not have reasonably foreseen, the agency lacks sufficient experience with an issue, or the underlying issues are specialized or varying in nature.<sup>276</sup> These rationales appear to apply generally in areas defined by new or changing technologies. It is unsurprising, then, that these are the areas in which we see the FTC pushing aggressively to rely on adjudication and characterizing its efforts as akin to “common law.”<sup>277</sup>

New and changing technologies have always presented vexing issues for courts, legislatures, and regulators. A full study of the reasons for this is beyond the scope of this Article, but some discussion is nonetheless important insofar as it may provide insight into the FTC's preference for adjudication.

The basic issue in the FTC's data security cases is whether a firm has adopted data security practices sufficient to protect consumer data in the face of evolving technology and threat vectors. Two sets of historic cases are useful to consider by analogy: medical malpractice cases arising in the late 1800s

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272. Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2256 (2001).

273. *Id.* at 2377.

274. *See supra* Part IV.C–D.

275. *Sec. & Exch. Comm'n v. Chenery Corp. (Chenery II)*, 332 U.S. 194, 202 (1947).

276. *See supra* Part IV.B.

277. *See supra* Part II.C (discussing the FTC's efforts relating to data security, privacy, and high-tech industries generally and relying on both its UDAP and UMC authorities).

after the advent of diagnostic X-ray technology, and *The TJ Hooper*, which considers the adoption of radio technology by seafaring industry. In both areas, the courts—through their common law method—faulted industry participants for failing to keep pace of changing technologies. These cases present a useful contrast to the argument that the FTC ought not rely primarily on adjudicatory approaches to changing data security technologies.

The basic story of the diagnostic X-ray cases is straightforward.<sup>278</sup> Prior to the discovery of X-rays, and the development of technologies that could use X-rays to non-invasively peer inside the human body, doctors had no way to diagnose various internal injuries or ailments. It was rare, therefore, for a doctor to be held liable for an incorrect diagnosis if a proper diagnosis would have required such information. The diagnostic X-ray changed that. The X-ray made it relatively easy for doctors to obtain such information, and the courts were quick to incorporate this new technology into doctors' duty of care. Within a few short years of the advent of this technology, a doctor who failed to use X-rays in the diagnosis of a patient would likely face liability for any harm that befell that patient as a result.<sup>279</sup>

Similarly, in the classic case of *The TJ Hooper*, the owner of the eponymous tugboat was found liable for the loss of cargo at sea.<sup>280</sup> The court found that had the tug been equipped with commonly available radio technology, the cargo likely would not have been lost.<sup>281</sup> In its defense, the owner argued that there was no common practice in the industry of equipping boats with radios—the TJ Hooper, therefore was operated in accord with the industry-standard level of care and therefore was not operated negligently.<sup>282</sup>

The court rejected this argument, explaining:

There are, no doubt, cases where courts seem to make the general practice of the calling the standard of proper diligence . . . . Indeed

278. See generally KENNETH ALLEN DE VILLE, *MEDICAL MALPRACTICE IN NINETEENTH-CENTURY AMERICA: ORIGINS AND LEGACY* 221–23 (1990); Zorina Khan, *Innovations in Law and Technology 1790–1920*, in 2 *THE CAMBRIDGE HISTORY OF LAW IN AMERICA: THE LONG NINETEENTH CENTURY* 483, 517–18 (2008); Daniel S. Goldberg, *The Transformative Power of X-Rays in U.S. Scientific & Medical Litigation: Mechanical Objectivity in Smith v. Grant (1896)*, 21 *PERSP. ON SCI.* 23 (2013).

279. The classic citation is *Smith v. Grant* (1896), which arose mere months after the discovery of the X-ray. Goldberg, *supra* note 278, at 26. As discussed at length in Goldberg, this case, which alleged medical malpractice for failure to properly diagnose a broken bone, was filed in April, 1896, mere months after Wilhelm Roentgen's discovery of the X-ray in November, 1895. *Id.* As Goldberg notes, "concerns over . . . 'X-ray litigation' were a major topic in almost every American medical professional association meeting as early as 1897." *Id.*; see also DE VILLE, *supra*, note 278, at 222 (noting that use of X-rays was recommended in every orthopedic case as early as 1897, and that "less than a year after [its] discovery, patients were suing physicians for failing to take x-rays."); Khan, *supra* note 278, at 518 (noting that "[l]ess than two years after the invention [of the X-ray] was introduced, a Midwestern jury was instructed to draw conclusions from X-ray photographs . . .").

280. *The T. J. Hooper*, 60 F.2d 737, 740 (2d Cir. 1932).

281. See *id.* at 739.

282. See *id.* at 739–40.

in most cases reasonable prudence is in fact common prudence; but strictly it is never its measure; a whole calling may have unduly lagged in the adoption of new and available devices. . . . Courts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission.<sup>283</sup>

These cases demonstrate instances in which entire industries have been required to adopt new technologies through adjudicatory—not legislative—processes. They demonstrate that such change can be brought about through adjudication, and that in some circumstances courts view this as a legitimate use of power.

But there are important differences between these cases and the FTC's approach to data security (and to other areas where the FTC is relying on adjudication to develop legal norms). The most fundamental difference is the nature of the new technology. Both diagnostic X-rays and shipboard radios are—and at the time, were—well understood technologies that could be simply and effectively used. There may have been resistance to the new technology but not disagreement that the technology was useful in these trades.

Data security is not about what new technologies firms should use, but rather about *how* new technology is used. If anything, the challenge of data security is that firms are adopting complicated technologies without sufficient understanding of how to effectively use them. The FTC's data security cases would be better analogized to hypothetical litigation against doctors for harm caused by X-ray radiation in the early years of the technology, when the effects of radiation and approaches to mitigate those effects were just beginning to be understood. Even that analogy, however, is inapposite—diagnostic X-rays were used and evaluated by a group of learned specialists as tools of their trade. The *TJ Hooper* court similarly explains the centrality of radios to the shipping trade, likening them to the captain's ears.<sup>284</sup> Indeed, the value of shipboard radio was well understood, having been the basis for regulation of the radio spectrum starting 20 years earlier.<sup>285</sup>

This suggests a second fundamental difference between these cases and the FTC's approach to data security: the scope of the regulation. The changing legal obligations with respect to shipboard radios and diagnostic X-rays only affected a relatively small, well-defined cadre of firms or practitioners. The FTC's data security regulations, on the other hand, purport

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283. *Id.* at 740 (citations omitted).

284. *Id.* (The radio “is the ears of the tug to catch the spoken word, just as the master's binoculars are her eyes to see a storm signal ashore.”)

285. The federal government began licensing and regulating wireless spectrum in 1912 directly as a result of the sinking of the Titanic. For one discussion of this history, see Patrick S. Ryan, *The ITU and the Internet's Titanic Moment*, STAN. TECH. L. REV., 2012, at 1, 3–5. Had ship-to-ship radio been standard technology at the time, nearby ships could have been alerted to the Titanic tragedy and hundreds of lives would have been saved.



to affect every business in the country, irrespective of size, resources, sophistication, or other regulatory obligations.

The real issue that data security poses for consumers, industry, and the FTC is the need for education and better technology. The scope of the data security problem is beyond the FTC's ability to address—a fact which FTC Commissioners themselves recognize.<sup>286</sup> Stories about significant vulnerabilities or breaches are in the news almost daily. These vulnerabilities affect every class of computer user, from ordinary consumers, to small businesses, to large businesses, and even to large technology specialists.<sup>287</sup> And breaches are often traced back to ordinary employees engaging in behavior that is hard to audit or protect against, short of implementing business-debilitating procedures.<sup>288</sup>

This issue is compounded by the fact that no matter how the FTC views itself, most consumers and businesses do not naturally think of it as a data security regulator—let alone as the nation's primary source of data security protections. The nexus between the FTC's consumer protection mission and privacy is relatively clear to the ordinary consumer and businesses: When a firm discloses a consumer's information, it is natural to think that the firm has

286. See, e.g., Julie Brill, Comm'r, Fed. Trade Comm'n, On the Front Lines: The FTC's Role in Data Security, Keynote Address Before the Center for Strategic and International Studies, "Stepping into the Fray: The Role of Independent Agencies in Cybersecurity" 9 (Sept. 17, 2014), [https://www.ftc.gov/system/files/documents/public\\_statements/582841/140917csisspeech.pdf](https://www.ftc.gov/system/files/documents/public_statements/582841/140917csisspeech.pdf) ("We at the FTC cannot address every data security challenge that the United States faces . . .").

287. Perhaps the most alarming—and informative—of these breaches are those that affect sophisticated security firms. Such breaches include, for instance: RSA and Comodo, see Steven Cherry, *Comodo and RSA: Who Shall Guard the Guardians?: When Two Key Internet Security Firms Are Hacked, Who's Safe?*, IEEE SPECTRUM (June 9, 2011, 8:19 PM), <http://spectrum.ieee.org/podcast/telecom/security/comodo-and-rsa-who-shall-guard-the-guardians>; DigiNotar, see Robert Charette, *DigiNotar Certificate Authority Breach Crashes e-Government in the Netherlands*, IEEE SPECTRUM (Sept. 9, 2011, 8:45 PM), <http://spectrum.ieee.org/riskfactor/telecom/security/diginotar-certificate-authority-breach-crashes-egovernment-in-the-netherlands>; HeartBleed, see Robert N. Charette, *Heartbleed Bug Bit Before Patches Were Put in Place*, IEEE SPECTRUM (Apr. 18, 2014, 1:23 PM), <http://spectrum.ieee.org/riskfactor/computing/it/heartbleed-bug-bit-before-patches-were-put-in-place>; and Hacking Team, see Jennifer Valentino-Devries & Danny Yadron, *Hacking Team, the Surveillance Tech Firm, Gets Hacked*, WALL STREET J. (July 6, 2015, 8:48 PM), <http://www.wsj.com/articles/hacking-software-maker-gets-hacked-1436223757>.

288. "Often" is arguably an understatement. See, e.g., IBM GLOB. TECH. SERVS., IBM SECURITY SERVICES 2014 CYBER SECURITY INTELLIGENCE INDEX: ANALYSIS OF CYBER AND INCIDENT DATA FROM IBM'S WORLDWIDE SECURITY OPERATIONS 3 (2014), [http://media.scmagazine.com/documents/82/ibm\\_cyber\\_security\\_intelligenc\\_20450.pdf](http://media.scmagazine.com/documents/82/ibm_cyber_security_intelligenc_20450.pdf) (finding that "What is fascinating—and disheartening—is that over 95 percent of all incidents investigated recognize 'human error' as a contributing factor."); PWC, 2015 INFORMATION SECURITY BREACHES SURVEY 7 (2015), <http://www.pwc.co.uk/assets/pdf/2015-isbs-technical-report-blue-03.pdf> (finding that 75% of large organizations and 31% of small businesses suffered a staff-related breach in the past year and that "50% of the worst breaches in the year were caused by inadvertent human error"); Mirko Zorz, *Insider Threat: A Crack in the Organization Wall*, HELP NET SECURITY (June 18, 2015), <http://www.net-security.org/secworld.php?id=18525> (finding "that businesses consistently rate human error as the leading contributor to security breaches." (quoting Todd Thibodeaux, President and CEO, CompTIA)).

done something inappropriate and harmful to the consumer. When a firm experiences a data breach, however, both consumers and firms are more likely to blame hackers or insecure technology for the breach.

This also raises concern about the efficacy of the FTC's efforts to define data security norms. Businesses are unlikely to seek out the guidance of the FTC for how to handle consumer data. Solove and Hartzog are surely correct that the FTC's efforts to date have yielded a coherent body of legal norms that are familiar to data security practitioners. But few law firms have data security practices—especially firms outside of Washington's sphere of influence or without significant regulatory practices.

In order to be effective, data security guidance needs to be readily available. Its requirements need to be economically and technically feasible, and in proportion to the capabilities of the firms subject to them. And guidance needs to come from sources that firms will seek out organically. These sources primarily include state-level business and corporate law, and industry specific regulators. Information posted to the FTC website—especially if not provided in readily accessible and understandable form—or known to a cadre of elite lawyers provides no meaningful guidance to the vast majority of firms potentially subject to data security breaches.

In light of these concerns, it is useful to return to the language of *Chenery II* that gives agencies discretion to choose whether to proceed by rulemaking or adjudication. As discussed previously, *Chenery II* gives agencies broad discretion in their choice of rulemaking procedure.<sup>289</sup> But the language does include some limitations—even if today those limitations are vestigial. The Court explained that there is “a very definite place for the case-by-case evolution of statutory standards,” for instance, “problems which must be solved despite the absence of a relevant general rule.”<sup>290</sup> But with data security the FTC is doing something beyond developing “statutory standards.”<sup>291</sup> The FTC is expanding the scope of its unfairness authority, not merely developing the statutory standards governing its authority. And while the problem that it is seeking to address is one that “must be solved,” it is unclear whether the FTC can, let alone must, be the entity to solve it.<sup>292</sup>

#### B. EFFECTIVE ADJUDICATION

Regardless the wisdom of the FTC's use of adjudication, the agency will surely continue to develop legal norms through adjudication. And despite the critique offered in this Article, there surely are instances where it is appropriate—even wise—for the agency to proceed through adjudication

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289. See *supra* Part IV.B.

290. Sec. & Exch. Comm'n v. *Chenery Corp.* (*Chenery II*), 332 U.S. 194, 202–03 (1947).

291. *Id.* at 203.

292. *Id.* at 202.

instead of rulemaking. The common-law critique offers guidance for how the Commission should proceed when using adjudication to develop legal norms.

Perhaps the most important, and most general, principle to keep in mind is the purpose of the FTC's efforts. To the extent that the agency is working to develop new legal norms—a "common law" of privacy, data security, or any other body of law—the Commission is working to develop rules. This is the idea that Commissioners and commentators mean to capture when referring to the Commission's work as common law-like. If the Commission is to be effective in these efforts, it must approach its work from a rulemaking perspective—it must escape the biases and motivations that come with its typical enforcement perspective. Chief among these, its goal must be to craft jurisprudentially sound rules—and its goal must not be simply to obtain successful verdicts.

With this in mind, the Commission should next recall that the meaningful availability of judicial review of agency action is the *sine qua non* of the common law process. This is true as a statutory matter: It is required by the APA.<sup>293</sup> It is true as a constitutional matter: Principles of Due Process require it.<sup>294</sup> And as a separation of powers principle, it is one of the basic elements of our constitutional structure.<sup>295</sup> Over the years, these requirements have been construed generously. Satisfying them requires only that an agency's statutory framework, as created by Congress, ensures that judicial review of final agency action is available to any party that seeks it. But this is a minimum standard. If the Commission is truly committed to developing sound legal norms, it should work to maximize litigants' access to judicial review. Indeed, wherever possible, it should choose to argue matters in federal district court in the first instance. Proceedings before administrative law judges or the Commission itself should be reserved to cursory matters that are not expected to—and that will not be interpreted to—contribute to the establishment of legal norms.

Related to this, the Commission should pursue those cases that are least likely to settle. This approach differs from that which Paul Ohm describes the Commission as using. Cases that are unlikely to settle are more likely to present matters at the margin of legal norms. These are the issues that need focus and refinement, and therefore are the issues that should be subject to the Commission's efforts. And, because these are the cases that present the most challenging issues, the Commission should expect to lose many of them. Litigation losses should be viewed as confirmation that the Commission is pursuing a positive rulemaking agenda. Relatedly, settlements should not be viewed as creating legal norms. This is true for cases that settled out of Article

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293. 5 U.S.C. § 706 (2012).

294. See *supra* Part V.C.

295. See *supra* note 133 and accompanying text (discussing the role of the independent adjudicator in the common law process, and relating this to the separation of power).

III courts. It is even truer for cases that settle during administrative proceedings.

Of course, the Commission should not simply ignore the vast majority of cases that do not present the most difficult legal questions. These are cases that the Commission should investigate and bring before an administrative law judge. But these are also cases that should settle with relative ease and minimal burden. The lesson from the common law tradition in these cases, however, is that they should not be a primary mechanism for developing legal norms. Rather, the Commission should use its enforcement actions only to alter prior behavior: It should not seek sanctions against these businesses, or to put in place a monitoring regime, unless there is some indication that such mechanisms are warranted for some exceptional conduct (e.g., repeat offenses or refusal to alter behavior). Indeed, modern understandings of administrative law suggest that we have, in some ways, returned to the era of *Wyman-Gordon*: Agencies are free to develop and change legal norms through adjudication (per *Chenery II* and *Fox I*), but due process notice concerns prevent such adjudication from having punitive effect (*Fox II*). In other words, agencies can prospectively develop legal norms through adjudication, but they cannot do so retrospectively.

In the more general course, the purpose of these investigations should be to gather information and insights necessary either to engage in notice-and-comment rulemaking or to report to Congress about the need to data security legislation. In the 1960s into the 1970s, Kenneth Culp Davis—one of the strongest critics of broad discretion to agency choice of procedure—argued that where Congress gives agencies power to develop legal norms, they should proceed by first developing standards and providing guidelines, then develop those standards as circumstances permit, and use this process to eventually craft rules.<sup>296</sup> A similar view was later adopted by Judge Friendly.<sup>297</sup> Critically, the focus of this process is the ongoing development and refinement of legal norms—not on the enforcement of those norms.

In a similar vein, the FTC should develop relationships with other, industry-specific, regulators. As discussed above, most businesses are unlikely to turn to the FTC for guidance on data security. They are, however, likely to turn to regulators that focus on their industry. The Commission should provide input to its regulatory peers to ensure that they adopt sound rules specific to their industry and provide sound and relevant guidance to firms that they regulate.<sup>298</sup>

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296. See, e.g., DAVIS, DISCRETIONARY JUSTICE, *supra* note 187; Gifford, *supra* note 187, at 103.

297. See generally *Nat'l Labor Relations Bd. v. Bell Aerospace Co., Div. of Textron, Inc.*, 416 U.S. 267 (1974).

298. There is a more subtle point to be made in this argument. The courts often prefer specific statutes over general statutes. And, in the common-law context, the Supreme Court in recent years has signaled a strong preference for federal common law to give way to governance by federal agencies. See generally Hurwitz, *Administrative Antitrust*, *supra* note 22. Although there is

*C. A ROLE FOR THE FTC IN DATA SECURITY*

In addition to the general issue of how the FTC approaches the development of new legal norms, the FTC's approach to data security issues merits specific consideration. While this Article is by and large critical of the Commission's approach to date—especially where the Commission has relied upon its unfairness authority—aspects of data security surely fall within the Commission's statutory ambit. Consumer protection is one of the Commission's core missions, and it is certainly plausible that data breaches can harm consumers. The challenge is to understand how the Commission can use its statutory authority to offer consumers meaningful protection.

A better approach than the one that the Commission has currently charted would be to focus on firms' relationships with consumers, not their relationships with consumer data. That is, rather than focusing on whether a firm has good or bad data security practices, focus on whether that firm is meaningfully communicating its practices—whatever they are—to those from whom it collects data.

This would have little effect upon a great many of the cases that the Commission brings. In particular, those cases that the Commission premises on deception claims—the least controversial of the Commission's data security cases—would not be affected by this shift in policy. In such cases, a firm has generally given affirmative assurances to consumers about its treatment of their data. Sanctions against the firm are based on its violation of those assurances, not on its actual handling (or mishandling) of consumer data.

The harder, and more controversial, cases are those based on unfairness claims—cases where a firm does not affirmatively assure consumers of how it will handle their data. In these cases, the Commission should not take action against firms based upon how they handle consumer data, for the myriad reasons discussed throughout this Article. The Commission, however, may find reasonable legal footing to bring unfairness claims against companies that collect consumer data without offering consumers sufficient affirmative assurances about how that data will be handled. That is, it may be “unfair” to consumers, within the meaning of section 5, for a firm to collect consumer data without having in place a public data security policy.

Of course, once a firm has such a policy in place, a failure to live by it could result in a more substantial deception suit should that policy be violated.

This approach has a number of virtues compared the Commission's current efforts to regulate data security practices through its unfairness authority. As an initial matter, it is not subject to the notice and due process

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little precedent directly on point, it is likely that the same principles would apply in the regulatory context, such that the courts would find the FTC's authority over data security issues is subordinate to the authority of industry-specific regulators.

concerns discussed above. Information disclosure is a traditional consumer protection function, well within the Commission's established unfairness authority. Even more important, however, is that this approach removes the Commission from the position of developing data security standards. This is important for three distinct reasons. First, as discussed as this Article's framing idea, the Commission's current approach lacks various characteristics of the common law that make the common law a suitable tool for developing legal norms and standards. If the Commission's current approach is ineffective, it should seek out and embrace more effective alternatives. Second, and reinforcing this first point, the Commission has turned to adjudication instead of rulemaking because it understands that the current understanding of data security, and complexity of the underlying technology, means that good "data security" is not amenable reduction to standardized practices. And third, rather than turning to the Commission to accomplish this impossible task with ineffective "common-law-like" tools, by channeling its efforts to standardizing the promulgation of data security policies the Commission can harness the power of the market to assist in the process of developing data security norms. Indeed, this is also a standalone reason to embrace this approach: In addition to its consumer protection mission, the FTC's other primary mission is competition advocacy and protection. Promoting the disclosure of firms' data security policies promotes competition between firms. Such competition advances the interests of consumers and also encourages the development of new, better, and more standardized data security technologies.

As a matter of both law and policy, the Commission should not be as aggressive under this approach as its current policies suggest it is inclined to be. A few important limitations should be noted. First, as argued in the previous Part, the Commission should to seek punitive sanctions against firms lacking data security policies. In principle, the Commission could rely on the same, flawed, consent-decrees—based approach to dealing with firms without data security policies—indeed, it could go so far as to require the same 20 years of regular audits as a condition of settling its unfairness claims. As a matter of policy, the Commission should resist that urge. Rather, its focus should be on encouraging firms to develop and disclose data security policies. The development and promulgation of such policies serves two functions: the obvious function of disclosing information to consumers, but also the less obvious function of encouraging firms to sit down, think about, and develop their policies. Thus the policy is vindicated without the need for sanctions—at least in the case of firms that respond positively to initial, non-punitive, scrutiny from the Commission.

There are also important legal limits on the Commission's ability to take action against some firms—especially smaller firms. Section 5(n) of the FTC Act requires that any unfairness claim meet three conditions: (1) actual or likely substantial injury; (2) which is not reasonably avoidable by consumers;

and (3) that is not outweighed by countervailing benefits to consumers or to competition.<sup>299</sup> The second and third of these prongs may present challenges to enforcement actions in some cases. Consumers can almost always avoid potential harms resulting from a firm's data security practices or policies (or lack thereof) simply by not engaging in online interactions. It is not, however, reasonable, to expect consumers to forego all online interactions. There is, however, a sound argument that consumers bear some burden in deciding which firms to interact with. This is particularly true in the case of smaller, less well known, firms, firms participating in thick markets, where consumers have many firms to choose from, and firms with offline presences to which the consumer could turn. In such cases, it may be reasonable to place the burden on the consumer to respond to questionable conduct by firms—such as not being forthcoming about data security policies—by altering her behavior. This concern is compounded by the third section 5(n) factor, that any potential injury to consumers not be outweighed by offsetting benefits to consumers or competition. In the case of smaller firms—especially those which are less likely to have data security knowledge, let alone expertise, or that are unlikely to turn to the FTC for guidance on data security practices—imposing substantial data security requirements has the potential to be quite burdensome. Such burdens can have adverse effects on competition, ranging from merely imposing incremental costs on firms to making it uneconomic for firms to participate in the market at all. Regulatory action with this effect may well fail the third prong, harming competition and consumers to the extent that we prefer to allow some amount of questionable data security conduct.

## VII. CONCLUSION

Over the past 15 years, the Commission has embarked on an aggressive effort to regulate firms' data security practices, relying at first on its authority to take action against "deceptive" acts and practices and, increasingly today, on its authority to take action against "unfair" acts and practices. This Article has challenged the FTC's efforts—and, in particular, the FTC's use of agency adjudication and consent decrees to develop a so-called "common law" of data security.

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299. 15 U.S.C. § 45(n) (2012). Section 5(n) reads in full:

The Commission shall have no authority under this section or section 57a of this title to declare unlawful an act or practice on the grounds that such act or practice is unfair unless the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition. In determining whether an act or practice is unfair, the Commission may consider established public policies as evidence to be considered with all other evidence. Such public policy considerations may not serve as a primary basis for such determination.

The Commission's approach suffers two basic flaws. First, although it is superficially similar to "common law," it lacks several key characteristics that give the common law its jurisprudential virtues. Key among these, at common law, judges are neutral arbiters that decide cases because they must, and the cases before them are generally the "close calls"—the FTC's cases, on the other hand, are selected and heard by the Commission on a discretionary basis to carve our large swaths of law. More generally, and second, the Commission's reliance on adjudication instead of rulemaking is ill-considered. It is in line with established precedent—but it is a line of precedent that has long been criticized for its lack of due process, and that the Supreme Court has in recent years shown some inclination to revisit. If it holds its current tack, the Commission may find itself on the vanguard of unfavorable precedent.

At the same time, the Commission is to be commended for its attention to data security issues. Data security is one of the most important and challenging issues facing the modern economy. While it is possible that the Commission's efforts are bringing some marginal attention to, and encouraging some marginal new thinking about, these problems, fundamentally data security is a problem that is far larger than anything that the Commission is able to address on its own. Regardless, this Article argues that there is a positive role for the Commission to play in addressing these issues: It should focus on the relationship between firms and consumers, as opposed to focusing on how firms handle consumer data. This falls well within the ambit of the Commission's traditional consumer protection authority.

#### AFTERWORD

As this Article is being finalized for publication, there have been important updates in both the *LabMD* and *Wyndham* cases. On November 13, 2015, the Administrative Law Judge hearing the *LabMD* case rejected all of the FTC's claims against LabMD.<sup>300</sup> A few weeks later, on December 9, 2015, Wyndham and the FTC announced a settlement of the FTC's claims against Wyndham.<sup>301</sup> The ALJ opinion in *LabMD* is the first decision on the merits in any of the FTC's cases relating to data security practices and is a resounding defeat for the FTC (and, implicitly, affirmation for the arguments made in this Article)—though the FTC complaint counsel will appeal the decision to the full Commission.<sup>302</sup>

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300. Initial Decision, No. 9357 (F.T.C. Nov. 13, 2015), [https://www.ftc.gov/system/files/documents/cases/151113labmd\\_decision.pdf](https://www.ftc.gov/system/files/documents/cases/151113labmd_decision.pdf).

301. *Wyndham Settles FTC Charges It Unfairly Placed Consumers' Payment Card Information at Risk*, FED. TRADE COMMISSION (Dec. 9, 2015), <https://www.ftc.gov/news-events/press-releases/2015/12/wyndham-settles-ftc-charges-it-unfairly-placed-consumers-payment>.

302. See Complaint Counsel's Notice of Appeal, *LabMD, Inc.*, No. 9357 (F.T.C. Nov. 24, 2015), [https://www.ftc.gov/system/files/documents/cases/580032\\_-\\_labmd\\_-\\_complaint\\_counsels\\_notice\\_of\\_appeal.pdf](https://www.ftc.gov/system/files/documents/cases/580032_-_labmd_-_complaint_counsels_notice_of_appeal.pdf). In terms of procedure, any loss before an ALJ can be appealed to the Commission



There are few conclusions that can be drawn from the *Wyndham* settlement. As discussed above, the Third Circuit was surely correct in finding that some data security practices can constitute unfair acts or practices.<sup>303</sup> And, while the judges hearing *Wyndham's* interlocutory appeal raised questions about the FTC's process and approach to establishing data security norms, it is also the case that *Wyndham* experienced repeated data breaches that resulted in substantial losses of consumer information.<sup>304</sup> What is more, the FTC's case against *Wyndham* also included a deception claim, arguing that *Wyndham* had failed to live up to affirmative security-related assertions made in its privacy policies.<sup>305</sup> On balance, despite the jurisprudential concerns raised by the FTC's approach to cases such as *Wyndham*, the Commission had a reasonably strong case against the firm. Having failed to secure a resounding victory in its interlocutory appeal, it is unsurprising that *Wyndham* decided to follow the path of settlement, well-worn by the dozens of other firms that had preceded it in FTC data security investigations.

The *LabMD* decision is a different matter.<sup>306</sup> In his opinion, ALJ Chappell not only rejected the FTC's claims against *LabMD*, but rejected the FTC's basic theory of the case. As he explained, the FTC argued that "Section 5 unfair conduct liability can be imposed based solely on the risk of a data breach and that proof of an actual data breach is not required."<sup>307</sup> Under this theory, "'unreasonable' data security, by definition, [would be] an unfair practice," based on the Rube-Goldberg-like idea that unreasonable security practices make a data breach more likely, and that if a data breach occurs it is possible that consumer data will be stolen, potentially leading to consumer harm.<sup>308</sup> Judge Chappell had none of the FTC's argument. The term "likely," he tells us, "does not mean that something is merely possible. Instead, 'likely' means that it is probable that something will occur."<sup>309</sup> The FTC's specific allegations in *LabMD* were therefore insufficient to meet the statutory requirements of section 5(n), defining unfair conduct as that which, in part, "causes or is likely to cause substantial injury to consumers."<sup>310</sup>

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which reviews the case *de novo* but treats the ALJ findings as part of the record. Once the Commission decides a case, that decision can be appealed to an Article III court.

303. See *supra* text accompanying note 95.

304. See *supra* text accompanying note 78.

305. Fed. Trade Comm'n v. *Wyndham Worldwide Corp.*, 10 F. Supp. 3d 602, 626 (D.N.J. 2014), *aff'd*, 799 F.3d 236 (3d Cir. 2015).

306. This discussion is based on an analysis of the opinion previously published on TechPolicyDaily.com. See Gus Hurwitz, *LabMD Ruling Should Be a Wake-Up Call for FTC Data Security Enforcement*, TECHPOLICYDAILY.COM (Nov. 23, 2015, 6:00 AM), <http://www.techpolicydaily.com/technology/labmd-ruling-wake-up-call-ftc-data-security-enforcement>.

307. Initial Decision, No. 9357, at 87 (F.T.C. Nov. 13, 2015), [https://www.ftc.gov/system/files/documents/cases/151113labmd\\_decision.pdf](https://www.ftc.gov/system/files/documents/cases/151113labmd_decision.pdf).

308. *Id.* at 86.

309. *Id.* at 54.

310. 15 U.S.C. § 45(n) (2012).

But Judge Chappell goes beyond rejecting the FTC's specific claim in the *LabMD* case, explaining—in accordance with the argument made in this Article—that

[i]f unfair conduct liability can be premised on 'unreasonable' data security alone, upon proof of a generalized, unspecified 'risk' of a future data breach, without regard to the probability of its occurrence, and without proof of actual or likely substantial consumer injury, then [the statutory standard provided in section 5(n)] would not provide the required constitutional notice of what is prohibited.<sup>311</sup>

In other words, not only is the FTC's theory of the case insufficient to meet the statutory requirements of section 5, but if it were, then the FTC's interpretation of section 5 is unconstitutional: "Fundamental fairness dictates that proof of likely substantial consumer injury under Section 5(n) requires proof of something more than an unspecified and hypothetical 'risk' of future harm, as has been submitted in this case."<sup>312</sup>

Judge Chappell's opinion is the first decision on the merits in one of the FTC's myriad data security cases. But, as discussed in this Article, he is only the latest in a series of jurists to express concern about the FTC's approach to data security. It is easy to understand this concern. Under the FTC's theory, any firm that may experience a data breach—even if no breach ever actually occurs—is arguably engaged in an "unfair" practice, and any firm that actually experiences one is demonstrably engaged in such a practice. But it is likely that more than half of the firms in the United States have experienced breaches. And it is a basic principle of computer security that there is no such thing as a "secure" system—any firm's data could potentially be breached by a sufficiently motivated attacker. Under the FTC's theory of data security, under which the possibility of a data breach demonstrates unfair security practices, at least half of the firms in the United States, and arguably every firm in the United States, could be the subject of an FTC enforcement action. All that protects any given firm from such an investigation is the whim of the FTC commissioners—or, worse and more likely, the whim of FTC staff. The constitutional due process and notice concerns discussed in this Article and raised by these judges are unsurprising.

To their credit, proponents of the FTC's efforts do have an understandable concern: On its face it does not make sense that, if two otherwise identical firms are engaging in identical and legitimately bad security practices, only the firm that has the misfortune of experiencing a data breach that results in consumer harm should be subject to an enforcement action. Both firms were doing the same bad thing, and it seems problematic

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311. *Initial Decision*, No. 9357, at 86–87.

312. *Id.* at 87.

that only the firm that experienced the misfortune of a breach can be sanctioned for those practices.

But while this seems problematic, it is actually a central aspect of the common law process. As discussed in Part III, the development of the common law is premised, in part, on a multiplicity of cases being brought before independent tribunals by parties that have experienced actual harm. This process deliberately filters out those cases in which there is no case or controversy. If a practice is actually bad—if it is so likely to result in data breaches and harm to consumers—then there should be examples of such breaches. The FTC can take action against those firms, or use them as examples to support agency rulemaking efforts, to identify conduct that is actually problematic. Firms engaging in similar practices, even if they have not (yet) experienced a data breach, can then learn from the consequences imposed upon firms engaged in practices that resulted in consumer harm. If, on the other hand, examples are so far and few between that the FTC cannot find cases in which consumers are actually harmed, that suggests that the commission is not addressing a substantial concern—or, more poignantly, a concern that is likely to cause substantial injury, for any meaningful definition of “substantial.” We will never be able to prevent all data breaches. We should focus our attention instead on addressing those which we can avoid at reasonable cost. The “harm” requirement implicitly brings the Commission within the norms of the common-law approach to developing legal norms. That the FTC would eschew this requirement is a nice demonstration of this Article’s basic argument, that the FTC’s so-called “common law of data security” lacks the core characteristics and jurisprudential legitimacy of the common law.