

# OPTIMAL TEST FOR STRATEGIC ANTITRUST SHAM LITIGATION

– a mechanism design approach\*

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## Abstract

We propose a simple and accurate test method for recognizing anticompetitive sham suits. We consider the problem of testing the null hypothesis that a lawsuit *vis-à-vis* an actual or potential competitor is not sham against the alternative that the suit is sham. We develop game theoretical model of bargaining and litigation in the context of entry deterrence, to analyze the incentive of a predator, reacting strategically to the judicial norm creating process, to pursue sham litigation and achieve anticompetitive goals. The theory implies that the question of whether an illegal sham act is baseless or not is irrelevant. When considering open suits-against-competitors to antitrust liability, assessing whether the alleged predator's legal expenditures can be expected to pay off is necessary, but insufficient. An appropriate test for sham litigation should be based on close examination of the market structure and thorough analysis of the economic relationship between the parties in dispute. Reputation is the hallmark of the test: the incumbent battles to maintain others' perception of its readiness to fight entry via frivolous legal battle. *Journal of Economic Literature Classification Numbers: K21, L11.*

*Keywords:* sham litigation, litigation expenditures, litigant incomplete information, illegality of pressing claims, predatory incentives, reputation, objective tests.

## 1 Introduction

SHAM LITIGATION refers to the predatory use of adjudicative procedures to achieve anticompetitive goals. It is a typical case of non-price predation: the predator uses legal processes to impose expenses and delay, at little cost to itself. In the United States, an exception to *Noerr-Pennington* immunity<sup>1</sup> exists where one

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<sup>1</sup>Noerr-Pennington immunity holds that, efforts to influence public officials through lobbying, publicity, and other contact are protected by the petition clause and are not a violation of antitrust law even when the petitioning activity is undertaken

uses the governmental process, rather than its outcome, as a sham to cover anticompetitive conduct.<sup>2</sup> In Europe, sham acts may constitute an abuse of a dominant position, contrary to article 82 EC.<sup>3</sup> The key piece of evidence in identifying sham litigation is the absence of genuine interest in receiving judicial relief. Establishing the genuine motive of the plaintiff, therefore, has been the central issue to much of the case law on sham litigation in Europe and in the United States. The purpose of this paper is to investigate the economic implications of various existing methods courts employ to identify sham litigation and thereby devise a simple and accurate test for correctly recognizing sham suits.

In practice, courts adopt two different approaches to identify sham claims. Some took a narrow view and defined sham litigation as a pattern of baseless claims made without regard to their merits, and designed to delay and tie up the judicial process. Others based their assessment of the real motive of the plaintiff on a cost-benefit analysis of his economic interest to bring suit.

With regards to the first approach, the existence of a predatory intent is clearly demonstrated in situations of misrepresentations of facts or law to tribunals, perjury, fraud or bribery. However, the courts also consider as sham litigation actions that are manifestly unfounded or without probable cause. In assessing the existence of probable cause the courts examine the situation existing when the action in question was brought. Probable cause to institute civil proceedings requires no more than a reasonable belief that there is a chance that a claim may be held valid upon adjudication. This approach makes virtually conclusive the presumption that a successful suit cannot be a sham. It requires as a first step of the analysis of the claim of sham litigation by the courts, the proof that the lawsuit is objectively baseless, in the sense that no reasonable litigant could realistically expect success on the merits. However, there are important reasons to object to this test. Probable cause may be absent if the claim is not supported by the adequate factual evidence. It is also possible that a claim is considered baseless because of a misconceived interpretation of the law. However, in the second situation some courts may consider baseless an action that other courts will consider meritorious. This risk is particularly present in situations in which the concept of what constitutes a baseless claim may be influenced by the court's conception of the adequate balance to achieve between the risk of market failure and that of regulatory failure, as is often the case in competition law. The establishment of a bright-line rule may lead to an important risk of false negatives. Furthermore, it might not be objectively reasonable to bring a lawsuit just because there is a probability of some success on the merits, no matter how insignificant the value of the claim may be.

The second approach followed by the courts is broader. The fact that the claim is not baseless does not preclude the finding that the use of litigation constitutes an antitrust violation. Rather, the existence of sham litigation is evaluated by a purely objective test focusing on the economic interest of the plaintiff to bring legal action. What counts is whether the suit's expected value to the plaintiff exceeds its costs. The "economic test" for sham litigation is essentially a predation test, as it requires the proof of a profit sacrifice, which cannot be recouped by the plaintiff at a later stage in the event his legal action is successful. The application of this test raises numerous questions. For instance, information with respect to relative legal merits of the opposing parties and the amount of recovery may be privately held. The parties must learn about each other before they can identify suitable settlement terms. This learning is difficult because of incentives to misrepresent private information.<sup>4</sup> Further, economies of scale in legal services may prompt for a disfavored motive, such as eliminating competition. (See, e.g., *United Mine Workers v. Pennington* (1965) 381 U.S. 657 ; *Eastern Railroad Presidents Conference v. Noerr Motor Freight* (1961) 365 U.S. 127.)

<sup>2</sup>See, *Walker Process Equipment v Food Machinery and Chemical Corp.* (1965) 382 U.S. 172 .

<sup>3</sup>See, *Case T-111/96, ITT Promedia NV v Commission* (1998) ECR II-2937.

<sup>4</sup>See, e.g., *Ausubel et al.* (2001), *Myerson and Satterthwaite* (1983).

large or dominant firms to follow anticompetitive rent-seeking strategies. As a result, some anticompetitive rent-seeking cases may be identified as non-predatory by the empirical measures.

The forgoing naturally leads to the question as what is a workable standard for establishing the existence of sham litigation. Unlike the vast literature on predatory pricing, however, economists have had little to say on the issue of predatory sham litigation.<sup>5</sup> Economic literature has yet to produce an objective examination of the incentives for sham acts. This paper makes a start in that direction. Our model explains how an incumbent firm strategically reacts to antitrust law rules and regulations on sham litigation, and profits from battling a current entrant in court to deter subsequent potential entrants.

The first novelty of our approach is that it provides critical insight into the important and thorny issue related to distinguishing litigations purely motivated by competitive interests and those motivated by monopolistic and anticompetitive interests arising from reduced competition. Competitive litigations are fought over the property right over the financial returns on a fixed investment or strategic assets evaluated at current market prices. They do not constitute an offense under the antitrust laws: even though it may harm competitors, it does not hamper competition. Anticompetitive (predatory or sham) litigation is illegal because it results in monopolistic or market power rents that arise when actual or potential competition is limited or eliminated and market prices are maintained at, or elevated to, otherwise unsustainable levels. In practice, distinguishing these motivations for litigation often prove to be difficult. Our approach provides a solution to this problem.

The second novelty of our method is that it does not pose more stringent information requirement than the current court practice. Courts, who uses “probable cause” as criterion or apply cost-benefit analysis to identifying sham acts, will necessarily confront the problem of case selection bias and the problem that litigants may possess incomplete information about the strengths of their cases and their legal expenses. Lawsuits which are highly likely to prevail on the merits, and inexpensive to pursue, are usually settled outside of the courtroom. Conversely, claims with little chance of winning and expensive to allege, are rarely pursued. The only cases proceed to trial are those for which the plaintiff’s chance of winning is ambiguous, or the costs of litigation are particularly difficult to estimate ex ante extensive discovery and litigation.<sup>6</sup> It is our purpose in this paper to devise a selection bias free, statistically well founded test method, that does not rely on information about the strengths of the case or the litigation expenses of the sham suit plaintiff. This is done by *divorcing* probable cause as sufficient to rebut a claim of sham litigation, and by *abandoning* cost-benefit analysis to determine if Sherman Act liability could attach to claims which are successful on the merits. Instead we investigate the bargaining history of the disputants, and evaluate the entry deterrence incentives of the incumbent. This new test can then be performed in the same datasets where “entry analysis” is performed, which are readily accessible to antitrust courts.

The test we introduce in this paper is called *strategic induction test* (SIT). It requires the court take into account that firms react strategically to the way the test is carried out. In economic language, this describes a mechanism design problem: a small firm (the “countersuit plaintiff”) sues a dominant firm (the

<sup>5</sup>The only exception is Klein (1990). Klein (1990) has tested the hypothesis that the courts’ decisions in antitrust suits on claims of sham litigation have been consistent with the economic analysis of litigation as a predatory strategy. Klein provides evidence from 117 Sherman Act claims of sham litigation prior to 1986 that confirms that hypothesis that there exists significant relationship between the presence of predatory characteristics and the success of the antitrust litigation.

<sup>6</sup>Priest and Klein (1984) argue that failure to reach a pretrial settlement is due to either overoptimistic beliefs by either the plaintiff or the defendant. Since each route of failure is equally probable, they predict that plaintiffs will win approximately half of the time. This prediction is supported by their study of approximately 15,000 litigated civil cases tried by the jury in Cook County, Illinois, over 1959 -1979: the plaintiffs won 48.47 percent of the time.

“predator”) for predatory use of adjudicative procedures (the “sham suit”) to achieve anticompetitive goals. The predator knows whether she is liable or not, but the court does not. We ask what are the relevant test parameters and fee-shifting (which, together, we call a mechanism) rules a court should employ to minimize the rate of anticompetitive litigation subject to its resource constraint and without deterring the pursuit of legitimate interest. Three main results are derived. The first is a characterization of a lower bound on the legal expenses and delay costs a countersuit plaintiff would experience from frivolous sham suit, that is consistent with the predator’s anticompetitive incentive to bring in sham suit. This lower bound is shown to be independent of the predator’s case merits and its own cost-benefit calculations. It is shown that whenever this bound is attained, a predator will have incentive to initiate a predatory litigation. The second result describes a simple practicable method that computes this lower bound. The third result shows that any mechanism that deters predatory litigation without discouraging pursuit of legitimate interests, must utilize information on parties’ pretrial bargaining history and employ the English fee-shifting rule (according to which all litigation costs are shifted to the loser in the trial).

This paper is organized as follows. The next section presents the economic background. Section 3 introduces the model and how anticompetitive litigation is identified in this general framework by analyzing the incumbent’s entry deterrence incentives. Section 4 discuss which type of data are needed to identify sham acts in practice. Section 5 compares current court practice and our approach and argue that our method pose less stringent data requirement. Finally section 6 concludes. The proof of the results can be found in the appendix.

To avoid semantic difficulties, we follow Klein’s (1990) terminology. The initial act (that is alleged to be sham) is referred to as the “sham act” or the “sham suit.” The plaintiff in the sham suit is called the “predator” and the defendant is called the “target.” The Sherman Act suit that the target files in response to the sham suit is called the “countersuit.”