Optimal Tests for Strategic Antitrust Sham Litigation

--A Contract Theory Approach

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Structure of the Presentation

- Motivations/Legal background
- Research Question
- Related Literature
- Model set-up
- Results 1. A non-predatory plaintiff only alleges baseless claims;
- Results 2. A predator alleges strong cases more often than a non-predator;
- Results 3. Claims alleged by group are more likely to be sham.
- Conclusions and Policy Implication.

Motivations/Legal background

- Sham litigation: predatory use of adjudicative procedures to achieve anticompetitive goals
- Problem: finding an optimal test for identifying sham incentives
- Current tests
  - The objectively baseless test
    - the lawsuit must be objectively baseless in the sense that no reasonable litigant could realistically expect success on the merits (misrepresentation and omission of facts, controversial legal theory/question of law)
  - The expected economic return test
    - The suit's expected value to the plaintiff does not cover its costs
- Criticism of the current tests

Research Question

- When should an antitrust court dismiss a claim?

Or equivalently,

- What case characteristics should the motion to dismiss be based on?

Related Literature

- *Klein (1990) “Predation in the courts: legal versus economic analysis in sham litigation,” *International Review of Law and Economics*, 10. pp.29-40.

- Klein (1986) “Strategic sham litigation: economic incentives in the context of the case law,” *International Review of Law and Economics*, 6. pp.241-253.

- Myerson, R. (1979) “Incentive compatibility and the bargaining problem,” *Econometrica*, 47. pp. 61-74.

- Myerson, R. (1981) “Optimal auction design,” *Mathematics of Operations Research*, 6. pp. 58-73.

Model set-up (Information)

1. *objective merits/strength* of plaintiff's case: $\theta \in \Theta = [0, 1]$

2. *density function*: $f : \Theta \to \mathbb{R}^+$;
   twice differentiable, positive and strictly increasing.

3. Attorney observes θ, plaintiff only knows $f(\cdot)$.

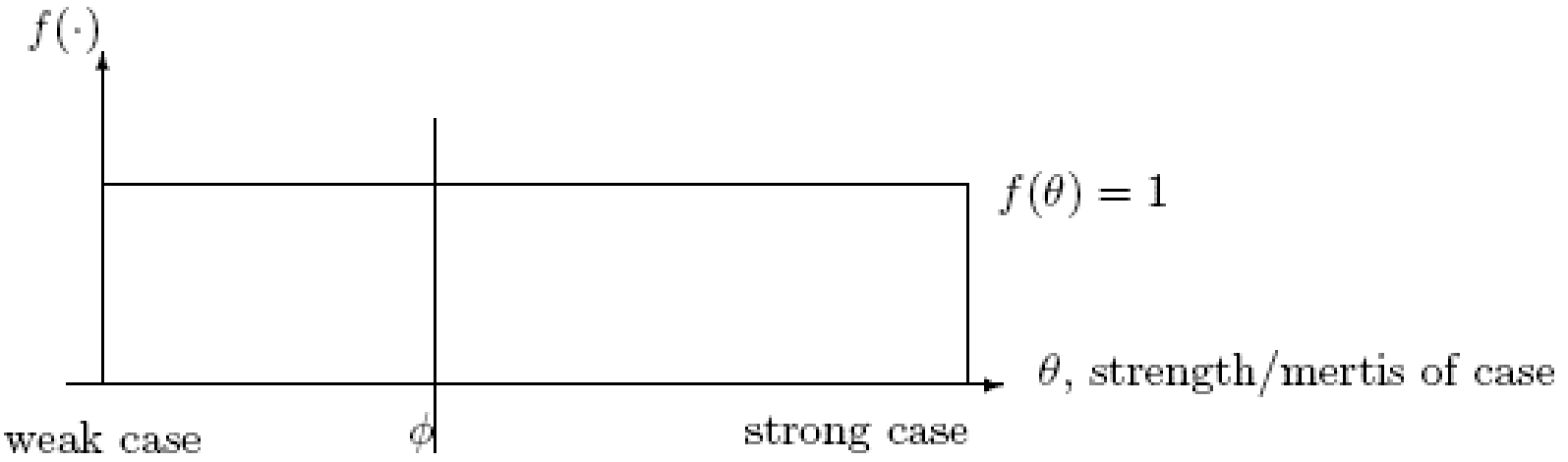


Figure 1. Distribution of Cases

Model set-up (Information)

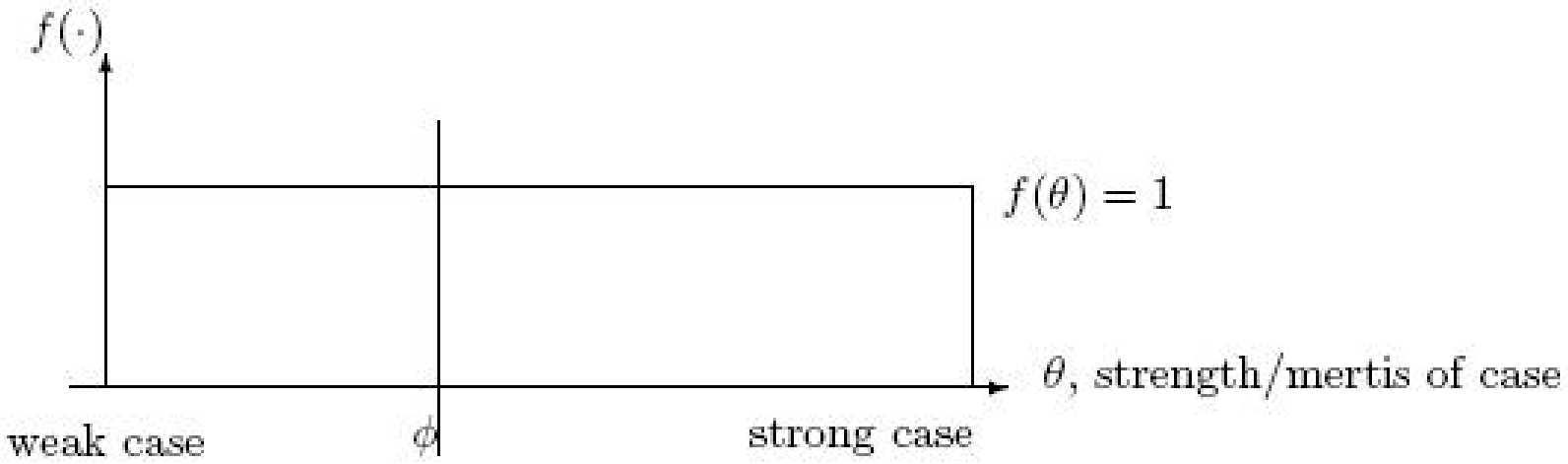


Figure 1. Distribution of Cases

Interpretation:
Cases differ in strength and merits;
lawyer knows the strength and merits of each case;
client only knows how likely her case is strong/weak.

Model set-up (Preferences)

- Lawyer's preference

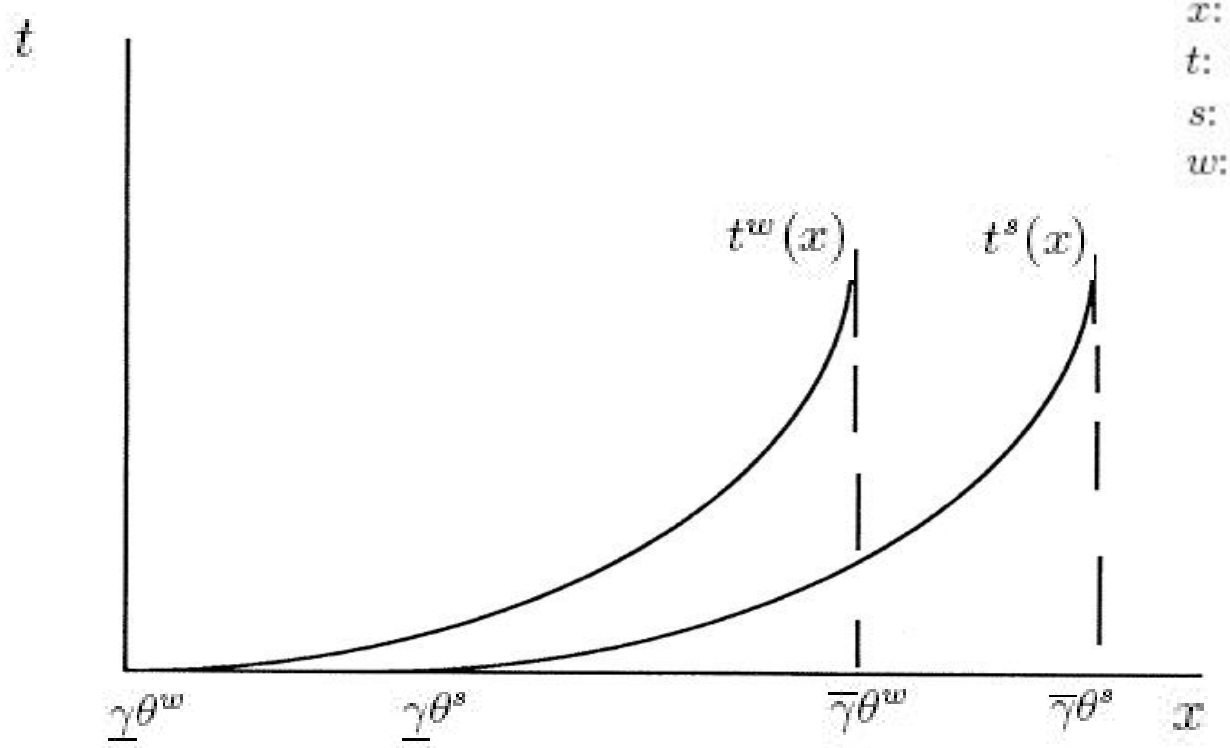
$$u_a(x, t; \theta) = r - t(x, \theta) - \overline{t},$$

r: *reward* from the plaintiff;
$\overline{t}$: *fixed costs/time*;
$t(x, \theta)$: *variable costs/time* to achieve x in pretrial negotiation for plaintiff when case strength is θ.

Interpretation:
lawyer receives compensation (monetary, reemployment, etc.) for negotiating settlement, he then discounts it by time and effort spent on the case.

Model set-up (Lawyer's time/effort)

x: negotiated settlement;
t: lawyer's time;
s: strong case;
w: weak case.



Interpretation:

Investigating fact/law and contacting defendant/ witness
is time consuming /costly for plaintiff's lawyer;
But it is less (resp. more) time consuming/costly
to improve negotiated settlement when case is strong (resp. weak).

Model set-up (Plaintiff's Preferences)

In settlement, plaintiff receives utility

$$U_p^s := u_p(x^s) - r^s, \text{ with } \frac{du_p}{dx}(x) > 0.$$

Interpretation:
By using incentive contract $\langle \hat{r}^s, \hat{x}^s \rangle$,
plaintiff enjoys utility/benefit $u^p(\hat{x}^s)$ from receiving settlement offers $\hat{x}^s$; she then pays her lawyers $\hat{r}^s$ for negotiating the settlement.

Model set-up (Plaintiff's Preferences)

In litigation,
court will enforce transfer

$$y \in [\underline{\gamma}\theta, \overline{\gamma}\theta]; \text{ with } 0 \leq \underline{\gamma} \leq \overline{\gamma}.$$

from defendant to plaintiff (*innocent* or *predator*), based on the *intrinsic merits* of the case – θ;

a *predator* receives, **in addition**, $\pi > 0$
from imposing cost on defendant via evoking formal legal proceedings.

Note. Cost can take form of

1. delaying (16.5%) or preventing (25.2%) expansion by competitors,
2. causing the target to lose sales (12.2%), and
3. raising competitors costs of doing business (12.2%).

Result 1. (Interpretation and Intuition)

- PROPOSITION 1. *For **both** innocent plaintiff and predator, **only** weak cases (Baseless claims) proceed to trial; strong cases settle outside of the court room. The more the plaintiffs believe their cases are strong, the more weak cases they litigate.*

- ***Way of proof.*** Suppose in negation that, plaintiff would litigate strong cases and settle weak ones, then it can be shown that any incentive-compatible-contracts without-litigation will yield the the plaintiff a higher payoff.

- ***Intuition.*** Baseless (resp. strong) claims are those hopeless (resp. promising) ones that the plaintiff needs to compensate the lawyer *a lot (resp. little)* for marginal (resp. great) improvement in negotiated settlement. Giving up negotiating weak cases allows the plaintiff to give her lawyer *better* incentive to work harder when cases are indeed strong, while at the same time keeping the information rent paid to the lawyer low.

Result 1. (Graphical Illustration)

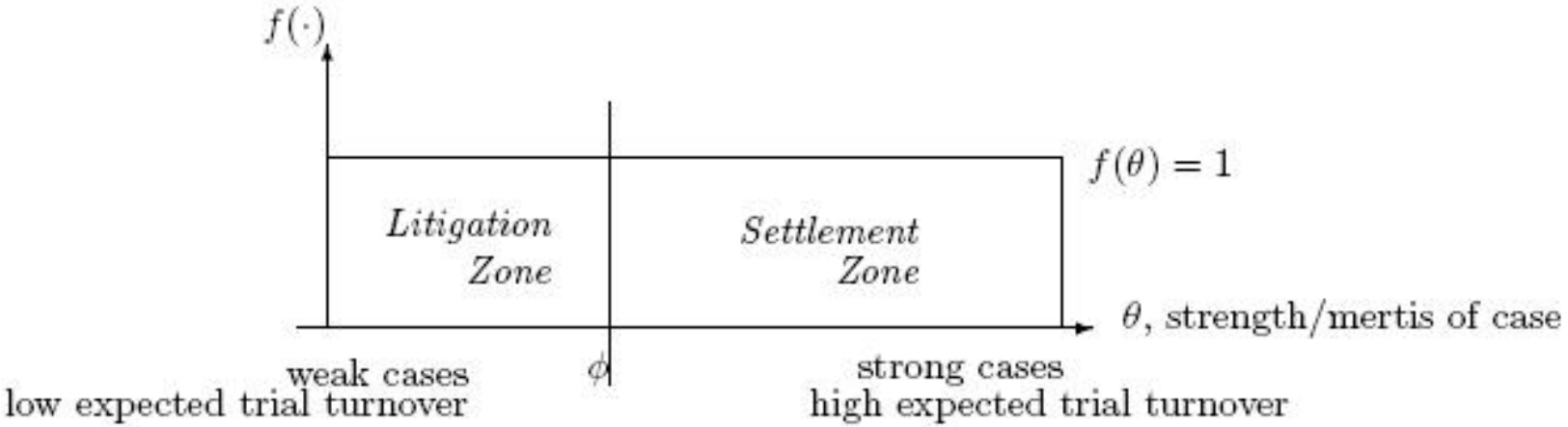


Figure 2. Litigation-Settlement Decision of Innocent/Non-Predatory Plaintiff

Result 2. (Interpretation)

- PROPOSITION 2. *A predator litigates strong cases (strictly) more frequently than an innocent plaintiff. Strong cases are litigated more frequently by a predator when predatory profit of litigation is higher.*

- **Intuition of proof.** For any given level of case merits, a predator obtains strictly higher payoff from litigation than an innocent plaintiff does.

- **Remark.** The court should dismiss it more often if

  a. defendant/plaintiff(s) are competitors (plaintiff derives benefit from imposing costs) and

  b. the case has obvious merits.

Result 2. (Predator litigates more strong cases)

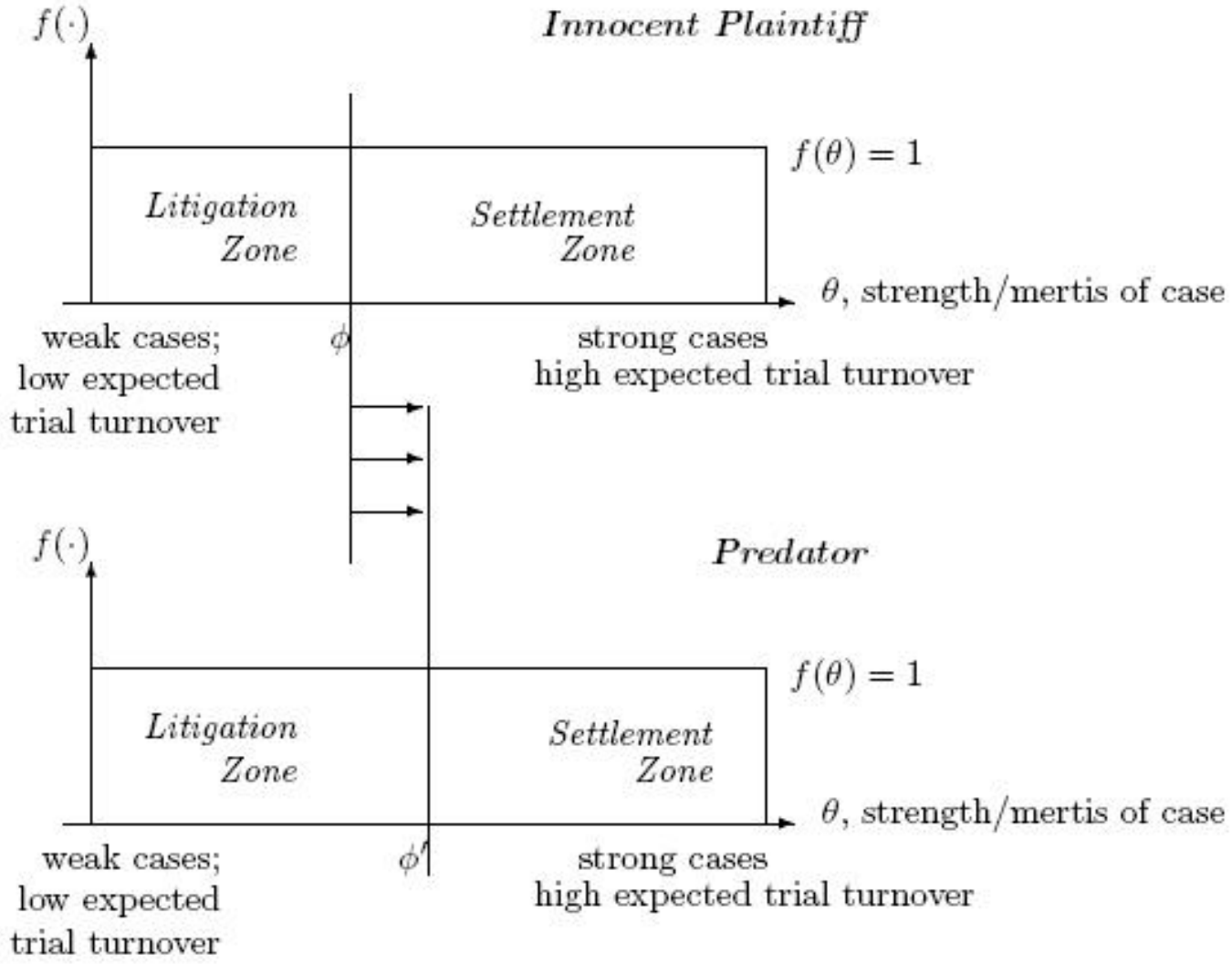


Figure 3. Litigation-Settlement Decision of Non-Predatory and Predatory Plaintiff Compared

Result 2. Distribution of Sham Suits

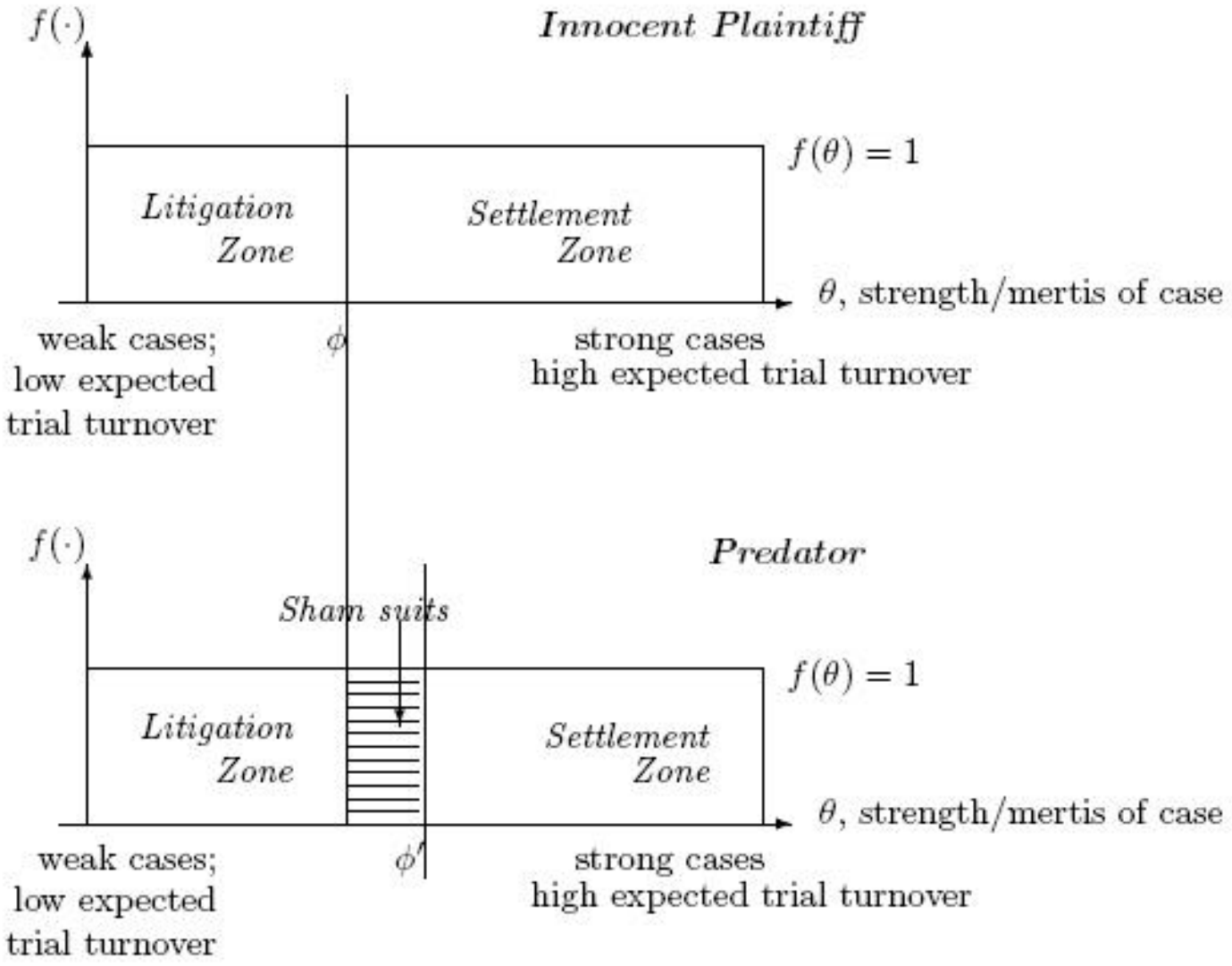


Figure 3.1. Distribution of Sham Suits

Result 2. (Supporting Empirical Evidence)

Table 1. Economic Characteristics of Counter suits sample

Characteristic	%*
Dismissed	37.6
Relationship: **Defendant/Plaintiff**	
→ Competitors	32.5
Entrant/Competitor	20.5
Competitor/Group	21.3
Entrant/Group	10.3
Entrant/Entrant	1.7
Competitor/Entrant	2.5
Supplier/Customer	7.7
Customer/Supplier	23.1
T. Sells Complement	5.1
P. Sells Complement	18.0
Unrelated	7.7

No. Observations: 117
Source: U.S. Federal Court Opinions, Klein (1990).

Result 2. (Empirical Evidence (Continued))

Logit regressions dependent variable: PASS (asymptotic t-statistics in parentheses)

Independent Variable	*L1*		*L2*	
Constant	0.37	(1.20)	0.62	(1.85)*
RENTS	1.03	(2.36)**	1.41	(2.71)**

Likelihood Ratio Test (Chi-square test)
L1: 10.03* with 4 d.f.
L2: 16.32* with 6 d.f.
L3: 24.02** with 12 d.f.

*Significant at 0.05 level.
**Significant at 0.01 level.

RENTS = 1 if:
The predator is a competitor or a group.
The target is an entrant or a competitor.
Entry/expansion was prevented or delayed, or exit occurred.

The possibility of causing entry/expansion delay to competitors, raises the probability that a claim gets dismissed by between 0.23 and 0.30.

Result 3. (Motivating Empirical Evidence)

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More than 80% of Federal Court dismissed claims were alleged by groups

Result 3.

- PROPOSITION 3. *Given that a claim has been alleged, the chance that the claim is sham is higher when its alleged by multiple-party plaintiff than a single-party plaintiff.*

- **Intuition:** cost sharing by plaintiffs (on both trial and settlement) reduces the information-rent paid to the lawyer per plaintiff →

  Settlement negotiation is cheaper when the pool of plaintiffs is larger → Settlement (resp. litigation) becomes more (resp. less) attractive an option for larger group with grievance →

  The fact that efficient settlement does not take place should lead the court to infer that

  the plaintiffs derive additional gains

  from evoking extensive court proceedings.

Result 3. (Claims by group plaintiffs are more likely to be sham)

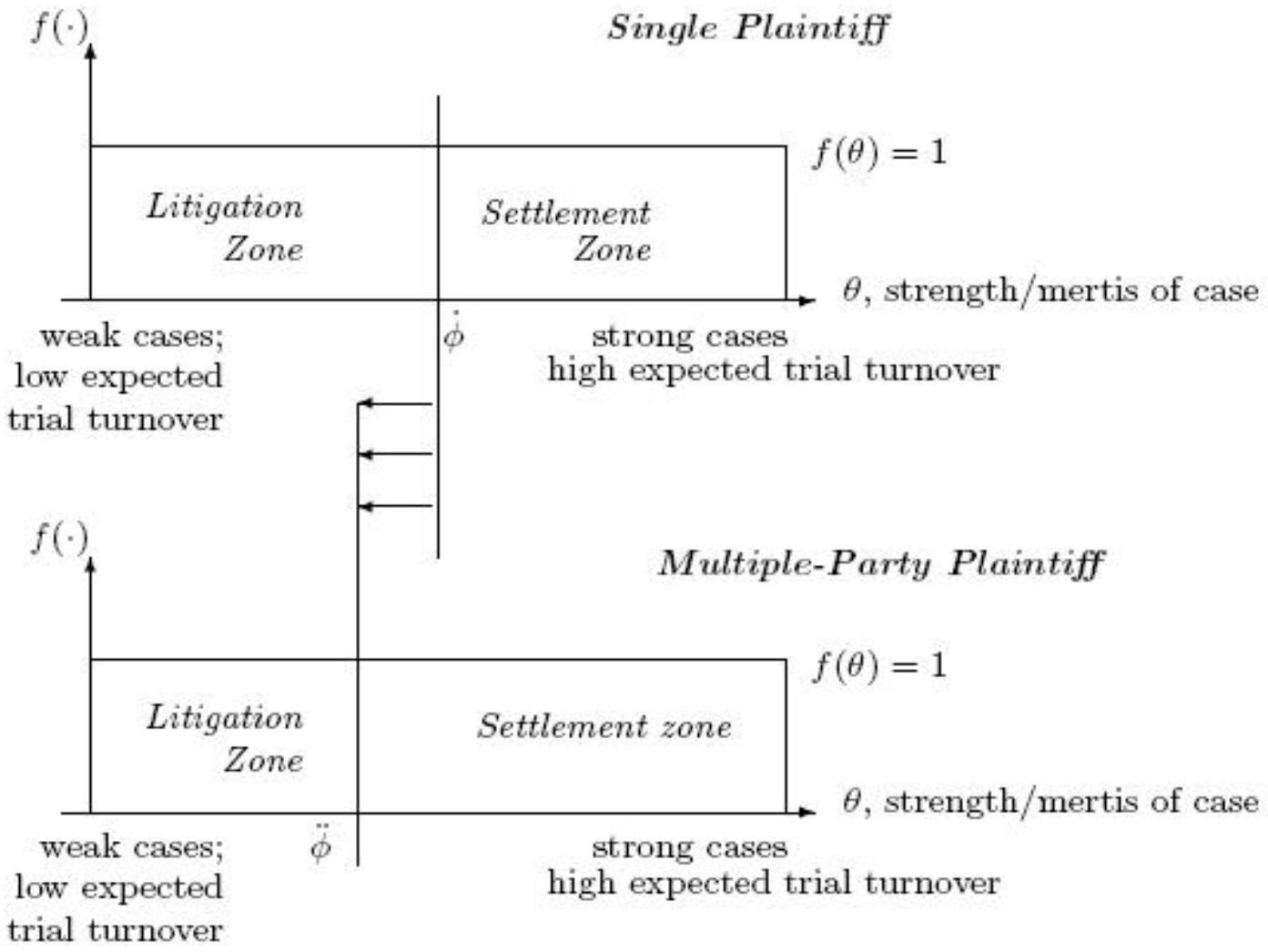

Figure 4. Litigation-Settlement Decision of Single vs. Multiple-party plaintiffs

Conclusions and Policy Implications

- Sham claims are more likely to have clearer objective merits and higher expected judgement, → current tests should be abolished.

- Motion to dismiss a claim should be based on the economic characteristics of the case – economic relationship of defendant/plaintiff , economic relationship between plaintiffs:

  cases between competitors are more likely to be sham;

  case alleged by group of plaintiffs are more likely to be sham.