

Collective Dominance Under the European Merger Control Regulation: The Implications of the *Airtours* Case

ABA Section of Antitrust Law “Brown Bag” Program

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Editor’s Note: On June 6, 2002 the European Court of First Instance (“CFI”) handed down its long-awaited decision in *Airtours PLC v. Commission of the European Communities* (Case T-342/99, [2002] 5 C.M.L.R. 7). It was the first of three merger cases to be overturned by the CFI in the last six months. In its *Airtours* decision, the CFI overturned the Commission’s decision of September 22, 1999, O.J. 2000 (L 93) 1, that the acquisition of First Choice PLC by Airtours PLC would create a position of collective dominance in contravention of the European Merger Control Regulation. In its *Airtours* decision, the Commission took the position that the proposed merger would create a dominant position in the U.K. market for short-haul foreign package holidays. According to the Commission, the aggregate market share of the three largest competitors post-merger (*Airtours/First Choice, Thomson, and Thomas Cook*) would have been 80 percent.

On appeal before the CFI, the issues focussed on whether the Commission had met its evidentiary burden. The parties agreed on the three conditions that are necessary for a finding of collective dominance: (1) the market must be transparent (i.e., each member of the oligopoly must have the ability to know how the other members are behaving); (2) the situation of tacit coordination must be sustainable over time (i.e., there must be an incentive not to depart from the common policy); and (3) the foreseeable reaction of current and future competitors, as well as of consumers, cannot jeopardize the results expected from the common policy.

In *Airtours*, the CFI held that the Commission failed to show that these three conditions were present. To the relief of many practitioners, the uncharacteristically critical disposition of the CFI to the Commission’s decision stimulated an internal review by the Commission of the procedures it employs to assess mergers—in particular, where oligopolistic dominance is alleged. The CFI’s disposition in Case T-5/02, *Tetra Laval v. Commission* (October 28, 2002), and Case T-310/01, *Schneider Electric v. Commission* (October 22, 2002), will most likely instill a sense of greater urgency to the internal review. On a substantive level, the decision of

the CFI in Airtours is significant because it clarifies the evidentiary burdens the Commission needs to meet in order to substantiate a finding of collective dominance. The subsequent holdings in Tetra Laval v. Commission and Schneider Electric v. Commission serve a similar purpose, albeit regarding different theories.

In view of the significance of the Airtours case, the International Antitrust and Foreign Competition Law Committee of the ABA Section on Antitrust Law sponsored a seminar addressing the issues raised by the Airtours case on June 26, 2002. As one of the Vice-Chairs of the Committee, I was fortunate to have the opportunity to moderate the seminar. The speakers were Götz Drauz, Director of the Merger Task Force of the European Commission's Competition Directorate; Paul Malric-Smith, Head of Unit IV, Merger Task Force; F. Enrique Gonzalez-Diaz, Head of Unit, Merger Task Force; Malcolm Nicholson of Slaughter and May, London; and Alan Overd of Lexecon Ltd., London.

Although the seminar preceded the publication of the Tetra Laval v. Commission and Schneider Electric v. Commission decisions, we thought that it would be beneficial to the antitrust community to print an edited version of the seminar because of the insights shared by the speakers. Although each speaker has had the opportunity to review and revise his comments, we have attempted to retain the original language to the extent possible.

ANDRE FIEBIG

GARDNER CARTON & DOUGLAS



Andre Fiebig

ANDRE FIEBIG: Mr. Nicholson, who represented Airtours in the legal proceedings leading up to the decision of the CFI, has kindly agreed to be our first speaker.

MALCOLM NICHOLSON: The facts of the *Airtours* case are very easily and rapidly stated. The proper and real concern for regulators is how to approach mergers in industries characterized by only a few competitors. You have to devise a set of rules for distinguishing between those oligopolies that are benign, i.e., that operate in a competitive fashion, and those where the concern is that they will operate in an anticompetitive fashion in a way that, in the parlance, is characterized as "collective dominance." Now, the *Airtours* case involved an acquisition in the U.K. tour operator market. It would have reduced the number of competitors from four to three. We thought it was a fairly competitive market at the time. It had been examined by the U.K. Competition Commission just a couple of years earlier and had been given a clean bill of health. Anyone reading the newspapers knows that you can get a week holiday in Southern Spain for US \$150. Although it looked pretty competitive to us, the Commission disagreed. In essence, the Commission said that following the merger, it would be rational for the parties to constrain capacity and thereby maintain supracompetitive prices. The Commission prohibited the merger on that basis. We disagreed. Now Alan Overd can now take you over some of the key issues.

ALAN OVERD: The key issue in the *Airtours* case relates to perhaps one of the most difficult questions in competition policy: When is an oligopoly competitive? Put another way, given that oligopolies are characterized by the interdependence of large firms, how do we differentiate between unacceptable oligopolistic behavior and acceptable oligopolistic behavior? From an economist's perspective, the key criticism of the Commission's decision is that a detailed reading



Alan Overd

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shows that if the Commission's approach was allowed to stand, it would give the Commission the discretion to block any merger it wanted in an oligopolistic market.

What specifically is the objection to the application of collective dominance in this case? A good place to start is the distinction between unilateral effects and coordinated effects. Prior to the *Airtours* case, it was thought that collective dominance related to the possibility of coordinated effects. What was the basis for this view? Well, the first point to note is that the court's judgment in *Gencor v. Commission*, Case T-102/96, (March 25, 1999), was consistent with this view. Further, various Commission officials had confirmed this interpretation before the *Airtours* case actually started. Finally, the checklist of market characteristics that the Commission tends to use in collective dominance cases, such as product homogeneity, similar cost structures, absence of demand volatility, and so on, are textbook factors which are thought to facilitate coordination. The conditions necessary to establish and maintain tacit coordination are widely accepted. To be able to reach a mutual understanding to restrict competition, the market needs to be sufficiently transparent. Further, transparency helps to ensure that this behavior can be monitored effectively. There must also be a scope for credible punishment mechanism to undermine the well-recognized incentive to cheat. Further, as an aside, such an exercise has little point if entry barriers are low and other firms could come into the market rapidly if prices were to rise. The CFI in its judgment confirms the basis of this interpretation of collective dominance in paragraph 62 of its judgment.

The key economic criticism in our case was that in the *Airtours* decision, the Commission applied a different test. This test seemed to involve an objection to oligopolistic interaction per se. A good example is in paragraph 150 of the decision, which states the following:

What matters for collective dominance in the present case is whether the degree of interdependence between the oligopolists is such that it is rational for the oligopolists to restrict output, and in this sense, reduce competition in such a way that a collective dominant position is created.

Oligopolists are by definition interdependent. Restricting competition is rational if it leads to higher sustainable profit. This paragraph, along with many others in the decision, does not appear to describe tacit coordination, or to assess its feasibility. It might be argued that these sentences are somewhat ambiguous or maybe somewhat clumsily phrased. However, any claim that the [*Airtours*] decision was reasonable but merely badly drafted is unsustainable in the light of the court's demolition of the decision. In the specific context of the incorrect test for collective dominance applied in this case, I think a number of examples undermine such a claim but I would say, because time is short, I will pick only two.

The first relates to my assertion that the Commission merely described interdependent market conduct per se rather than a more sinister tacitly coordinated outcome. This is well captured in the court's discussion of the Commission's assessment of capacity setting in the foreign package-holiday market. The Commission asserted in paragraph 138 of the decision that there was already a tendency towards collective dominance in the market at present, particularly in the setting of capacity, although, as a footnote, it is worth noting that it later conceded in its pleadings that the market was not characterized by collective dominance premerger. But let's look at capacity setting.

The key plank of the Commission's case in this regard was that the cautious planning of capacity was symptomatic of a tendency towards collective dominance. But we argued that taking account of what your rivals are doing is an inherent feature of an oligopolistic market. It is, to quote the court in a previous judgment, consistent with the right of firms to "adapt themselves intelligently to the existing and anticipated conduct of their competitors." In the *Airtours* judgment, the

court noted that remarks made by executives stressing the importance of matching capacity to demand do not give the slightest indication that there is no competition between the main operators.

The second example of how the collective dominance test was misapplied relates to the need for a punishment mechanism. The need for a punishment mechanism, or its interchangeable variation, retaliation, is well recognized in the economic literature and indeed is explicitly stated in the U.S. Merger Guidelines. In the *Airtours* decision, the Commission states at paragraph 55 that it does not regard a strict punishment mechanism as a necessary condition for collective dominance, adding that where there are strong incentives to reduce competition, coercion may be unnecessary. Similar sentiments were expressed elsewhere in the decision, such as in paragraph 150. The court noted these comments by the Commission and describes the Commission's approach as "somewhat ambiguous," given that the Commission denied the need for a punishment mechanism but then went on to argue that punishment was perfectly feasible in this market anyway. The court went on to dismiss the hypothetical punishment identified by the Commission, such as the de-racking of brochures, as entirely inadequate.

Hence the court is particularly robust in its insistence on the need for a punishment mechanism, showing a good understanding, particularly in paragraphs 193 and 194, that tacit coordination is essentially a dynamic analysis. In economist's terms, it's essentially a repeated game—and that sustainable tacit coordination really does require the need for a deterrent mechanism to align the incentives of the oligopolists. So, in sum, the main economic criticism of the methodology of collective dominance in this case was that it really captured oligopolistic interdependence per se rather than capturing the more narrowly based tacit coordination.

What the court did not say in this case—and no one should run away with it—it did not say collective dominance does not exist. It says it does exist, it defines it, and it said it's not established on the facts of this case.

MALCOLM NICHOLSON: I want to draw a few conclusions from the methodology adopted by the CFI in its decision. The first one is that there is a natural complexity in the relationship between the Commission and the CFI. The Commission has a role in assessing mergers—it evaluates economic evidence—and the CFI is the review body. Traditionally, the European courts have said that where the Commission is engaged in an exercise of complex economic assessment, it will allow the Commission a degree of discretion, it will cut it some slack, and it will only look to see if the facts are a problem and if they substantiate the economic theory that the Commission is relying on. In this case, the CFI paid lip service to that point but concluded that, in a sense, where law and economics inter-react and cannot be distinguished, the court is prepared to articulate as a matter of law a test for collective dominance.

The second observation I want to make goes to burden of proof. When we were at the hearing in Luxembourg, the opening comment from the reporting judge was that this is not a state aid case. The presumption is that state aids are bad unless they are approved. This is a merger case. Mergers are good unless they are established to be bad. That rigorous approach to burden of proof permeates everything in the CFI's judgment in this case.

The third point is the way the CFI conducted its substantive assessment of the Commission's decision. The CFI concentrated on four areas. It looked at the relevance of existing competition; it looked at a number of the so-called competitive dominance checklist items; it looked at the evidence of retaliatory mechanisms as they were alleged to exist; it then looked at the competitive impact of the fringe.

Now, if we look at existing competitive pressures, the departure point of the CFI was really a question at the hearing where they said to the Commission, "You have said (as they did in their pleadings), that this market is competitive with the four players in it. What are the fundamental

—MALCOLM NICHOLSON

changes that mean it is not going to be competitive when there are only three players in it?” And again that issue permeates the way the court analyzed the case. As you look at paragraph 58 of the judgment, the court says that if there is no substantial alteration to competition as it stands, the merger must be approved. And on the facts, the court then found that incorrect inferences had been drawn from data related to the existing competitive situation involving the parties, how they went about the capacity planning process and the significance of market share changes, and so on and so forth.

The next broad area was the checking of a number of items from the collective dominance checklist. The court concentrates on three well-known questions for people looking to try to distinguish benign and anticompetitive oligopolies—namely, is the market static, or does it exhibit demand growth? Is there demand volatility? And is the market transparent (in which connection product homogeneity is relevant)? The point I want to make here is that on the facts the CFI found that the Commission did not establish (i.e., prove) the conclusions that it sought to draw in its decision, but the court also gave quite helpful guidelines or notes throughout the judgment. I’ll just take one example in relation to demand volatility. Paragraph 139 of the judgment states: “the Court observes in limine that, as the Commission recognizes, economic theory regards the volatility of demand as something which renders the creation of a collective dominant position more difficult. Conversely, stable demand, thus displaying a low volatility, is a relevant factor indicative of the existence of a collective dominant position insofar as it makes ‘deviations’ from the common policy (that is, cheating) more easily detectable.” Now, here you’ve got a little note from the CFI as to why a particular item on the collective dominance checklist is relevant. The court sets that out and then goes on to reflect the evidence in front of it. And as I say, on all those elements it concluded on our side of the fence rather than the Commission’s.

It did so similarly with the methodological approach in looking at the evidence of the retaliatory mechanisms that would be available.

Finally, and I freely admit by this time I think the Court was on a roll; I do not think it was the strongest part of our case. It found that the little fringe of smaller players would also exercise a competitive constraint.

So, at the end of that sort of analysis—and it’s a pretty detailed, full review, rigorous analysis by the CFI—whether or not you agree with the outcome, the methodological approach is, I think, extremely helpful. The court concluded in paragraph 294 of the judgment that the decision, far from basing its prospective analysis of post-merger competition on evidence, is vitiated by a series of errors of assessment as to factors fundamental to any assessment of whether a collective dominant position might be created. And that seems to me to be a fairly firm statement by the CFI regarding this particular case. What the court did not say in this case—and no one should run away with it—it did not say collective dominance does not exist. It says it does exist, it defines it, and it said it’s not established on the facts of this case.

ANDRE FIEBIG: Over the years, the European courts have consistently given deference to the European Commission in the application of Article 81(3) of the EC Treaty, stating repeatedly that the application of Article 81(3) involves matters of complex, economic appraisals which are better left to the Commission. Why all of a sudden is the CFI now willing to engage in a complex economic assessment in the context of the Merger Control Regulation?

MALCOLM NICHOLSON: I think the true reason lies in the fact the court has grown up and grown in confidence over twenty or thirty years. It feels better equipped to second-guess some of these

things. I think it is also a feature of the fact that this is before the CFI, which is a full review court, rather than the European Court of Justice which is more of an appellate supreme court.

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GÖTZ DRAUZ: First of all, I can understand that Malcolm takes a certain degree of pride in the judgment; and I think he really deserves it. We are still assessing the judgment in its full importance and, of course, at the same time, we are assessing whether the judgment needs to be appealed. Therefore, what we can say today may be limited to some extent.

Our first impression is that the judgment should not be read as intending to limit the scope of the dominance concept in the context of the Merger Control Regulation. What the CFI has done, and I think this is very much welcomed despite the sometimes very critical language used by the CFI, is to clearly establish the criteria which must be fulfilled in order to reach a finding that a particular transaction is likely to result in the creation or strengthening of dominance in the form of tacit collusion. In doing so, the CFI has made it clear that a high standard of proof must be met before we can reach such a conclusion. What I think it has not done, however, is to say that this is as far as Article 2 of the Merger Control Regulation can be stretched in terms of dominance scenarios involving multiple firms. The case before the CFI as we understood it and as the parties understood it was a case of tacit collusion. It was not a unilateral effects case. So my first point is that we do not interpret that judgment as limiting the scope of the unilateral effects theory because that was not the question before the CFI. It was a case of tacit collusion.

Let me address one point Malcolm has made when he talked about methodology. He suggested that the CFI has departed from the traditional way that it reviews these kinds of economic issues. Malcolm suggests that the traditional way is to check whether there are manifest errors of assessment. As far as I see the case, it was one where we could not convince the CFI. One of the main building blocks had been a study of the UK Monopoly and Mergers Commission that was published only two years earlier. The major finding of this study was that a market with four players was sufficiently competitive. In the *Airtours* case, the CFI basically said that if the market has been competitive, then we simplify by saying that the market was “white.” Now, let us look at what the market is with three players—has the market which has been previously white, now becomes black? We have tried, and I recognize we may not be fully clear and convincing here, and I have no problem of taking blame for certain inconsistencies, but our main argument was that the market with four players was already reduced in competition, and the change from four integrated players to three integrated players had an effect of making collusive behavior a real possibility. Actually, this is a problem in any oligopolistic dominance case—it is a decision to make when the market has sufficiently changed—whether to intervene. If you look at an oligopolistic market with five players, is it when you go from five to four, is it if you go from four to three, or three to two, or two to one? Of course, this is a very difficult exercise and, again, I would like to say we have failed to sufficiently clarify these issues.

—GÖTZ DRAUZ

The question concerned the type of punishment mechanism, rather than the necessity of one.

PAUL MALRIC-SMITH: I just wanted to pick up on a few points which I think are important in looking at the *Airtours* case. The first concerns the question whether the Commission tried to introduce some novel theory of collective dominance in the case. When one reads the judgment of the CFI, I think it reflects orthodox theory about the elements that would lead to a finding of tacit coordination amongst a small group of players. The Commission’s theory in this case was not different from the CFI’s position. For example, the Commission’s position was not that punishment mechanisms were unnecessary. There was a question as to what sort of punishment mechanism would be a sufficient one. I think we felt that, for example, the reversion to a more competitive equi-

—PAUL MALRIC-SMITH

librium as a result of cheating could be a punishment mechanism. I think we were well in line with U.S. jurisprudence and thinking on that point. The question concerned the type of punishment mechanism, rather than the necessity of one.

The observation that the Commission could block any collective dominance case that came along on the basis of the theories which we were supposedly developing in this case goes too far. As has been said, there are certainly opportunities to make a draft better and clearer. No doubt those things could be done. As regards fringe competition, we didn't think that this could effectively constrain the parties to the oligopoly if there were a collective dominant position operating and reducing capacity. On the question of growth in the market, the conclusion overall was, and everybody seemed to agree, that the market was growing somewhere in the region of 3 to 4 percent a year. That is not incompatible with a finding of tacit coordination.



F. Enrique Gonzalez-Diaz

My understanding is that the CFI specifically decided not to rule on the unilateral effects issue.

—F. ENRIQUE GONZALEZ-DIAZ

F. ENRIQUE GONZALEZ-DIAZ: I would like to come back to the issue of whether the Commission actually tried to advance a theory of unilateral effects or a theory of tacit collusion, and to what extent the CFI has ruled out the possibility of analyzing a case under a theory of unilateral effects in an oligopolistic market. My understanding is that the CFI specifically decided not to rule on the unilateral effects issue. Airtours developed the argument that the Commission was applying a different test in this case and that this test was not acceptable for a number of reasons. In deciding the case, the CFI has specifically taken care not to rule on this issue and has concentrated on whether or not the conditions for tacit collusion were supported by the facts in this case. The CFI did not thus mean to limit the scope of the Merger Control Regulation to cases of tacit collusion. In that regard, I fully concur with Götz Drauz in reaching the conclusion that this judgment does not close any doors as to how the notion of dominance can be applied in future cases.

MALCOLM NICHOLSON: I have a degree of sympathy with Götz when he says it is a problem when it goes from five to four, or four to three, or three to two. I see that. The fact of the matter is, the way the pleadings in this case developed, the Commission conceded that the market was sufficiently competitive premerger. That it was going from four to three brought about the definitive change and therefore the line of questions of the court—well, what's the difference with four and with three; the factors you've identified, the structural features exist already; and if you're going to constrain capacity, you can do it when there are four players instead of when there are three—that seems to me to be the particular bed the Commission chose to lie on and the court was not happy with it. In relation to collective dominance and the unilateral effects, I am quite clear that, in effect the CFI told the Commission they applied an incorrect test. At the beginning of the section on dealing with this particular case—the particular facts in issue—it sets out the framework that had to be applied in collective dominance cases. That's in paragraphs 61 and 62 of the judgment. I do not want to go over it now, but it's there and that is what it says has to be established for collective dominance. Remember that when we're talking about collective dominance, it is a theory that says the players in the market are so interdependent that they operate as if they were one single monopoly. Now, that's a slight over-simplification, but that is the whole thrust of the analysis. If my Commission colleagues are saying that you are one player of four and you've got a 15–20 percent market share, and the Commission can look and be seeking to identify unilateral effects, then what we said was unilateral effects really corresponds to single-firm dominance—not collective dominance—that's where you look at unilateral effects. As it appeared to us in its original decision, the Commission was intending to depart from the tight and fairly firm test for col-

lective dominance, tacit collusion, coordinated effects as understood in U.S. antitrust law, and rely on incentives and rational behavior. What we were trying to argue in our pleadings was to say incentives and rational behavior are not enough to conclude that the players are acting as if they were a single monopoly. It is intelligent adaptation of behavior in the light of your understanding of what other people could do, and that's not a problem under the competition rules and does not become a problem under the competition rules until such time as you have single-firm dominance.

GÖTZ DRAUZ: I fundamentally disagree with the description of the scenarios that could be the subject of scrutiny in the context of oligopolistic markets. I think that Malcolm is depicting a situation where you either have a single dominant firm charging potentially supracompetitive prices, or you have a group of companies colluding tacitly in the marketplace, with nothing in between these two extremes. And we all know, and there are theories available to support this position, you could still have situations in oligopolistic markets where a concentration could lead to a price increase even if there is no tacit collusion. Current economic theory shows that in the context of oligopoly, a merger could lead to a price increase even in the absence of collusion. In this particular case, the Commission did not advance a theory of one-shot moves based on any of these models. We defended the case on the basis of tacit collusion. It is on this basis that the court has judged the merits of the case. I still believe that we can read this judgment as not closing the door to any future cases advanced on a different basis. It seems to me that we have to agree to disagree because Malcolm feels very strongly about the fact that the court has closed the debate and opened a huge gap in the potential application of Merger Control Regulation to anticompetitive mergers.

I think if anything, this case shows a very strong need for a much more rapid appeals process, and one that certainly goes far beyond the proposal that's been implemented for the fast track procedure.

ALAN OVERD: I think there is no denying that unilateral effects have a key role to play in merger analysis, but I would merely point to the U.S. Merger Guidelines where there is a clear distinction between coordinated effects and unilateral effects. If you reach a position where collective dominance is in one case coordinated effects and in another case coordinated effects plus unilateral effects, or whatever, things get very confused. I think we're mixing up a debate here between what is an appropriate merger control test and how best to apply the test of dominance that we have at the moment. I also think we're missing one of the main points of the judgment, and that is, when Commission decisions are subject to forensic scrutiny by a third party, a number of things can come out of the woodwork. And it's worth stressing that this case took three years for the court to reach a judgment. I think in the discussion of what is the ongoing debate relating to which is preferable—a significant lessening of competition test or dominance test—we should also bear in mind that the institutional arrangements are very important. I think if anything, this case shows a very strong need for a much more rapid appeals process, and one that certainly goes far beyond the proposal that's been implemented for the fast track procedure.

ANDRE FIEBIG: The evidentiary problems that the Commission encountered in the *Airtours* case may stem from the necessity to fit the coordinated effects theory into the dominance test set forth in the Merger Control Regulation. Would the introduction of a substantial lessening of competition test in the Merger Control Regulation solve that problem?

—ALAN OVERD

GÖTZ DRAUZ: I do not necessarily think that changing the substantive test would have an impact on the degree of scrutiny that the court is going to devote to the arguments on the factual evidence. I think that the debate on substantial lessening of competition versus dominance is more

linked to whether or not there is a gap in the Merger Control Regulation or whether or not there is a potential anticompetitive effect arising out of a merger which can be caught by the dominance test. The court is going to be less flexible with the Commission when the Commission assessment is based on a set of facts and findings of economics that it does not share.

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MALCOLM NICHOLSON: I think it is fundamentally important to distinguish the two elements to which substantial lessening of competition may or may not give rise. There may be a major gap in the existing dominance test, which means that you need a new test. What it cannot be used for, and I'm delighted to hear Enrique say that he agrees, is to enable the Commission to substitute lower burdens of proof, lower degrees of substantiation of the theory they are advancing in a given case. You've got to distinguish the theory and the evidencing of the case, and the evidencing of the case must be as rigorous as the court suggests in this case. Otherwise, I think we're all lost.

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QUESTION FROM AUDIENCE: Do you think that *Airtours* has significance in terms of the margin of deference that the CFI will give to the Commission's findings, for example, that competitors would be unable to compete and eventually leave the market segment, and conclusions such as eventual price increases?

in this case.

MALCOLM NICHOLSON: I think the *Airtours* decision shows that in an appropriate case, the CFI is prepared to look very closely at the substance of the case. I think it probably is going to depend on whether it smells a rat. The court needs to read the dossier, read the pleadings, see that this is a real issue, and if they think there is, then they get into it. If they think there is on the facts of *GE/Honeywell* (and we are not involved in it) so I do not know, then, yes, clearly the *Airtours* case shows that they are prepared to do so if they think they need to. There will no doubt be cases where the court decides that there is not that need; there is not enough in the appeal to make it worthwhile to devote that effort. In that case it will not.

Otherwise, I think we're all lost.

—MALCOLM NICHOLSON

GÖTZ DRAUZ: I fully agree this time with Malcolm. I do not think this case represents a fundamental change in the way the CFI is looking at its role. As I said earlier, I think the court was not convinced about the Commission's case. The court was disturbed in a certain way by some inconsistencies and some shortcomings which, again, I fully accept. I think the court under these circumstances decided to have a very close look at the case. And I think in that way it is one of the very helpful outcomes of the court because it reminds everybody that you can only win such a complicated case in a court of law if you can show that you have made a good case and that you have basically adhered to do all the necessary principles. I also believe that the court found it important to emphasize that there is a court of law in the system, and this cannot be and must not be overlooked. I think this is the clear message from *Airtours*.

ANDRE FIEBIG: What is the significance of the *Airtours* case for the application of Article 82 of the EC Treaty? For example, would the punishment activities necessary to support a collective dominance theory constitute abuse under Article 82?

MALCOLM NICHOLSON: I do not necessarily believe that you have to have absolute identity of the definitions of dominance, including collective dominance, in relation to Article 82 of the EC Treaty and the Merger Control Regulation. You can't allow the definitions to depart significantly

because otherwise you get into a terrible confusion. I do not think the punishment mechanism is particularly relevant as an indicator of abuse although it is relevant as a defining feature on whether or not these independent players are acting as if they were a single dominant player. And punishment mechanisms of a sort constitutive of abuse are those directed at third parties outside the collectively dominant players and not, as it were, within the collectively dominant players as a feature constitutive of their position.

PAUL MALRIC-SMITH: I would very much go along with what Malcolm has said. The analysis also has to consider the harm that you are trying to address. In cases of abuse of dominant position, there may be various forms of harm to competition which you might be concerned with.

QUESTION FROM AUDIENCE: In the future, if the Commission is faced with an oligopoly situation and the facts do not support a tacit coordination claim, will the Commission still bring the case or will it still argue that the merger will create a collective dominance position or a single-firm dominance position?

GÖTZ DRAUZ: We have no concrete plans to challenge a transaction on a specific theory. We have to see what kind of cases we get. But I can give you a hypothetical example. Take an oligopoly of four players where the fourth player is the most active company in that market and tries to gain market share by adopting a policy of undercutting the other three. Now, in my example, the largest competitor proposes to acquire the fourth largest, and therefore basically eliminates the player that has a different policy from the other ones. This is a transaction we certainly would carefully consider challenging. By eliminating, if you like, the “active” competitor, it will benefit the three other ones who have, for instance, a similar policy and, therefore, allow them to raise prices by having eliminated that obstacle. That is one scenario. In the first place you will look at the effect unilaterally by buying out this active competitor, and second, you would look at the effect on the remaining oligopoly players.

QUESTION FROM AUDIENCE: In your hypothetical case, what will the last paragraph of your decision read like? Would the decision conclude that the merger is not compatible with the Merger Control Regulation because it creates a dominant position or a joint dominant position?

GÖTZ DRAUZ: In my opinion it probably would call it a joint dominant position. I should also, of course, remind you that the test in the Merger Regulation does not talk about single-dominance or collective dominance. It talks about a creation or strengthening of a dominant position as an effect of which effective competition would be significantly impeded. In other words, I am not sure that the only avenues for the test we have at the moment are to identify single or collective dominance. But I have to say this is a very hypothetical answer on a hypothetical question. I’m quite sincere that we will certainly see that our test here in Europe even without changing it—and a position on that has not been taken; you probably know that Commissioner Monti has made it very clear that for the moment we have an open mind on it—we would try to build as convincing a case as possible and would see whether our courts will follow us in on this approach to bring European law in line with, if you like, basically U.S. law.

QUESTION FROM AUDIENCE: The CFI was careful in its judgment to talk about manifest error and margin of appreciation, at least in relation to market definition. However, the CFI never really

came back to that formulation when looking at the evidence and consequently ended up with an unfamiliar formulation of the Commission not having met the requisite standard of proof. And the question coming out of that is, what in the past has the Commission regarded as the burden of proof, and what do you think the CFI means by that formulation?

PAUL MALRIC-SMITH: The standard, of course, is manifest error. At the end of the day, the CFI came up with a series of errors which added up to a picture they then characterized as not having met the legal standard. I do not think there is a fundamental change in the court's attitude to the burden of proof. I think in this case they obviously have looked very carefully. I think the CFI has made tough judgments for the Commission in the past; in other cases it has certainly made tough decisions against the Commission.

GÖTZ DRAUZ: I do not believe it is a fundamental change by the court.

QUESTION FROM AUDIENCE: Can a single undertaking alone abuse a collectively dominant position under Article 82 of the EC Treaty?

MALCOLM NICHOLSON: It seems to me that if all the conditions for collective dominance are met for the purposes of Article 82 of the EC Treaty, then if one person undertakes action which inures to its benefit and to the benefit of other members of the oligopoly and that action is in some way abusive, then that can involve a breach of Article 82 by that one member of the collectively dominant group. Now, whether or not that's right, I do not know, but that seems to me to be a logical and sensible way of approaching the issue.

QUESTION FROM AUDIENCE: In the United States, it can also be a violation to have a market structure that increases the possibility of interdependence without tacit collusion. I do not think I heard the Commission respond to that. Does the Commission have a position as to whether something less than tacit collusion could be caught by the Merger Regulation?

PAUL MALRIC-SMITH: There could be a case that involves a structure which leads to higher prices without the existence of tacit coordination. In principle that is a possibility.

QUESTION FROM AUDIENCE: I gather from your answers that if the Commission finds the right case it may employ a unilateral effects theory.

PAUL MALRIC-SMITH: That is possible. ●

The Perils of Expert Disclosures in an Electronic World

Geoffrey M. Howard and Thomas S. Hixson

Antitrust litigators spend a lot of time with experts—consulting, discussing, and contributing to the formation of opinions that may tip the balance on a dispositive motion or at trial. Often, a case will require multiple experts on a variety of issues, each supported by one or more “consultants” who help develop raw data, empirical studies, or other analyses. This is familiar terrain. Increasingly familiar as well are the pleasures and perils of electronic discovery, with a particular focus on email and the difficulty of retaining and producing it. But what happens when these two worlds intersect?

Several recent cases illustrate the dangers to litigators of not having produced—or, worse, no longer possessing—documents required to be disclosed under the expert disclosure provisions of Federal Rule of Civil Procedure 26. In these circumstances, lawyers may lose their experts, get sanctioned, and suffer adverse inference instructions at trial. And, under these same recent cases, it is no longer safe for counsel to rely on arguments that they acted in good faith and without violating a prior court order.

Trigon Insurance Co. v. United States, 204 F.R.D. 277 (E.D.Va. 2001), provides a starting point for this analysis. *Trigon* was a taxpayer suit against the United States, in which the government made the decision to retain Analysis Group/Economics (AGE) as a litigation consultant and then use two employees affiliated with AGE—one of its managers and one of its principals—as testifying experts. The AGE firm acted as a litigation consultant, it paid the fees of the testifying experts (and was in turn reimbursed by the government), it communicated with the testifying experts, and it participated heavily in drafting the testifying experts’ Rule 26 reports. However, AGE and the testifying experts did not retain many of the communications between AGE and the testifying experts, nor did they retain many of the experts’ draft reports. AGE and the testifying experts stated that this was pursuant to their normal document retention practice; and indeed, normally the internal communications within a firm acting as a litigation consulting expert would not fall within the expert disclosure requirements of Rule 26(a)(2)(B).

The problem for AGE was that two employees affiliated with the firm were also acting as testifying experts, and that dual role rendered the communications with those experts, and the draft reports sent to or from those experts, subject to mandatory disclosure. The plaintiff, *Trigon*, moved to compel production of those communications and drafts. When it became clear to the court “that a substantial amount of potential evidence had been destroyed,” *id.* at 281, the court ordered the government to hire an independent computer forensics expert to retrieve as much as possible from AGE’s and the experts’ computers. Deloitte & Touche was able to recover hundreds of communications and many draft reports (embarrassingly for AGE, which had represented that recovery was impossible), but not enough. The court found that the document destruction was sufficiently serious that it undermined

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Trigon's ability to cross-examine the government's experts, and it ordered sanctions in the form of an adverse inference instruction at trial.

The reasoning of the *Trigon* court, and other recent cases involving similar issues, have several important implications for expert disclosures, as discussed below.

What to Give the Expert

The first rule of thumb in dealing with a testifying expert is that every document the expert "considers" will have to be disclosed under Rule 26(a)(2)(B) and is of course fair game for a document request. "Considers" does not mean "relies upon." The drafters of the 1993 amendment to Rule 26 had originally proposed that the expert disclosure obligations extend only to "the data or other information relied upon in forming such opinions,"¹ but the Rule as adopted replaced "relied upon" with "considered." As the *Trigon* court explained, "as a consequence of the 1993 amendments, disclosure simply includes all documents that were provided to and reviewed by the expert." 204 F.R.D. at 283; see also *In re Pioneer Hi-Bred International, Inc.*, 238 F.3d 1370, 1375 (Fed. Cir. 2001) (also holding that Rule 26 requires disclosure "whether or not the expert relies on the documents and information in preparing his report").

Courts have held that the term "considers" in Rule 26 should be construed broadly, and that there is "no distinction between *reviewing* a document and *considering* a document" because such a distinction "could become too easy a dodge." *Simon Property Group L.P. v. mySimon, Inc.*, 194 F.R.D. 644, 649–50 (S.D. Ind. 2000) (emphasis supplied). See also *In re Tri-State Outdoor Media Group, Inc.*, 283 B.R. 358, 364–65 (Bankr. M.D. Ga. 2002) ("[W]hen an expert has read or reviewed privileged materials before or in connection with formulating their opinion, the expert witness is deemed to have 'considered' the materials to satisfy Rule 26(a)(2)(B).").

Further, some courts find that the act of supplying a document to the testifying expert creates a rebuttable presumption that the expert "considered" it, shifting the burden to the party who retained the expert to prove that the document was not considered and therefore does not fall within the mandatory disclosure provisions in Rule 26(a)(2)(B). See *Musselman v. Phillips*, 176 F.R.D. 194, 202 (D. Md. 1997); cf. *Lamonds v. General Motors Corp.*, 180 F.R.D. 302, 306 (W.D. Va. 1998) ("There is no evidence that the experts received, but did not read, reflect on, or think about the memoranda.").

The *Trigon* court's willingness to apply this bright-line rule to the situation before it illustrates a problem with using a consulting firm as a source of both consulting and testifying experts. Normally, the internal communications within a consulting firm (or consultants' communications with counsel) would fall outside of the mandatory disclosures in Rule 26(a)(2)(B). But once one of the recipients or senders of an email or a draft document is someone who ends up becoming a testifying expert, that communication or document must be disclosed. Thus, the convenience of using well-educated consulting experts at trial carries the potential downside of rendering discoverable essentially all of the important communications and work product that the consultants have developed.

That exact situation existed in *United States Fidelity & Guaranty Co. v. Braspetro Oil Services Co.*, 2002 WL 15652 (S.D.N.Y. Jan. 7, 2002), where the defendants furnished their consulting

¹ *Preliminary Draft of Proposed Amendments to the Federal Rules of Civil Procedure and the Federal Rules of Evidence*, 137 F.R.D. 53, 89 (1991).

experts with more than a million documents, including privileged materials. Because the same firm doubled as both consulting and testifying experts, and because there was “no evidence supporting Defendants’ bare assertion that certain documents were reviewed by the experts solely in a consultative capacity,” and no evidence that the defendants tried to limit access to the documents at issue only to consultative purposes, the dual consulting-testifying expert roles rendered all of the documents discoverable. *Id.* at *6.

Nor does the attorney-client privilege or work product doctrine necessarily help: the disclosure obligation in Rule 26(a)(2)(B) may trump those protections. *See United States Fidelity & Guaranty Co.*, 2002 WL 15652 at *5. *Trigon* is in line with other cases in finding a per se waiver for any document or communication that the testifying expert considers. *See, e.g., In re Pioneer Hi-Bred International, Inc.*, 238 F.3d 1370, 1375 (Fed. Cir. 2001) (“[W]e are quite unable to perceive what interests would be served by permitting counsel to provide core work product to a testifying expert and then to deny discovery of such material to the opposing party.”); *Herman v. Marine Midland Bank*, 207 F.R.D. 26, 29 (W.D.N.Y. 2002) (noting that “the overwhelming majority of district courts” have held that the expert disclosure requirement in Rule 26(a)(2)(B) “trumps the substantial protection otherwise accorded opinion work product”).

Litigators who designate a client as a testifying expert should explore how to plausibly narrow the categories of information that could be deemed “in connection with” the client’s expert testimony.

In fact, the per se waiver rule was apparently intended by the drafters of the current Rule 26. The Advisory Committee Note to the 1993 Amendments to Rule 26 states that under the current Rule 26(a)(2)(B), “litigants should no longer be able to argue that materials furnished to their experts to be used in forming their opinions—whether or not ultimately relied upon by the expert—are privileged or otherwise protected from disclosure when such persons are testifying or being deposed.”

This waiver rule is also something to consider before designating a client as a testifying expert. *Kooima v. Zacklift Int’l, Inc.*, 209 F.R.D. 444 (D.S.D. 2002), held the per se waiver rule applicable even when the litigant was himself the expert, resulting in a presumably sweeping waiver of the privilege: “Because Plaintiff has designated himself as an expert . . . all documents and information disclosed to him (including correspondence from his attorneys) in connection with his anticipated expert testimony are discoverable.” *Id.* at 447. Litigators who designate a client as a testifying expert should explore how to plausibly narrow the categories of information that could be deemed “in connection with” the client’s expert testimony.² Opposing counsel will likely see a potentially valuable way to stick their nose under the tent and learn as much as possible about a lawyer’s case strategy and legal theories. To prevent a wholesale waiver of the privilege, a smart lawyer will separate emails dealing with the client’s planned testimony from other communications. In the context of a motion to compel, there may be other options available, such as *in camera* review, that can let the court determine for itself which documents must be disclosed under Rule 26.

What Must Be Retained

The second rule of thumb in dealing with a testifying expert is to make sure the expert retains every “considered” document. This requires giving thought at the outset of the case as to whether the expert may ultimately testify and, if so, to create or appropriately modify document retention

² *See Simon Property Group*, 194 F.R.D. at 650 (furnishing privileged documents to the testifying expert did not mandate finding waiver of privilege where documents “simply had nothing to do” with the expert’s testimony); *cf. B.C.F. Oil Refining, Inc. v. Consolidated Edison Co. of N.Y., Inc.*, 171 F.R.D. 57, 60 (S.D.N.Y. 1997) (Rule 26(a)(2)(B) does not mandate disclosure of documents supplied to testifying expert that “have nothing to do with the preparation of his expert report or his expert testimony”).

policies. Non-testifying experts who communicate with the testifying expert may need to take similar steps to retain their related documents. In *Trigon*, for example, the court held that the defendant had an obligation to ensure that communications between the consulting experts (AGE) and the testifying experts were retained, and it rejected the defendant's attempt to "scapegoat AGE's document retention policy." 204 F.R.D. at 289. The court noted that "AGE holds itself out to have expertise in litigation consulting," and it charged AGE with knowing its obligation to preserve communications and documents that the testifying experts reviewed. *Id.* Considering that AGE was not, in fact, the testifying expert (although it was affiliated with some of them), that obligation might not have been obvious. The problem was that AGE communicated with (and was affiliated with) the testifying experts, and that changed what might otherwise have been a legal document retention policy into one whose "rather obvious effect, and perhaps even the purpose . . . was to eliminate this source of undeniably meaningful cross-examination resource about the substance of the expert opinions and about the ghost writing of the opinions." *Id.* at 290.

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A concomitant lesson of *Trigon* is the scope of what litigators and experts must retain for discovery. The rule is simple: "The document retention policies of [the expert] do not trump the Federal Rules of Civil Procedure." *Trigon*, 204 F.R.D. at 289. The testifying expert must retain the documents and communications he considers in the course of forming his opinion. Implementing this rule with electronic documents is not always simple, however. Consider the common practice of testifying experts, sometimes encouraged by counsel, of saving new versions of a report over old versions, so that in the end only one electronic version of the expert's report exists. This practice appears to violate Rule 26(a)(2)(B), at least as to draft reports that reflect input from counsel or anyone other than the expert himself³: every time the author saves over the old version, he is destroying a draft expert report, which necessarily discusses "data or other information considered by the witness" in forming his ultimate opinion and, therefore, must be disclosed under Rule 26. Since in most cases it would be easy to alter this document retention policy in order to retain drafts of the expert report, it's unlikely that this practice would withstand scrutiny under Rule 26.

If documents that fall within Rule 26(a)(2)(B) have not been retained, litigators then must demonstrate that the documents would not have benefited the opposing party anyway—an uphill argument that courts view with suspicion. As discussed in the next section, courts are quick to infer that missing documents would have provided fuel for cross-examining the expert. So, if for some reason documents are not retained, counsel should give the best possible explanation and be prepared for opposing counsel's fireworks. Consider *Texas Instruments, Inc. v. Hyundai Electronics Indus. Co.*, 190 F.R.D. 413 (E.D. Tex. 1999), in which TI's expert scribbled notes while inspecting computer equipment in a "clean room," in which "human visitors" were required "to protect the sensitive equipment" by wearing "bulky suits, gloves, and helmets." *Id.* at 419 n.12. The expert threw away his notes, explaining that it was hard to write legibly in that environment, and the court declined to impose sanctions after finding that the expert's notes were duplicative of other, legible notes that were produced in the case. TI won that discovery battle, but the fact that Hyundai was willing to fight so hard to obtain sanctions for the loss of illegible scribbles illustrates that litigators should assume that any loss of documents will be presented in the worst possible light.

³ *Trigon* left open the question of whether the disclosure obligations in Rule 26(a)(2)(B) apply to "drafts prepared solely by that expert while formulating the proper language in which to articulate that expert's own, ultimate opinion arrived at by the expert's own work or those working at the expert's direction." 204 F.R.D. at 283 n.8.

Sanctions

In the event that the court finds that a party's expert disclosures were not sufficient, the issue becomes what remedies, if any, the court will impose. As with other discovery sanctions, the appropriate remedy for a violation of expert disclosure obligations is within the discretion of the district court. Courts commonly balance competing goals in deciding the appropriate sanction. In addition to the normal factors of intent, bad faith, and prejudice, courts evaluate other case-specific issues, such as whether the nature of the lawsuit requires some kind of expert testimony in order for the trial to be meaningful, or the relative importance of the electronic evidence when viewed in the case as a whole. *See, e.g., Trigon*, 204 F.R.D. at 289–91; *Texas Instruments*, 190 F.R.D. at 419–20; *Residential Funding Corp. v. DeGeorge Financial Corp.*, 306 F.3d 99, 107–10 (2d Cir. 2002). Generalizations about the appropriate remedy for a particular type of discovery violation are complicated because the timing of the violation can be significant: “[A]s a discovery deadline or trial date draws near, discovery conduct that might have been considered ‘merely’ discourteous at an earlier point in the litigation may well breach a party’s duties to its opponent and to the court.” *Residential Funding Corp.*, 306 F.3d at 112.

In the realm of expert disclosures, courts may impose sanctions without any showing of bad faith or violation of a prior discovery order.

In the realm of expert disclosures, courts may impose sanctions without any showing of bad faith or violation of a prior discovery order. *Trigon* is in line with the Second Circuit and the Ninth Circuit in finding that sanctions can be appropriate for a discovery violation even when a litigant did not violate a prior discovery order and did not act in bad faith. *Trigon* relied on a long line of Supreme Court cases to hold that a court’s power to remedy spoliation of evidence (there, the failure to retain communications with the expert and draft expert reports) is “inherent” and exists “even absent an antecedent order.” 204 F.R.D. at 285. *Trigon* acknowledged that a finding of spoliation requires a showing that the litigant intentionally destroyed evidence, but the court refused to equate “intentional” with “bad faith.” The court explained, “Reference to the intentional destruction of documents does not imply that bad faith is necessary for the imposition of sanctions for spoliation.” *Id.* at 287.

The Ninth Circuit has also rejected the argument that either bad faith (or willfulness or fault), or violation of a prior discovery order, is necessary in order to justify a sanction for failing to comply with expert disclosure obligations. In *Yeti by Molly Ltd. v. Deckers Outdoor Corp.*, 259 F.3d 1101 (9th Cir. 2001), the court held that a finding of bad faith is unnecessary for a sanction “less than a dismissal.” *Id.* at 1106.⁴ *Yeti* involved a rebuttal expert report that was submitted two years after the close of discovery, a year after the report it was supposedly rebutting, and a mere twenty-eight days before trial. The court noted that Rule 37(c)(1) provides that a litigant that does not comply with the expert disclosure requirements in Rule 26(a) is not permitted to use the evidence at trial unless its failure to disclose was substantially justified or harmless. The court’s opinion is significant in that it characterizes exclusion under Rule 37(c)(1) as an “automatic” and “self-executing” sanction, and the opinion bears out that characterization: After holding that there is no bad faith requirement for an exclusion sanction, the court simply dropped the issue of culpability and moved on to whether the litigant could demonstrate substantial justification or harmlessness (it couldn’t).

⁴ In general, some showing of culpability, such as bad faith or gross negligence is necessary for a terminating discovery sanction. *See, e.g., Hairston v. Alert Safety Light Prods., Inc.*, 307 F.3d 717 (8th Cir. 2002); *Fair Housing of Marin v. Combs*, 285 F.3d 899, 905 (9th Cir. 2002), *petition for cert. filed*, 71 U.S.L.W. 3169 (Aug. 30, 2002) (No. 02-332).

Yeti's statement that exclusion of expert testimony is an "automatic" sanction for an untimely expert report is in tension with Rule 37(c)(1)'s statement that a court may impose other sanctions "in lieu of" exclusion. Other courts have indicated that the exclusion of expert testimony based on a defective report is not automatic, but is an act of discretion, requiring the district court to weigh the importance of the testimony, the likely effect that exclusion would have on the trial, and the litigants' good or bad faith. See *Jacobsen v. Deseret Book Co.*, 287 F.3d 936, 952–54 (10th Cir. 2002), *petition for cert. filed*, 71 U.S.L.W. 3247 (Sept. 23, 2002) (No. 02-482); *Konstantopoulous v. Westvaco Corp.*, 112 F.3d 710, 719 (3d Cir. 1997). *Yeti* did not rule out the existence of such discretion, but it suggests that if the district court opts for the default sanction of exclusion, the Ninth Circuit, at least, might not fault the district court for failing to consider other possible remedies. Still, given the plain language of Rule 37, a district court might make an initial determination that the exclusion of expert testimony is an unduly drastic remedy. See, e.g., *Burton v. R.J. Reynolds Tobacco Co.*, 203 F.R.D. 636 (D. Kan. 2001) (plaintiff filed untimely supplemental expert reports, had no justification, and could not prove harmlessness; nonetheless, only monetary sanctions appropriate because striking expert disclosures would be too drastic); *but see Yeti*, 259 F.3d at 1106 (automatic sanction of exclusion appropriate even though "the district court made it much more difficult, perhaps almost impossible," for defendant to rebut plaintiff's damages calculations).⁵

The Second Circuit took a similar view to *Trigon* and *Yeti* in *Residential Funding Corp. v. DeGeorge Financial Corp.*, 306 F.3d 99 (2d Cir. 2002), although the case did not involve expert disclosures. In that case, the plaintiff, RFC, dragged its feet in producing emails to the defendant, DeGeorge. For about four-and-a-half months, RFC made representations that it was working diligently to obtain email from its back-up tapes and that it had retained an outside vendor to search through the tapes. On the eve of trial, RFC still had not produced any emails from the time frame relevant to the case, and it asserted that it was not possible to obtain them from its tapes. RFC turned over the tapes to DeGeorge three days before trial, and DeGeorge's outside vendor was able to retrieve 950,000 emails from the relevant time frame in the span of only four days. The sheer quantity of late-produced information rendered all of it unusable at trial. After RFC prevailed on a \$96.4 million verdict, DeGeorge asked for sanctions in light of RFC's foot-dragging. The district court declined to impose sanctions because although it found that RFC had been "purposefully sluggish" in producing emails, there was no evidence of bad faith.

The court of appeals disagreed, holding that "discovery sanctions, including an adverse inference instruction, may be imposed where a party has breached a discovery obligation not only through bad faith or gross negligence, but also through ordinary negligence." *Id.* at 101. In the Second Circuit's view, "purposeful sluggishness" was enough, and it was no defense that RFC had not violated any specific discovery order. The court of appeals sent the case back to the district court to determine what sanctions were appropriate given the evidence now available to the parties. *Residential Funding Corp.* thus represents a potential nightmare for the successful litigant at trial who has not fully complied with its obligation to produce documents in pretrial discovery—potentially putting at risk a large jury verdict because of discovery abuse.

⁵ Note that if an expert is excluded from testifying based on a failure to comply with Rule 26(a)(2)(B), a court may also prevent other, proper experts from testifying about draft reports they received from the excluded expert. See *Starling v. Union Pacific R.R.*, 203 F.R.D. 468, 480 (D. Kan. 2001).

Residential Funding Corp. also shows that courts are becoming increasingly comfortable with electronic discovery and intolerant of litigants unwilling to make use of available technology to expedite document production. The court viewed the existence of outside vendors with expertise in electronic document retrieval not as a convenience for the litigants, but as an obligatory tool in the discovery process. Indeed, the failure to use it with sufficient speed was a sanctionable offense.

These cases do not mean, however, that intent or bad faith have no role in the assessment of sanctions for failure to make proper expert disclosures. First, *Trigon's* view, and that of the Second and Ninth Circuits, that discovery sanctions may be imposed absent bad faith or violation of a prior discovery order is not shared by every court. The Sixth Circuit, for example, requires bad faith as a precondition for issuing sanctions under its inherent powers, although the district court need not make a specific finding of bad faith, if the facts demonstrate its existence. See *First Bank of Marietta v. Hartford Underwriters Insurance Co.*, 307 F.3d 501 (6th Cir. 2002). The Seventh and Eighth Circuits require both bad faith and a violation of a prior discovery order. See *Crabtree v. National Steel Corp.*, 261 F.3d 715, 720 (7th Cir. 2001) (citing *Phillips Medical System International, B.V. v. Bruetman*, 982 F.2d 211, 214 (7th Cir. 1992)); *Chrysler Corp. v. Carey*, 186 F.3d 1016, 1019 (8th Cir. 1999), and the Fifth Circuit requires a finding of bad faith. See *Advanced Display System, Inc. v. Kent State University*, 212 F.3d 1272, 1288 (Fed. Cir. 2000) (applying Fifth Circuit law and citing *Chavez v. M/W Medina Star*, 47 F.3d 153, 156 (5th Cir. 1995)), *cert. denied*, 532 U.S. 904 (2001). But see *United States v. Russell*, 109 F.3d 1503, 1511 (10th Cir. 1997) (bad faith not necessary for a discovery sanction).

Second, and perhaps more importantly, scienter can be an important question in determining the appropriate remedy to impose. The Tenth Circuit has held that in the absence of bad faith, the district court should impose the least severe sanction that will result in compliance with discovery obligations. See *United States v. Golyansky*, 291 F.3d 1245, 1249 (10th Cir. 2002).⁶

As to the specific sanction of an adverse inference instruction at trial, *Trigon* followed Fourth Circuit case law in holding that negligent loss or destruction of documents is not enough to support an adverse inference instruction as a sanction. See *Vodusek v. Bayliner Marine Corp.*, 71 F.3d 148, 156 (4th Cir. 1995) (“An adverse inference about a party’s consciousness of the weakness of his case . . . cannot be drawn merely from his negligent loss or destruction of evidence; the inference requires a showing that the party knew the evidence was relevant to some issue at trial and that his willful conduct resulted in its loss or destruction.”). So while bad faith might not be necessary for a discovery sanction, “some quantum of blameworthiness is required before sanctions for spoliation may obtain.” *Trigon*, 204 F.R.D. at 287. The Seventh Circuit has likewise held that an adverse inference instruction requires a showing that the document destruction or non-production was conducted in bad faith. See *Park v. City of Chicago*, 297 F.3d 606, 615 (7th Cir. 2002).

Residential Funding Corp. similarly embraced the view that an adverse inference instruction requires at least some level of scienter, although it ratcheted down the necessary level of culpability. The court held that “bad faith alone is sufficient circumstantial evidence . . . that the missing evidence was unfavorable to that party,” 306 F.3d at 109, but the court added that gross negligence in the untimely production of evidence will “in some circumstances suffice, standing

The court viewed the existence of outside vendors with expertise in electronic document retrieval not as a convenience for the litigants, but as an obligatory tool in the discovery process. Indeed, the failure to use it with sufficient speed was a sanctionable offense.

⁶ Note that under the Tenth Circuit’s view, good faith, standing alone, “would not be enough” to avoid discovery sanctions altogether for failing to submit proper expert disclosures. See *Jacobsen*, 287 F.3d at 954.

alone, to support a finding that the evidence was unfavorable to the grossly negligent party.” *Id.* That’s a significant holding when read in context: *Residential Funding Corp.* was not a spoliation case; the sanctionable misconduct consisted of the sluggish production of emails. And while the focus of the court’s opinion was on the fact that the delay in production rendered the evidence unavailable for trial, the “sluggish” time frame involved was not particularly unusual—less than five months to produce nearly a million emails.

Conclusion

Electronic communication and information storage present obvious opportunities for litigants in developing and challenging sophisticated expert testimony for trial. But they also present serious risks for counsel and experts not conversant in the requirements on Rule 26(a)(2)(B). Because antitrust cases typically require multiple experts, and a support system of consultants contributing to the development of those experts’ opinions, *Trigon* and related cases pose particular obstacles. In dealing with a testifying expert, counsel should be careful what documents they provide to the expert, since they will likely become discoverable, notwithstanding their former status as privileged or work product. Counsel should also ensure that the experts understand their obligation to retain every document they considered in the course of preparing their testimony, a burden that can be greatly expanded when the testifying expert is also, or is affiliated with, the consulting expert. And, finally, in the event that the litigator does not comply with Rule 26(a)(2)(B), the parties should be aware of the broad discretion a district court has to impose sanctions, sometimes even without a specific finding of bad faith or violation of a prior discovery order. ●

New Dawn for Forum Shopping: The Implications of *Vornado*

Robert P. Taylor

The decision of the U.S. Supreme Court in *Holmes Group, Inc. v. Vornado Air Circulation Sys.*, 122 S. Ct. 1889 (2002), marks a major shift in the relative responsibilities of the various circuits courts of appeals for handling patent cases. On first reading, the decision appears to be a routine interpretation of Title 28 (the portion of U.S. Code dealing with “Judiciary and Judicial Procedure”), determining only whether the Federal Circuit may exercise jurisdiction over an appeal from an order dismissing a trade dress claim. On further reflection, however, *Vornado* is a disruptive departure from settled procedural rules that have defined the jurisdictional divide between the regional circuits and the Federal Circuit for twenty years.

The *Vornado* decision reverses a jurisdictional practice, widely used by both the Federal Circuit and the regional circuits, that placed appellate jurisdiction in the Federal Circuit for any case in which either the original complaint or a properly pleaded counterclaim was based on a patent claim. In holding that Federal Circuit jurisdiction exists only where the complaint itself raises a substantial question of patent law, the *Vornado* ruling invites the regional circuits to expand their own role in defining rules of patent law and related areas of jurisprudence such as antitrust and unfair competition. This alone portends revival of the fine art of forum shopping in patent cases. The decision also unsettles a number of other procedural rules in ways that may take years to sort out.¹

The most interesting (and unanswered) question about *Vornado* is why the Supreme Court took interest in overruling a twenty-year old procedural rule that was relatively uncontroversial. At least one pair of commentators views the decision as a considered but unstated effort by the Supreme Court to reassess the singular and growing influence of the Federal Circuit in all matters related to patents.² Certainly the importance of the Federal Circuit has grown to proportions not envisioned when the court was created. The U.S. economy has doubled in size over the past twenty years. By any measure chosen, the economic significance of patents during the same period has increased several fold—the value of patents as corporate assets, the number and moment of patent lawsuits, or simply the presence of patent lawyers in corporate boardrooms and major financial transactions. This growing impact of patents has been the subject of much discussion in policy circles, prompted to some

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¹ The Supreme Court of Indiana, for example, recently construed *Vornado* as holding that the state courts of Indiana are compelled to litigate a copyright claim that arose in connection with a contract dispute, notwithstanding 28 U.S.C. § 1338, which gives to the federal district courts exclusive jurisdiction over copyright claims. See *Green v. Hendrickson Publishers, Inc.*, 770 N.E. 2d 784 (Ind. 2002).

² Bruce M. Wexler & Joseph M. O'Malley, Jr., *Deciding Jurisdiction in Patent Appeals: U.S. Supreme Court Vacates Federal Circuit Ruling and Opens Door to Forum Shopping*, N.Y. L.J., Aug. 12, 2002.

extent by the Federal Circuit's decision a few years ago to develop its own jurisprudence and no longer to use that of the regional circuits in resolving the interplay between patent law and antitrust law.³

Historical Background

Before considering *Vornado* and its implications, some history is useful. Prior to the creation of the Federal Circuit, procedural maneuvering for the choice of forum in patent cases was epidemic. An expensive venue fight was the norm in many if not most important patent cases. This strategic concern over forum selection was driven largely by widely disparate patent enforcement records among the regional circuits. Some circuits were thought to be biased in favor of, and other circuits heavily against, finding for the patent owner on issues of validity, infringement, and the antitrust-inspired defense of patent misuse. In that environment, the choice of a district court became critical because it determined which of the regional circuits would hear an ultimate appeal, and the choice of a regional circuit was thought likely to determine the winner.

In 1982, Congress created the United States Court of Appeals for the Federal Circuit specifically to reduce the impact of forum shopping in patent cases. The Senate Report on the Act identified "patent law as an area in which the application of the law to the facts of a case often produces different outcomes in different courtrooms in substantially similar cases."⁴ A centralized national court was given exclusive appellate jurisdiction to hear cases arising under the patent law to insure "nationwide uniformity in patent law . . . make litigation results more predictable and . . . eliminate the expensive, time-consuming, and unseemly forum-shopping that characterizes litigation in the field."⁵ By concentrating all patent appeals in a single appellate court, Congress hoped to achieve nationwide uniformity in the application of patent law and thereby eliminate the expensive and contentious venue fights that characterized most important patent cases.⁶

To a large extent, the Federal Circuit has been successful in achieving both the congressional objective of uniformity in the patent law and a significant reduction in the efforts spent by litigants seeking to influence the choice of forum. With virtually all patent litigation now making its way to the Federal Circuit, the need for strategic posturing designed to secure the most desirable

By concentrating all patent appeals in a single appellate court, Congress hoped to achieve nationwide uniformity in the application of patent law and thereby eliminate the expensive and contentious venue fights that characterized most important patent cases.

³ See, e.g., *Nobelpharma AB v. Implant Innovations, Inc.*, 141 F.3d 1059, 1068 (Fed. Cir. 1998) (determining without reliance on regional circuit precedent that withholding information from the U.S. Patent Office with an intent to deceive was sufficient to support the jury's finding of an antitrust violation); *CSU L.L.C. v. Xerox Corp.*, 203 F.3d 1322 (Fed. Cir. 2000) (using its own law in upholding summary judgment that a patent owner's unilateral refusal to license or sell was not a violation of antitrust law). See *Symposium: The Federal Circuit and Antitrust*, 69 ANTITRUST L.J. 3 et seq. (2002); Robert Pitofsky, *Challenges of the New Economy: Issues at the Intersection of Antitrust and Intellectual Property*, 68 ANTITRUST L.J. 913 (2001); Timothy J. Muris, FTC Chairman, *Competition and Intellectual Property Policy: The Way Ahead*, Remarks Before American Bar Association Antitrust Section Fall Forum (Nov. 15, 2001).

⁴ S. REP. NO. 97-275 at 5 (1981), reprinted in 1982 U.S.C.C.A.N. 11, 15.

⁵ COMM. ON THE JUDICIARY, REPORT ON THE COURT OF APPEALS FOR THE FEDERAL CIRCUIT ACT OF 1980 TO ACCOMPANY H.R. 3806, H. REP. NO. 96-1300 at 18-21 (1980) ("At present, the validity of a patent is too dependent upon geography (i.e., the accident of judicial venue) . . . [U]niformity in the law that will result from the centralization of patent appeals in a single court will be a significant improvement from the standpoint of the industries and businesses that rely on the patent system. Business planning becomes easier as more stable and predictable patent law is introduced").

⁶ See *Atari, Inc. v. JS & A Group, Inc.*, 747 F.2d 1422, 1437 (Fed. Cir. 1984) (en banc) (quoting congressional reports to show that the vesting of exclusive jurisdiction in the Federal Circuit "was intended to alleviate the serious problems of forums [sic] shopping among the regional courts of appeals on patent claims").

appellate court is no longer the principal concern of most litigants. While there remains considerable interest in making sure that litigation occurs in a convenient forum, the incentive for racing to the courthouse or otherwise provoking a venue fight is a fraction of what it was a few years ago.⁷

Federal Circuit Jurisdiction

The jurisdiction of the Federal Circuit is defined by statute in the terms of the original jurisdiction of the district court from which the appeal is taken. Under 28 U.S.C. § 1295, the Federal Circuit is given exclusive jurisdiction of any appeal from a case in which jurisdiction in the district court “was based, in whole or in part, on [28 U.S.C. §] 1338.” Section 1338 provides that the district courts have original and exclusive jurisdiction over “any civil action arising under any Act of Congress relating to patents,” among other things. This statutory scheme necessarily requires that both the Federal Circuit and the regional circuits act harmoniously to define jurisdictional boundaries.

Much of the success of the Federal Circuit in achieving uniformity in patent law has come about because both the Federal Circuit and the regional circuits have made this one of the underlying objectives in defining their shared jurisdictional boundary. The Federal Circuit assumed or was ceded jurisdiction over appeals in many cases that were not strictly patent infringement cases, as long as the case presented significant issues of patent law that required resolution. In so doing, the Federal Circuit confined its own independent jurisprudence to those rules of law necessary for a uniform construction and application of Title 35 (the Patent Act), applying the law of the appropriate regional circuit to procedural and nonpatent issues that were presented.⁸

⁷ The current interest of litigants in the selection of a suitable district court for patent litigation, while still driven by a desire to influence outcome, is usually less related to substantive rules of law than to more indirect considerations. Some districts are thought to have more patent expertise than others. Some districts—the so-called rocket docket—offer an opportunity for getting a case to trial more quickly than in other districts. For some litigants, the right to a local jury is an overriding concern. The cost and inconvenience of litigating on the opposite side of the continent has been a factor for many litigants.

⁸ *See, e.g.,* *Truswal Sys. Corp. v. Hydro-Air Eng'g, Inc.*, 813 F.2d 1207, 1212 (Fed. Cir. 1987) (applying Federal Circuit law to determination of relevance under Rule 26(b)(1) in a patent infringement suit); *Atari, Inc. v. JS & A Group, Inc.*, 747 F.2d 1422, 1439–40 (Fed. Cir. 1984) (en banc) (applying Seventh Circuit law to issue of copyright infringement); *Panduit Corp. v. All States Plastic Mfg. Co.*, 744 F.2d 1564, 1574–75 (Fed. Cir. 1984) (holding that regional circuit law applied to an appeal from an order disqualifying a law firm).

The Federal Circuit initially applied the law of the regional circuits to the so-called “interface” issues that arise when patent law must be reconciled with antitrust law or the principles of competition that underlie antitrust law. *See, e.g.,* *Am. Hoist & Derrick Co. v. Sowa & Sons, Inc.*, 725 F.2d 1350, 1366–67 (Fed. Cir. 1984) (applying Ninth Circuit law in determining whether fraud on the U.S. Patent Office was sufficiently established to support antitrust and unfair competition claims). More recently, however, the Federal Circuit began to develop its own jurisprudence for such issues. *See, e.g.,* *Nobelpharma AB v. Implant Innovations*, 141 F.3d 1059, 1068 (Fed. Cir. 1998) (applying Federal Circuit law to affirm jury finding that fraud on the Patent Office rose to a level sufficient to uphold verdict of attempted monopolization); *CSU L.L.C. v. Xerox Corp.*, 203 F.3d 1322 (Fed. Cir. 2000) (using Federal Circuit law to uphold summary judgment ruling that a patent owner’s unilateral refusal to license or sell was not a violation of antitrust law).

Although somewhat controversial, that change in course is consistent with the Federal Circuit’s congressional mandate of achieving nationwide uniformity in the handling of issues that affect the outcomes of patent cases. In *Nobelpharma*, for example, the Federal Circuit noted:

Because most cases involving these issues will therefore be appealed to this court, we conclude that we should decide these issues as a matter of Federal Circuit law, rather than rely on various regional precedents. We arrive at this conclusion because we are in the best position to create a uniform body of federal law on this subject and thereby avoid the “danger of confusion [that] might be enhanced if this court were to embark on an effort to interpret the laws” of the regional circuits.

141 F.3d at 1068.

More compelling, perhaps, is the increasing difficulty in trying to glean sensible rules of law for current use from what a regional circuit might have said or done twenty or more years ago. When the Federal Circuit was created, the “recent” experience with these issues lay in the regional circuits. Today, the bulk of these issues occur in cases that the Federal Circuit is handling, and the bulk of current experience resides with that court. In the intervening twenty years, antitrust law has gone through changes that relegate many of the older cases to

Over the twenty-year history of the Federal Circuit, dozens of cases taken collectively have established this well-settled and comfortable channel through which any case that required resolution of substantial patent law issues was likely to be given to the Federal Circuit for decision. A few exemplary cases illustrate the key points at which *Vornado* unsettles the law and invites new attention to procedural posturing.

The decisions of the Ninth and Federal Circuits in *In re Innotron Diagnostics*, 800 F.2d 1077 (Fed. Cir. 1986), marked a major milestone in early efforts at dividing jurisdiction. The case began as a simple antitrust complaint alleging that the defendant, Abbott Laboratories, tied its patented blood analyzer to the sale of reagents. Abbott then filed a separate lawsuit for patent infringement in the same court. The antitrust plaintiff moved for dismissal of the patent case, arguing that it was a compulsory counterclaim in the antitrust case. In lieu of dismissing, and apparently with the approval of the antitrust plaintiff, the district court consolidated the two cases under Rule 42, Federal Rules of Civil Procedure. Thereafter, the district court stayed the antitrust case to await trial of the patent case. The antitrust plaintiff sought a writ of mandamus in the Ninth Circuit, which refused to accept jurisdiction. The Federal Circuit assumed jurisdiction of the petition and denied the writ, holding that the district court had not abused its discretion. In agreeing with the Ninth Circuit that jurisdiction belonged in the Federal Circuit, the latter court relied on the fact that the patent case was clearly within its jurisdiction as a result of the initial filing, stating that the act of consolidating the patent case with the antitrust case should not alter the analysis. The Federal Circuit relied specifically on the “in whole *or in part*” language in Section 1295. *Innotron*, 800 F.2d at 1079–80.

In *Christianson v. Colt Industries*, 486 U.S. 800, 806 (1988), the Supreme Court held that the Federal Circuit did not have jurisdiction over an appeal from an order in a monopolization case finding several patents to be invalid under 35 U.S.C. § 112 for failure to disclose certain aspects of the patented technology. Because the need to address the patent law issues was not required by any issue pleaded in the complaint, the Court held that the Federal Circuit was without jurisdiction.⁹ *Christianson* set forth a two-prong test for determining when a case is one “arising under” the patent law:

[A] well-pleaded complaint establishes *either* that federal [patent] law creates the cause of action *or* that the plaintiff's right to relief necessarily depends on resolution of a substantial question of federal patent law, in that federal [patent] law is a necessary element of one of the well-pleaded . . . claims.”

Id. at 808 (emphasis added).

In *Xeta, Inc. v. ATEX, Inc.*, 825 F.2d 604, 606–07 (1st Cir. 1987), the First Circuit relied on *Innotron* to concede jurisdiction to the Federal Circuit of an appeal in a case, initially filed as an antitrust case, but in which a counterclaim for patent infringement was properly filed. The decision

museum status. The recent decision of the Seventh Circuit in *Scheiber v. Dolby Laboratories*, 293 F.3d 1014 (7th Cir. 2002) (Posner, J.), illustrates the impossibility of reconciling some of the older interface precedents with modern views of economics. The Seventh Circuit, faced with a 1964 decision of the Supreme Court squarely on point, refused to enforce a patent license calling for post-expiration royalties, even though the contract clearly required it. The opinion laments the absence of any economic justification for the 1964 rule and essentially invites the Supreme Court to grant certiorari and overrule it. (“[W]e have no authority to overrule a Supreme Court decision no matter how dubious its reasoning strikes us, or even how out of touch with the Supreme Court's current thinking the decision seems.”) *Id.* at 1018.

⁹ The initial appeal in *Christianson* was taken to the Federal Circuit, which declined jurisdiction in favor of the Seventh Circuit. The Seventh Circuit also declined jurisdiction. The Federal Circuit treated the latter ruling as “law of the case” and decided the appeal. The Supreme Court reversed, noting that having initially held itself lacking in jurisdiction, the Federal Circuit should not have then made any rulings. The Court noted that the Seventh Circuit should have accepted the appeal, treating the Federal Circuit's decline as the law of the case. *See 486 U.S.* at 816–17.

is deferential to the need for uniformity in the administration of patent law and rests on the statutory language “in whole *or in part*.”¹⁰

In *Aerojet-General Corp. v. Machine Tool Works*, 895 F.2d 736, 739–42 (Fed. Cir. 1990), the Federal Circuit sitting en banc reviewed the entire body of jurisdictional law related to counterclaims, concluding that it had jurisdiction over cases in which compulsory patent counterclaims were pending, given the congressional objective for uniformity in the patent law and the “in whole *or in part*” language in Section 1295. The *Aerojet* court reserved judgment as to permissive or noncompulsory patent counterclaims. 895 F.2d at 739. In *DSC Communications Corp. v. Pulse Communications, Inc.*, 170 F.3d 1354, 1358–59 (Fed. Cir. 1999), the court went on to hold affirmatively that it had jurisdiction over a nonpatent case in which a noncompulsory patent counterclaim was filed, citing the *Innotron* case for its rationale.

. . . the Supreme Court appears willing to tolerate diversity among the circuits as to issues of patent law and the related matters that often accompany them, most commonly antitrust and unfair competition claims. Indeed, a concurring opinion by Justice Stevens suggests that divergence between the regional circuits and the Federal Circuit on such issues may even be beneficial . . .

The *Vornado* Ruling

The specific ruling in *Vornado* is that the Federal Circuit is without jurisdiction to hear an appeal in a case, properly pleaded as a trade dress case, even though the defendants filed a compulsory counterclaim for patent infringement. The majority opinion by Justice Scalia rejects uniformity in the patent law as the primary determinant of Federal Circuit jurisdiction, emphasizing instead the right of a plaintiff to select its own forum (including the court to which appeals will be directed), and holding that a “well-pleaded complaint” alone determines the proper path for appellate jurisdiction. The Court seizes upon the “arising under” language in Section 1338, analogizing it to similar language in Section 1331 (establishing federal question jurisdiction) and Section 1441 (creating removal jurisdiction). Using precedents from these other areas, the Court holds that the Federal Circuit’s jurisdiction should be rigidly confined to whether the *complaint* raises a substantial question of federal patent law.¹¹

In so ruling, the Supreme Court appears willing to tolerate diversity among the circuits as to issues of patent law and the related matters that often accompany them, most commonly antitrust and unfair competition claims. Indeed, a concurring opinion by Justice Stevens suggests that divergence between the regional circuits and the Federal Circuit on such issues may even be beneficial:

Necessarily, therefore, other circuits will have some role to play in the development of this area of the law. An occasional conflict in decisions may be useful in identifying questions that merit this Court’s attention. Moreover, occasional decisions by courts with broader jurisdiction will provide an antidote to the risk that the specialized court may develop an institutional bias.

122 S. Ct. at 1898.

This aspect of the *Vornado* decision, in particular, has far-reaching implications. Certainly the decision invites the revival of conditions fertile for forum shopping and venue fights. It is too soon

¹⁰ After *Christianson*, the Federal Circuit began treating transfer orders as the “law of the case.” See, e.g., *Xeta, Inc. v. AteX, Inc.*, 852 F.2d 1280, 1281 (Fed. Cir. 1988) (citing *Christianson*).

¹¹ Curiously, there is only passing reference in the opinion of the fact that Section 1338, in addition to giving the district courts jurisdiction over patent cases, also gives jurisdiction over “any civil action arising under any Act of Congress relating to . . . trademarks,” which presumably would include the trade dress case at issue in *Vornado*. Section 1295, in defining the appellate jurisdiction of the Federal Circuit, carves out “a case involving a claim arising under an Act of Congress relating to copyrights, exclusive rights in maskworks, or trademarks and no other claims under section 1338(a) . . .” Although the Supreme Court might have reached the same conclusion as it did using only the patent provision of section 1338, the trademark provision seems as or more relevant than the patent provision.

to know the extent to which the regional circuits—in response to the suggestion of Justice Stevens in *Vornado* to create “an occasional conflict” between circuits—are likely to develop and apply rules of patent law that diverge from those of the Federal Circuit. What is clear, however, is that *Vornado* at least suggests that possibility, which in turn is likely to prompt strategic maneuvering intended to exploit whatever opportunities may exist or be created.¹²

Despite its pejorative name, forum shopping is neither improper nor unusual. Lawyers have a duty to their clients to consider and take proper advantage of all factors likely to bear on the outcome of a case. If the choice of forum is such a factor, and if the stakes are high enough to justify the costs involved, forum shopping is inevitable. The reason that forum shopping in patent cases is not more prevalent today is that the benefits do not justify the costs. If the cost-benefit equation changes, litigants may discover new incentives to “steer” the litigation to the appellate court of preference, depending upon whether and how the patent issues are raised.

It may be some time before we know the full procedural reach of *Vornado*. Facially, at least, the decision appears to unsettle much established law. Arguably, for example, *Vornado* overrules all cases, such as *Aerojet-General* and *Xeta v. Atex*, in which Federal Circuit jurisdiction turned on a patent counterclaim in an otherwise nonpatent case.¹³ This will not be dispositive for all cases, however, because in *Vornado* there was no argument that the trade dress cause of action required resolution of a substantial question of patent law. Where the underlying case in the district court is a nonpatent claim, but one in which resolution of a substantial patent question is required, there remains a compelling argument that the Federal Circuit should still have jurisdiction. Many antitrust cases involving patents, for example, are premised on the theory that the patent in question is not valid. This would seem almost always to satisfy the second prong of *Christianson*.

Nor is it clear how *Vornado* will affect consolidation of patent causes of action with nonpatent causes of action, such as occurred in *Innotron*. Since the patent portion of the case clearly satisfies the test for Federal Circuit jurisdiction, it seems likely at least that the “in whole or in part” language in Section 1295 would take effect and confer such jurisdiction.

Compulsory vs. Permissive Counterclaims

One issue that is certain to see action in the new era is whether a counterclaim is “compulsory.” A patent owner confronted with a first-filed nonpatent complaint (as in *Innotron*) will immediately consider whether it is *required* to file a counterclaim for infringement or is merely *permitted* to do so. With the knowledge that any appeal from a counterclaim is likely to lie in the regional circuit, whereas an appeal from a separate patent case will go to the Federal Circuit, the patent owner will then assess which appellate court it wants to be in, based on the issues most likely to be determinative. If the former, it will file a counterclaim. If the latter, it will file a separate action.

¹² At least one proposal for legislation to override *Vornado* is in circulation. An ad hoc committee of the Federal Circuit Bar Association has proposed an amendment to Section 1338(a) to add the words “involving any claim for relief,” an indirect reference to Fed. R. Civ. P. 8, in which the term “claim for relief” is defined to include claims, counterclaims, cross-claims and third party claims. The report argues that the *Vornado* decision is directly at odds with the intent of Congress in creating the Federal Circuit.

¹³ The Federal Circuit recently transferred jurisdiction over an antitrust action in which a patent infringement counterclaim was raised to a regional court of appeals, specifically acknowledging that prior to *Vornado* it would have retained jurisdiction. See *Telcomm Tech. Servs., Inc. v. Siemens Rolm Communications, Inc.*, 295 F.3d 1249 (Fed. Cir. 2002). In the most recent post-*Vornado* decision, the Federal Circuit exercised jurisdiction over an appeal from the dismissal of the plaintiff’s federal and state antitrust and unfair competition claims, because the plaintiff’s declaratory relief action for patent noninfringement clearly “arises under the patent laws.” *Ilan Golan v. Pingel Enter., Inc.*, No. 01-1626 (Fed. Cir. Nov. 7, 2002).

The party with the nonpatent claim will make the same assessment. If it prefers to be in the Federal Circuit, it can always try to file a declaratory relief action (assuming the patent owner has created the requisite apprehension of imminent litigation to support declaratory relief). If the regional circuit is the preferred appellate forum, the nonpatent claimant can file the case without reference to the patent issues. Conversely, if the nonpatent claimant is sued first for patent infringement, it will decide whether it prefers to have the appeal of the antitrust case heard in the Federal Circuit, in which case it will file a counterclaim. If the nonpatent claimant wants the antitrust case to be heard in the regional circuit, it will file a separate case.

Under Rule 13(a) of the Federal Rules of Civil Procedure, a party must assert any counterclaim “if it arises out of the transaction or occurrence that is the subject matter of the opposing party’s claim.” The law is not well defined as to when a counterclaim is compulsory, but the risk is on the defendant in not filing. The danger is that the counterclaim will be lost in trying to assert it in subsequent litigation.¹⁴

The Supreme Court’s decision in *Vornado* states in passing that the patent counterclaim there was “compulsory” in light of the trade dress claim but does not state why.¹⁵ The subject came up in oral argument, but was deflected by both parties. The trade dress plaintiff, trying to defeat Federal Circuit jurisdiction, argued for noncompulsory status. The patent owner, trying to sustain jurisdiction, argued that it was required to assert the patent case as a compulsory counterclaim. This reversal of roles from the usual situation, in which the failure to assert a counterclaim in prior litigation is argued to be preclusive, detracts significantly from any precedential effect that the Supreme Court’s dicta might have.¹⁶ Moreover, it will be an unusual nonpatent case for which a patent infringement counterclaim is both (1) compulsory and (2) does not simultaneously require resolution of a “substantial question of patent law,” the latter of which would seem to create

¹⁴ See, e.g., *Critical-Vac Filtration Corp. v. Minuteman Int’l, Inc.*, 233 F.3d 697, 703–04 (2d Cir. 2000) (dismissing complaint because antitrust claims were compulsory counterclaims in earlier patent litigation between the parties).

¹⁵ Although the same set of products would have been the subject of both the trade dress claim and the patent claim, this seems to be a tenuous basis for entwining—as “compulsory” counterclaims—all imaginable causes of action relating to a single set of products. It seems strange, for example, to hold that liability for the sale of a defective product and a patent infringement claim *must be* litigated together merely because both are concerned with the same products.

Regional circuit law on compulsory counterclaims underscores this point. The regional circuits, using as a foundation the logical relationship test set forth by the Supreme Court in *Moore v. N.Y. Cotton Exch.*, 270 U.S. 593 (1926), have identified several factors to determine whether a counterclaim is part of the “same transaction or occurrence,” thereby making it compulsory under Rule 13(a). See, e.g., *Pipeliners Local Union No. 798 v. Ellerd*, 503 F.2d 1193, 1198 (10th Cir. 1974). The factors considered include (1) similarity of factual and legal issues; (2) whether res judicata would bar subsequent suit on the counterclaim (absent the compulsory counterclaim rule); (3) similarity of the evidence which supports or refutes the claim and counterclaim; and (4) whether a logical relationship exists between the claim and counterclaim. See *id.* Considering these factors, it seems unlikely that causes of action, related solely because both are concerned with the same products, would be compulsory counterclaims.

¹⁶ In few if any decisions has the Federal Circuit actually resolved a dispute over this issue by holding squarely that a patent infringement counterclaim is compulsory in a case filed as a nonpatent claim. In *Aerojet-General*, for example, the Federal Circuit assumed that the counterclaim was compulsory because the parties had agreed that it was. 895 F.2d at 738. Most of the situations in which the Federal Circuit has actually held patent counterclaims to be compulsory are those in which the original case seeks declaratory relief on the patent claims. See, e.g., *Vivid Techs., Inc. v. Am. Sci. & Eng’g, Inc.*, 200 F.3d 795, 802 (Fed. Cir. 1999) (holding that a counterclaim for patent infringement is compulsory in a declaratory judgment action for noninfringement).

Procedurally, the Federal Circuit uses the law of the regional circuit when deciding whether an antitrust counterclaim is compulsory in a patent infringement suit. See, e.g., *Genentech, Inc. v. Regents of the Univ. of Cal.*, 143 F.3d 1446, 1456 (Fed. Cir. 1998) (applying Seventh Circuit law to hold that an antitrust claim was compulsory in an earlier filed suit).

Federal Circuit jurisdiction under the second part of the *Christianson* test, despite *Vornado*.¹⁷

The question of when a counterclaim is compulsory in cases raising both patent and antitrust issues is somewhat distorted as a result of *Mercoïd Corp. v. Mid-Continent Investment Corp.*, 320 U.S. 661 (1944). There, the Supreme Court—in a determined effort to find against the patent owner—allowed an unsuccessful infringement defendant to bring a subsequent antitrust claim alleging a conspiracy to expand the patent monopoly, even though the antitrust claim could have been brought in the first action. The Court viewed such a counterclaim as permissive only, and therefore not barred by failure to plead it in the first patent infringement suit.¹⁸ Thus, the Court concluded that the antitrust counterclaim was not barred since it involved different “matters in issue or points controverted” than the earlier patent infringement litigation.

The Fifth and Ninth Circuits appear to follow *Mercoïd*, although in some cases reserving judgment on whether the *Mercoïd* exception applies to every antitrust counterclaim arising in a patent infringement context.¹⁹ Other circuits, such as the Second and Fourth, appear to limit the holding in *Mercoïd* to its facts.²⁰ The Federal Circuit, because it uses the law of the regional circuits in deciding what is a compulsory counterclaim, has no unique rule of its own on the application of *Mercoïd*. This interplay between *Mercoïd* and the remainder of the rules on compulsory counterclaims promises to add layers of complexity to the identification of the appropriate regional circuit in which to file.

The Preference for a Particular Circuit Will Not Be Predictable

It is not entirely clear which direction forum shopping is likely to take in particular situations. The accused infringer, for example, may not always want to be in the regional circuit on a patent law issue. The patent owner may not always prefer the Federal Circuit for either patent law issues or for antitrust issues.

Although the Federal Circuit is often viewed as a patent-friendly court, there are many issues on which that court has been tougher on patent owners that might be true in one of the regional

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¹⁷ In a post-*Vornado* ruling, for example, *In re Tamoxifen Citrate Antitrust Litig.*, 2002 WL 1962125, 2002 U.S. Dist. LEXIS 17211 (E.D.N.Y. Aug. 26, 2002), the Eastern District of New York denied a motion to remand an antitrust case to state court, holding that plaintiffs' state antitrust claims necessarily required resolution of a “substantial question of federal patent law.” Plaintiffs allege that a settlement agreement reached by patent holder Zeneca and manufacturer Barr in a separate suit enabled Zeneca to revive a patent Barr had proven was invalid and unenforceable and to exclude competition from generic manufacturers. Because plaintiffs must prove that Zeneca's patent was invalid or unenforceable, and there was no alternate nonpatent theory on which the plaintiffs could rely to prevail, the district court had original jurisdiction under § 1338.

¹⁸ The antitrust plaintiff, *Mercoïd*, although not a party to the first patent suit, had paid for and directed the unsuccessful defense of a customer sued for patent infringement. After prevailing in the first patent case, the patent owner then sued *Mercoïd* for contributory infringement. *Mercoïd* asserted patent misuse as a defense and an antitrust counterclaim for damages, both of which could have been asserted in the earlier action but were not. Without putting too fine a point on its reasoning, the Supreme Court held that the “claim for [antitrust] damages is more than a defense; it is a separate statutory cause of action. The fact that it might have been asserted as a counterclaim in the prior [infringement] suit by reason of Fed. R. Civ. P. 13 (b) does not mean that the failure to do so renders the prior judgment *res judicata* as respects it.” *Mercoïd*, 320 U.S. at 671. The Court held that the case should be “governed by the principle that where the second cause of action between the parties is upon a different claim, the prior judgment is *res judicata* not as to issues which might have been tendered, but ‘only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered.’” *Id.*

¹⁹ See, e.g., *Tank Insulation Int'l, Inc. v. Insultherm, Inc.*, 104 F.3d 83, 88 (5th Cir. 1997) (holding that while an antitrust claim based upon conspiracy to file a wrongful patent infringement suit was compulsory in the underlying infringement suit, *Mercoïd* created an exception, but declining to decide whether *Mercoïd* applied to every antitrust counterclaim); *Hydranautics v. Filmtec Corp.*, 70 F.3d 533, 536 (9th Cir. 1995) (holding that an antitrust counterclaim based on predatory patent litigation was permissive in a patent infringement suit).

²⁰ See, e.g., *Critical-Vac Filtration*, 233 F.3d at 703–04; *Burlington Indus., Inc. v. Milliken & Co.*, 690 F.2d 380, 389 (4th Cir. 1982).

*In light of the complexities and uncertainties of the possible need to counterclaim, one of the early casualties of *Vornado* may be the willingness of patent owners to engage in pre-litigation efforts to find a commercial solution to a potential patent dispute.*

circuits. Examples abound. The entire body of law that has evolved since 1988 applying 35 U.S.C. § 112(6) to “means-plus-function” claims has narrowed significantly the scope of protection afforded to the patent owner.²¹ Similarly, the Federal Circuit has been tough on patent owners seeking to expand their claim coverage through the doctrine of equivalents.²² The Federal Circuit has also been demanding of patent owners with respect to the enablement of patent claims in the less predictable arts, such as biological sciences and chemistry.²³ If the regional circuits were to develop rules that soften those of the Federal Circuit in any of these areas, it will be the patent owner, not the accused infringer, that benefits from steering any appeal away from the Federal Circuit.

The converse may be true of antitrust claims related to patents. Although the general perception seems to be that the Federal Circuit is more harsh than the regional circuits on antitrust claims raised in connection with patent issues, antitrust claimants facing an actual decision as to the appellate court of choice may prefer the Federal Circuit over one of the regional circuits on particular issues. In *Nobelpharma*,²⁴ for example, the Federal Circuit held that enforcement of a patent found by a jury to have been procured by fraud, given proper market conditions, was properly the basis for finding a violation of Section 2 of the Sherman Act. A number of the regional circuit courts of appeals have no similar precedential rulings in favor of an antitrust plaintiff on such a claim. Similarly, in *C.R. Bard, Inc. v. M3 Sys., Inc.*, 157 F.3d 1340 (Fed. Cir. 1998), the Federal Circuit affirmed liability under Section 2 of the Sherman Act based on a claim that an anticompetitive purpose by the patent owner in designing the patented disposable needles used in a patented biopsy device gave rise to a violation of Section 2. One would search long and without success for a comparable precedent in most if not all of the regional circuits.

In light of the complexities and uncertainties of the possible need to counterclaim, one of the early casualties of *Vornado* may be the willingness of patent owners to engage in pre-litigation efforts to find a commercial solution to a potential patent dispute. Unlike many other types of litigation, patent cases often are preceded by significant negotiations between the patent owner and the accused infringer. To start the running of the clock on damages, for example, patent owners sometimes give formal written notice that certain products infringe their patents, leading to dialogue in search of a settlement. Patent owners occasionally send cease and desist letters to give an infringer the opportunity to redesign its product so as not to infringe, again leading either to a redesign or dialogue in search of a settlement. Patent owners sometimes approach an accused infringer, or vice versa, in hopes of negotiating a license and avoiding litigation.

Even without the holding in *Vornado*, such efforts at a commercial resolution of a potential dispute must be carried out with considerable care by both sides. Patent owners wanting to retain

²¹ *Pennwalt Corp. v. Durand-Wayland, Inc.*, 833 F.2d 931 (Fed. Cir. 1987) (finding against the patent owner because a claim subject to Section 112(6) is actually more narrow than it reads); *Valmont Indus., Inc. v. Reinke Mfg. Co.*, 983 F.2d 1039 (Fed. Cir. 1993) (finding against patent owner because accused structure was not the equivalent of what was disclosed); *Cybor Corp. v. FAS Techs., Inc.*, 138 F.3d 1448 (Fed. Cir. 1998) (en banc) (holding patent not infringed based on arguments made to the Patent Office).

²² The recent Supreme Court decision in *Festo Corp. v. Shoketsu Kinzoku Kogyo Kabushiki Co.*, 122 S. Ct. 1831 (2002), is an excellent example. There the Federal Circuit all but eliminated the doctrine of equivalents, holding essentially that any claim that had been modified during prosecution before the Patent Office was not entitled to a range of equivalents. See *Festo Corp. v. Shoketsu Kinzoku Kogyo Kabushiki Co.*, 234 F.3d 558 (Fed. Cir. 2000). The Supreme Court reversed, holding that the ruling was unnecessarily rigid and deprived the patent owner of substantial rights.

²³ See, e.g., *Enzo Biochem, Inc. v. Calgene, Inc.*, 188 F.3d 1362 (Fed. Cir. 1999) (antisense technology not enabled for higher life forms); *In re Wright*, 999 F.2d 1557 (Fed. Cir. 1993) (full scope of broad claims to vaccine not enabled, based on post-filing experimentation).

²⁴ *Nobelpharma AB v. Implant Innovations, Inc.*, 141 F.3d 1059 (Fed. Cir. 1998).

the option of selecting the trial court in the event litigation becomes inevitable must avoid creating in the other party an “apprehension of litigation” sufficient to trigger the right to pursue declaratory relief.²⁵ The dialogue between patent owner and infringer is thus designed to differentiate an offer to license or a notice of infringement from a threat of litigation. Where circumstances make such differentiation impossible, the prudent course, even before *Vornado*, has been for the patent owner to “shoot first and negotiate later.” *Vornado* may exacerbate the problem, particularly where the infringer is likely to have a significant nonpatent claim that, if asserted alone, could steer even the patent issues to the regional court of appeals, or alternatively, if asserted as a declaratory relief action against the patent could steer the case to the Federal Circuit. In an environment that raises the value of selecting the appellate forum that ultimately will hear the case, efforts to resolve patent disputes commercially may disappear altogether.

Conclusion

Vornado appears to presage a significant shift in the way that patent cases are brought. By giving litigants the opportunity to steer the appeals in their cases, the decision will clearly rejuvenate interest in a comparative analysis of the various circuits in an effort to discern possible advantage in one procedural strategy over another. The way that all this will play out is difficult to discern generally and is likely to vary from case to case. In a search for winners and losers, the legal profession appears likely to post the largest gains. Patent litigants appear destined to foot the bills. ●

²⁵ See, e.g., *EMC Corp v. Norand Corp*, 89 F.3d 807 (Fed. Cir. 1996) (holding district court’s exercise of jurisdiction over declaratory relief action for noninfringement and invalidity was proper where patent owner’s conduct during license negotiations created a reasonable “apprehension of litigation”).

Paper Trail: Working Papers and Recent Scholarship

This edition of the Paper Trail is a bit briefer than usual, but is, we hope, no less informative. The paper by Josh Lerner provides a sweeping empirical view of the benefits of patent protections. Dave Scheffman, Director of the FTC's Bureau of Economics, continues to use that position as a bully pulpit for deeper and different empirical analyses in merger investigations, an empirical enthusiasm that some find refreshing. His paper with Mary Coleman both provides further insights into how that front office views mergers, simulations, and empirical analyses and offers some previews of research to come from the Bureau. And we would be surprised if any antitrusteer has authored more serious papers on market definition than Greg Werden at the Justice Department. In the short paper discussed here, Werden advises practitioners on how to avoid incorrect inferences using critical loss/critical elasticity analysis, once again in the spotlight as a result of the FTC's cruise lines decision. In the final paper summarized in this edition, Cornell economist David Sally offers a theory of the role of sympathy in cartels.

As always, any suggestions for coverage in the Paper Trail are welcome. Please email Bill Page (page@law.ufl.edu) or John Woodbury (jrw@crai.com).

Papers and Summaries

Josh Lerner, Patent Protection and Innovation Over 150 Years, National Bureau of Economic Research Working Paper Series, Working Paper 8977 (June 2002), <http://papers.nber.org/papers/W8977>.

A key presumption in evaluating the antitrust implications of exclusionary conduct with regard to IP is that exclusion enhances incentives for innovation. (See the Point/Counterpoint exchange in the July issue of *The Antitrust Source*.) While not addressing exactly that question, a recent working paper by Josh Lerner empirically reviews the history of patent policy since 1850 in about 60 countries. The purpose of the paper is to determine whether changes in patent policy, particularly those that increase the extent of patent protection, have effects that one might expect, such as an increase in the number of patents. In the process, Lerner attempts to account for numerous other factors that might have affected the number of patents, including some that are not usually part of our ordinary antitrust control-variable tool-kit, such as wars, revolutions, and the extent of political stability. In fact, his data and analysis indicate that an increase in patent protection reduces the extent of patenting. To be sure, one could certainly (and likely correctly) be cautious about this result given the nature of the data (there are gaps in the 150-year history), including using patents as a measure of innovation. Nonetheless, it is disquieting that over the broad sweep of history, the value of patent protection cannot be identified.

—JRW

David T. Scheffman and Mary T. Coleman, Current Economic Issues at the FTC, *Review of Industrial Organization* (forthcoming), <http://www.ftc.gov/ftc/economic.htm>.

This short paper provides some insights into the current state of thought within the leadership of the FTC's Bureau of Economics (Scheffman is the Bureau Director and Coleman is the Deputy Director

for Antitrust) and offers some teasers about forthcoming BE efforts. At the outset, the paper seems to pan the use of Bertrand simulations using scanner-based demand estimates for a competitive effects analysis of horizontal mergers involving differentiated products. It's not always clear whether Scheffman is panning just simulations that rely on such demand estimates or whether he is just panning simulations. While I personally am of the view that these simulations are not the end of economic analysis of a differentiated product merger, they certainly can be useful at the least as a preliminary gauge of how much reliance must be placed on other factors (such as entry and repositioning) if the merger deal is to pass muster at the agencies. In any event, the paper reports that BE is analyzing the extent to which marketing documents specifically, and the marketing literature generally, can be used to estimate demand elasticities. Similarly, the paper alludes to examining the extent of competition between firms directly, but provides little in the way of guidance for practitioners. While continuing to promise the coordinated effects paper, this one offers a nice summary of the kind of empirical evidence helpful in merger analysis, suggesting new merger retrospectives (including health care mergers), possible policy developments in the IP/antitrust nexus, and a staff report on the state of the oil industry.

—JRW

Gregory J. Werden, *Beyond Critical Loss: Tailoring Applications of the Hypothetical Monopolist Paradigm*, EAG Discussion Paper EAG 02-9 (Aug. 2002).

In this short and accessible paper, Greg Werden discusses some common pitfalls in blindly applying the critical elasticity/critical loss approach to both market definition and competitive effects. In particular, he discusses how the critical elasticity/loss analysis can result in incorrect inferences when the elasticity composition of market demand, differing marginal costs across capacity units, and differing fixed costs across capacity units can lead to incorrect inferences about the scope of the market or the magnitude of the competitive effects. Fortunately for us, Werden explains how the analysis can be tweaked to account for these differences.

—JRW

David Sally, *Two Economic Applications of Sympathy*, *Journal of Law, Economics, and Organization* (2002).

This article is the latest in a series by Sally exploring the role of sympathy in economic relations. It should be interesting to antitrust lawyers because it offers a theory of why successful cartels typically involve strenuous efforts by their members to cultivate sympathy or fellow-feeling. Using a duopoly model, he shows that “[s]ympathy makes deeper cooperation possible,” because members of the cartel take account not only of their own gains and losses, but those of their “friends.” Sally’s model also identifies the sorts of problems that are likely to undermine cooperation. He points to accounts of several famous cartels, including the electrical equipment and lysine conspiracies, as evidence supporting importance of sympathy. He suggests, for example, that although ADM voiced the famous motto that “the competitor is my friend,” a lack of real sympathy undermined the cartel: “the salience of the social distance, both physical and psychological, between Decatur, Illinois, and Tokyo, may have created a low ceiling to sympathy . . . , preventing the bonds necessary for effective collusion.”

—WHP