

# THE SEDONA CONFERENCE JOURNAL®

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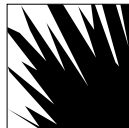
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## PUBLISHER'S NOTE

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Welcome to Volume 13 of *The Sedona Conference Journal*<sup>®</sup> (ISSN 1530-4981), an annual collection of articles originally presented at our conferences, and papers prepared by our Working Groups, over the past year. The Sedona Conference<sup>®</sup> was founded in 1997 to provide a forum for advanced dialogue by the nation's leading attorneys, academics and jurists of cutting-edge issues of law and policy in the areas of antitrust, intellectual property rights, and complex litigation. We host Regular Season Conferences, international programmes, TSCI conferences and several Working Group meetings each year, providing unique and rewarding opportunities to seriously explore the boundaries of various areas of the law with those who are creating them. This volume of the *Journal* contains articles selected from our most recent Regular Season Conferences on antitrust law and litigation (Fall 2011), patent litigation (Fall 2011), and complex litigation (Spring 2012), our TSCI conference on Staying Ahead of the eDiscovery Curve (Spring 2012), and our annual International Programme on Cross-Border Discovery & Data Privacy (Summer 2012).

We hope that you will find that the papers in this Journal reflect the same mix of theory and experience found at our Conferences and Working Group Meetings, including the creativity and constructive irreverence required to challenge traditional thinking. The views expressed herein are those of the authors, and we encourage the submission of counterpoint pieces. Submissions can be sent electronically to [info@sedonaconference.org](mailto:info@sedonaconference.org), or by mail to The Sedona Conference<sup>®</sup>, 5150 North 16th Street, Suite A-215, Phoenix, AZ 85016, USA. If you are interested in participating in one of our Regular Season Conferences, our TSCI conferences or international programmes, or in joining our Working Group Series, please visit our website for further information ([www.thesedonaconference.org](http://www.thesedonaconference.org)).

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# THE PAST YEAR IN REVIEW: SUPREME COURT & FEDERAL CIRCUIT CASE LAW UPDATE

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## I. THE SUPREME COURT IN AGREEMENT WITH THE FEDERAL CIRCUIT.<sup>1</sup>

Over the last several years, it has been realistic to assume that the Supreme Court's granting of *certiorari* in a patent case was the precursor to its reversing the Federal Circuit to correct what it sees as the Federal Circuit's error or misdirection. Many expected this year to be more of the same, and were surprised to see the Supreme Court upholding the Federal Circuit on multiple issues of patent law. Also of note, in departure from many other of the Supreme Court's recent patent decisions (*eBay* and *KSR*, to name a couple), the Supreme Court's patent decisions this term tended to lean in favor of affirming patent holders' rights. With both of these trends seemingly in direct contravention of past wisdom regarding the relationship between the Supreme Court and Federal Circuit, we are left wondering what surprises the Supreme Court has in store for us next term and, as always, we are also left grappling with how to apply the Supreme Court's latest rulings going forward.

We review the Supreme Court's decisions in patent cases since last year's The Sedona Conference®, along with their implications and the questions they raise, below:

### **A. *Microsoft Corp. v. i4i Ltd. Partnership*, 131 S. Ct. 2238 (decided June 09, 2011)**

In an 8-0 decision, with an opinion authored by Justice Sotomayor, the Supreme Court affirmed that invalidity must be established by clear and convincing evidence, based on the presumption of validity written into the Patent Act, putting an end to thoughts that that the Court might lower the evidentiary standard for invalidity to combat issuance of what some argue are so many "bad" patents by the PTO. The decision, while perhaps not unexpected, is notable because both the Court's affirmance of the Federal Circuit and the decision's favoring of patent holders' rights were a departure from the trend of recent years.

The questions the decision left open, however, are fuel for discussion. Under the facts in *i4i*, the jury was presented with evidence regarding a prior art reference that was not before the Patent Office in any way (forming the basis for the argument that the presumption of validity should not apply in the case). After affirming the presumption, Justice Sotomayor suggested that, if prior art before the jury for consideration was not

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<sup>1</sup> This section does not address Supreme Court decisions regarding patentable subject matter, which are addressed separately below.

before the PTO, the jury should be so instructed. Thus, it seems that while the Court upheld the presumption, it may under certain facts recommend that the presumption be diluted by allowing the jury to consider the extent to which a reference was considered by the PTO. Because Microsoft had not requested such an instruction below, however, the Court addressed this only in *dicta*. Going forward, courts will need to wrestle with whether, and how, to apply this suggestion:

Simply put, if the PTO did not have all material facts before it, its considered judgment may lose significant force. *Cf. KSR*, 550 U.S. at 427. And, concomitantly, the challenger's burden to persuade the jury of its invalidity defense by clear and convincing evidence may be easier to sustain. In this respect, although we have no occasion to endorse any particular formulation, we note that a jury instruction on the effect of new evidence can, and when requested, most often should be given. When warranted, the jury may be instructed to consider that it has heard evidence that the PTO had no opportunity to evaluate before granting the patent. When it is disputed whether the evidence presented to the jury differs from that evaluated by the PTO, the jury may be instructed to consider that question. In either case, the jury may be instructed to evaluate whether the evidence before it is materially new, and if so, to consider that fact when determining whether an invalidity defense has been proved by clear and convincing evidence. *Cf., e.g., Mendenhall v. Cedarapids, Inc.*, 5 F.3d 1557, 1563-1564 (C.A. Fed. 1993); *see also* Brief for International Business Machines Corp. as Amicus Curiae 31-37. Although Microsoft emphasized in its argument to the jury that S4 was never considered by the PTO, it failed to request an instruction along these lines from the District Court. Now, in its reply brief in this Court, Microsoft insists that an instruction of this kind was warranted. Reply Brief for Petitioner 22-23. That argument, however, comes far too late, and we therefore refuse to consider it. *See Rent-A-Center, West, Inc. v. Jackson*, 561 U.S. \_\_\_, \_\_\_ (2010) (slip op., at 12); *cf. Fed. Rule Civ. Proc.* 51(d)(1)(B).

*Microsoft Corp. v. i4i Ltd. Partnership*, 131 S. Ct. at 2251.

Determining just when such an instruction is warranted, and when the PTO had “no opportunity” to evaluate the reference before granting the patent, may prove a difficult task. As the Court itself noted in Footnote 10 of its opinion regarding the impracticality of “drop[ping] the heightened standard of proof where the evidence before the jury varied from that before the PTO,” it is difficult to determine where to draw the line regarding what was “considered” by the PTO, as there is an entire spectrum of levels of consideration by the PTO. Although this footnote is regarding the standard of proof, it would seem to apply equally to the jury instruction issue:

Not the least of the impracticalities of such an approach arises from the fact that whether a PTO examiner considered a particular reference will often be a question without a clear answer. In granting a patent, an examiner is under no duty to cite every reference he considers. We see no indication in §282 that Congress meant to require collateral litigation on such an inherently uncertain question.

*Id.* at 2250, n. 10 (citations omitted).

Indeed, the IBM amicus brief cited by Justice Sotomayor suggests giving jury instructions, but highlights the complicated nature of this task by noting four different situations along the spectrum of “consideration” by the PTO. The amicus brief proposes four different limiting instructions for the distinct example situations: (1) where the reference at trial was never presented to the PTO; (2) where more information was presented at trial than was before the examiner regarding a reference; (3) where the examiner was generally aware of a reference but did not explicitly note it in the file of the patent-in-suit; and (4) where there is a concurrent reexamination proceeding where the examiner has issued a non-final rejection based on the reference. It seems that a fifth situation is where the applicant or examiner has cited a prior art reference among a long list, but where the file history does not evidence that the examiner explicitly addressed or discussed that reference.

Which of these scenarios warrants an instruction and what should its content be? How will courts implement this suggestion moving forward? Where is the correct line for determining which prior art was before the PTO and which prior art was not before the PTO, warranting an instruction? Would the instruction also be appropriate if the prior art reference was part of a long list of references of which the PTO had constructive knowledge, but was not explicitly discussed or considered by the PTO? Does the fourth jury instruction proposed by IBM invite potential for unfair prejudice by allowing the jury to consider a non-final reexamination proceeding?

Additionally, how would instructing the jury regarding which art was not before the PTO square with precedent stating that courts and juries should not look behind proceedings at the patent office outside of the contexts of inequitable conduct or prosecution history estoppel? For example, how would jury instructions as Justice Sotomayor suggests reconcile with the Federal Circuit’s holding in *Norian Corp. v. Stryker Corp.*, 363 F.3d 1321 (Fed. Cir. 2004), where the Court found that it was error for the district court to instruct the jury that “[ ]in determining whether Stryker ha[d] carried that burden [to overcome the presumption of validity by clear and convincing evidence] in this case, you may consider the proceedings before the examiner and the extent to which and the manner in which the prior art was considered by or before the examiner”?

It remains to be seen the extent to which and in what manner trial courts will follow Justice Sotomayor’s suggestion. It will be difficult to apply this open suggestion uniformly, however, and the gray area will need to be sorted out in future opinions.

### **B. *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S. Ct. 2060 (decided May 31, 2011)**

In an 8-1 ruling, the Supreme Court examined the intent standard for inducement and affirmed the ruling by the Federal Circuit, which found that Global-Tech infringed by inducement.

The high Court ruled that induced infringement under § 271(b) requires knowledge that the induced acts constitute patent infringement, and applied a more stringent intent standard than the Federal Circuit, requiring “willful blindness” to satisfy this element in the absence of actual knowledge, and finding that “deliberate indifference,” the standard applied by the Federal Circuit, was insufficient to support a finding of inducement. The Supreme Court agreed with the Federal Circuit, however, on a larger point: that a state of mind short of actual knowledge would suffice. Thus, the Court’s finding of inducement in the absence of actual knowledge on balance appears to lean in favor of patent holders.

In *Global-Tech* the Court was faced with a question of statutory interpretation, determining what state of mind is required to find liability under Act § 271(b) (“Whoever actively induces infringement of a patent shall be liable as an infringer.”), and in particular whether induced infringement can be “active” if the defendant does not know of the particular patent. The main question presented was whether deliberate indifference was enough for inducement liability. The Court sought to require a state of mind far enough along the intent spectrum to protect innocent actors, while at the same time punishing culpable conduct. The Court settled upon “willful blindness,” a standard imported from criminal law and analogizing to criminal statutes – “defendants cannot escape the reach of these [criminal] statutes by deliberately shielding themselves from clear evidence of critical facts that are strongly suggested by the circumstances....” The Court then fleshed out the standard with two requirements: (1) that the defendant must subjectively believe that there is a high probability that a fact exists, and (2) that the defendant must take deliberate actions to avoid learning that fact, stating, “these requirements give willful blindness an appropriately limited scope that surpasses recklessness and negligence.”

One striking thing about this opinion is that the most critical portion appears to be the first three pages – the facts. The Court seemed driven to reach the same result as the Federal Circuit based on what it found to be egregious facts, the highlights being: (1) plaintiff SEB invented a design for a deep fryer, and obtained a U.S. patent for that design, selling practicing products in the U.S.; (2) Sunbeam Products, Inc., asked a wholly owned Hong Kong subsidiary of Global-Tech Appliances, Inc. to supply it with deep fryers to meet certain specifications; (3) the Global-Tech subsidiary purchased an SEB fryer made for sale in a foreign market (lacking U.S. patent markings) and copied everything except its cosmetic features; and (4) retained an attorney to conduct a right-to-use study without telling the attorney that it had copied SEB’s design. The fourth fact, failure to tell its patent attorney that it had reverse-engineered a particular product from a particular source, especially stuck in Court’s mind: “[W]e cannot fathom what motive [Global Tech’s representative] could have had for withholding this information other than to manufacture a claim of plausible deniability in the event that his company was later accused of patent infringement.”

The facts were so strong here in the Court’s mind, that it found the evidence sufficient to find inducement under the newly minted “willful blindness” standard, affirming rather than remanding, even though the jury was not instructed on this standard, and this standard was not put forth at any stage in the litigation. The evidence cited as constituting willful blindness is: defendants’ decision to copy reflected belief that SEB’s fryer embodied technology that would be valuable in the U.S. market (although the implicit assumption here that valuable aspects are necessarily patented seems suspect), defendants’ decision to copy a foreign model knowing it would not be marked with U.S. patent numbers, and, of course, defendants’ decision not to tell its attorney that the product the attorney was asked to evaluate was based off of another company’s fryer. Whether this rather circumstantial evidence truly establishes that Global-Tech subjectively believed that there was a high probability that the aspects of the fryer it copied were protected by valid patents is a matter of opinion.

Questions are left with from the *Global-Tech* decision include: How confined is the holding to the unique facts of the case? What other fact patterns satisfy the “willful blindness” standard? Given the facts of the case, might companies going forward be less likely to obtain opinions of counsel? Might companies also be incentivized not to look at competitors’ patents and to remain ignorant of any potential infringement? Additionally, given the heightened intent standard (imported from criminal law no less), will a finding of

inducement by “willful blindness” also necessarily, *ipso facto* establish the requisite intent for willful infringement? Put differently, if an accused infringer is found to have been “willfully blind,” can they avoid willful infringement? How would an accused infringer defend against an allegation of willful infringement after having been found to meet the “willful blindness” standard?

**C. *Board of Trustees of Leland Stanford Junior University v. Roche Molecular Systems, Inc.*, 131 S. Ct. 2188 (decided June 06, 2011)**

In a 7-2 decision that is a combination of statutory interpretation and contract law, the Court affirmed the Federal Circuit and determined that patent ownership rights do not automatically vest in universities under the Bayh-Dole Act when the underlying research was federally funded. This is in keeping with the precedent in U.S. patent law that rights to an invention can be obtained only through assignment by the inventor. Chief Justice Roberts noted precedent establishing the general rule that “rights to an invention belong to the inventor,” and although “an inventor can assign his rights in an invention to a third party,” this assignment must be express; thus an employee “must expressly grant his rights in an invention to his employer if the employer is to obtain those rights.” Contrary to Stanford’s arguments, the Act does not expressly deprive inventors of their interest in federally funded inventions but instead provides that contractors *may* elect to retain title to an invention.

Under the facts in *Stanford v. Roche*, the inventor had made an initial agreement with Stanford, which the Court found to be only a promise to assign rights in the future, and thus Roche, to whom the inventor had assigned rights, had a valid ownership interest obtained through assignment by the inventor and could not be sued by Stanford on the patent.

The decision focuses on statutory interpretation, the Supreme Court noting that if Congress had intended to enact what Stanford proposed, it would have said so clearly, not obliquely through an ambiguous definition of “subject invention” and an idiosyncratic use of the word “retain.” Moreover, the Court noted that the result of Stanford’s proposed construction of the act would have been to allow title to vest in the University even if an inventor had conceived of the invention before becoming a University employee, and federal funds only supported the reduction to practice.

This appears to be a narrow holding, affecting only the presumption that rights are presumed to be the inventor’s, not the university’s.<sup>2</sup> As with most presumptions, the parties can easily contract around it through technology transfer agreements. The real-world result of the holding is that universities will be certain that their employment contracts with researchers clearly constitute a current, present assignment of all future rights to the university, rather than a promise to assign rights in the future. As the Court noted, however, these assignment contracts are already “common practice.”

**D. *Kappos v. Hyatt* 132 S. Ct. 1690 (decided Apr. 18, 2012)**

In a 9-0 opinion by Justice Thomas (with a concurrence by Justice Sotomayor, joined by Justice Breyer), the Supreme Court once again affirmed the Federal Circuit, holding that there are no limitations on a patent applicant’s ability to introduce new

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<sup>2</sup> Justice Breyer in dissent argued that the majority’s opinion disregarded the principle that inventors be denied patent rights on inventions “for which the public has already paid,” arguing that this should be the presumption under the Bayh-Dole Act.

evidence in a 35 U.S.C. § 145 proceeding beyond those already present in the Federal Rules of Evidence and the Federal Rules of Civil Procedure. If new evidence is presented on a disputed question of fact, the district court must make *de novo* factual findings that take account of both the new evidence and the administrative record before the Patent and Trademark Office.

An unsuccessful patent applicant has two possible paths available to seek redress. If a patent examiner rejects a patent application, the applicant may first appeal to the Board of Patent Appeals and Interferences (Board) at the U.S. Patent and Trademark Office (PTO). A patent applicant who is dissatisfied with the Board's decision may then appeal the decision by either proceeding in a § 141 action before the Federal Circuit, or in a §145 action (which have thus far been heard by the District Court for the District of Columbia, but following enactment of the America Invents Act will be heard in the Eastern District of Virginia). In a §141 action before the Federal Circuit, the patent applicant is not permitted to introduce new evidence that was not presented to the PTO.

In reviewing the Federal Circuit's *en banc* decision,<sup>3</sup> the Supreme Court addressed two questions presented:

1. Whether the plaintiff in a Section 145 action may introduce new evidence that could have been presented to the agency in the first instance.
2. Whether, when new evidence is introduced under Section 145, the district court may decide *de novo* the factual questions to which the evidence pertains, without giving deference to the prior decision of the PTO.<sup>4</sup>

The Federal Circuit below established new rules for a Section 145 action, reversing long-standing precedent and holding: (1) that a patent applicant is allowed to introduce new evidence in a Section 145 civil action filed to challenge a USPTO refusal to grant patent rights; and (2) that the issues implicated by the new facts must be considered *de novo*, because a Section 145 civil action is not an appeal, but rather a new, separate lawsuit filed to force the PTO to act.

The Supreme Court affirmed on both counts, holding that: (1) in a Section 145 proceeding, the applicant may present new evidence to the district court that was not presented to the PTO, and that there are no evidentiary restrictions on the introduction of such evidence beyond the restrictions already imposed by the Federal Rules of Evidence and the Federal Rules of Civil Procedure; (2) regarding the standard of review that should be applied when considering new evidence, the district court must make a *de novo* finding when the new evidence is presented on a disputed question of fact. In reaching its second holding, the Court reasoned that the district court must act as a factfinder and thus cannot apply a deferential standard:

The district court must assess the credibility of new witnesses and other evidence, determine how the new evidence comports with the existing administrative record, and decide what weight the new evidence deserves. As a logical matter, the district court can only make these determinations *de novo* because it is the first tribunal to hear the evidence in question.”

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<sup>3</sup> *Hyatt v. Kappos*, 625 F.3d 1320 (Fed. Cir. 2010) (*en banc*)

<sup>4</sup> Order Granting Cert. (June 27, 2011).

*Kappos v. Hyatt*, 132 S. Ct. at 170.

The ruling means that an unsuccessful patent applicant can make a full evidentiary showing in Section 145 proceedings, utilizing the district court's ability to handle all types of evidence that could be introduced at trial, including expert testimony, demonstrations, and fact witness testimony (which the PTO is understandably unable to handle).

There are of course many questions going forward regarding the effect that *Hyatt* will have. Under the Federal Circuit's decision, Section 145 actions will likely be more attractive to patent applicants because they can bring new arguments and evidence to bear in a potentially more receptive forum (the Federal judges of the Eastern District of Virginia). Will the workload of the Eastern District of Virginia increase? If applicants choose § 145 actions instead of a § 141 actions so that they can introduce new evidence, will the Federal Circuit's workload be reduced? Will applicants bypass the slow process at the PTO and opt for Section 145 actions as soon as possible, receiving a final rejection and immediately appealing to the BPAI so that they can reach the Eastern District of Virginia?

Additional questions also remain concerning the impact of the new approach following the completion of Section 145 proceedings. Will a patent that has been issued as a result of a successful §145 action be blessed with more judicial deference as to the validity determinations in infringement litigation than one that had not been so tested? Will applicants be wary of the fact that all evidence presented would build a hefty prosecution record that could later be used to assert prosecution history estoppel?

There may also be inherent dangers in the fact that patent applicants will now be able to put on more and better evidence to the district court than would be possible before the PTO. Justice Thomas addressed this issue, expressing skepticism that this posed any real risk:

The Director warns that allowing the district court to consider all admissible evidence and to make de novo findings will encourage patent applicants to withhold evidence from the PTO intentionally with the goal of presenting that evidence for the first time to a nonexpert judge. We find that scenario unlikely. An applicant who pursues such a strategy would be intentionally undermining his claims before the PTO on the speculative chance that he will gain some advantage in the § 145 proceeding by presenting new evidence to a district court judge.

*Kappos v. Hyatt*, 132 S. Ct. at 1700.

The Federal Circuit judges appear to have varying levels of concern as to the likelihood of the danger that applicants will withhold information from the first round before the PTO, saving it to bring before the district court. Judge Newman in concurrence-in-part stated:

The PTO Solicitor and my colleagues in dissent argue that applicants will deliberately withhold evidence in their possession, in order to spring it on the district court under section 145. I share the view of the *amici curiae* that it is unlikely that applicants will withhold winning evidence from the examiner, in favor of a multi-year and expensive civil action in the district court.

*Hyatt v. Kappos*, 625 F.3d at 1341 n.1.

In contrast, Judge Dyk joined by Judge Gajarsa in dissent, showed much more concern:

In my view today's majority decision reflects a remarkable departure from settled principles of administrative law. The majority holds today that a patent applicant may decline to present his evidence supporting a patent application to the Patent and Trademark Office ("PTO"), the expert agency charged by Congress with reviewing patent applications. Instead, he may elect to present that evidence to a district court in a *de novo* proceeding. As the majority itself states, "We hold that 35 U.S.C. § 145 imposes *no limitation* on an applicant's right to introduce new evidence before the district court, apart from the evidentiary limitations applicable to all civil actions...." Maj. op. at 1323 (emphasis added). Moreover, when the district court considers that new evidence, it owes no deference to the PTO's resolution of the fact issues. Rather, the district court makes *de novo* findings of fact.

*Id.* at 1341-42 (emphasis in original).

While perhaps the concern that applicants will actually withhold evidence from the PTO is unfounded, it is certainly true that the district court provides a forum to present additional types of evidence (for example, testimony from lay witnesses and experts) that are not available in the PTO proceedings. Applicants appealing a decision of the Board will have every incentive to present their case through a full evidentiary showing, while also gaining the benefit of a *de novo* standard when new evidence is presented.

The Supreme Court also noted that "[i]n deciding what weight to afford that evidence, the district court may, however, consider whether the applicant had an opportunity to present the evidence to the PTO." "Although we reject the Director's proposal for a stricter evidentiary rule and an elevated standard of review in § 145 proceedings, we agree with the Federal Circuit that the district court may, in its discretion 'consider the proceedings before and findings of the Patent Office in deciding what weight to afford an applicant's newly-admitted evidence.'" It remains to be seen whether this discretion to give less weight to newly presented evidence if the applicant had an opportunity to present the evidence to the PTO will be an exception that undermines the rule allowing presentation of new evidence. However, it may also provide an estoppel-like safeguard, allowing the district court to afford evidence less weight if the applicant had an opportunity to present it to the PTO and chose to withhold it.

Moreover, what is the nature of the opposition that applicants will be met with in Section 145 proceedings? The defendant will be the director of the PTO, represented by the Solicitor's Office, which has limited resources. Although the Solicitor's Office can likely also present new evidence (although this was not expressly addressed by the Federal Circuit), this may have little practical effect given the lack of available resources. Also, might third parties, such as competitors, offer support to the Solicitor's Office in opposing the applicant?

## II. THE FEDERAL CIRCUIT WEIGHTS IN, *EN BANC*.

The Federal Circuit has had a very busy past year, which has included a number of significant *en banc* decisions, including:



**A. *TiVo Inc. v. EchoStar Corp.*, 646 F.3d 869 (Fed. Cir. April 20, 2011) (*en banc*)**

In an *en banc* decision authored by Judge Lourie, the Federal Circuit clarified the standard for contempt proceedings, a scenario encountered where after entry of an injunction, the accused infringer comes up with an alleged design-around that the patentee challenges by asserting contempt of the existing injunction. The Federal Circuit overturned the prior three-judge panel decision in *KSM Fastening Systems, Inc. v. H.A. Jones Co., Inc.*, 776 F.2d 1522 (Fed. Cir. 1985), firmly placing the decision whether to conduct a contempt proceeding in the trial court's discretion and also clarifying the standards for a contempt determination.

In the trial in *TiVo v. EchoStar*, the jury determined that the models of EchoStar receivers at issue literally infringed hardware and software claims of TiVo's patent claims relating to DVR technology. The trial court issued an injunction requiring EchoStar to: (1) stop making, using, offering to sell and selling the receivers that had been found to infringe by the jury; and (2) disable the DVR functionality in both existing receivers that had already been placed with EchoStar's customers and in new receivers that were yet to be placed with EchoStar's customers. When TiVo initiated a contempt proceeding, EchoStar argued that it had redesigned its receivers so that specific claim limitations were not met in the redesigned products.

The *en banc* Federal Circuit found that the district court did not abuse its discretion in initiating contempt proceedings. The Court also replaced the previous two-step process for seeking contempt, which required a threshold finding of whether the modified product is colorably different to determine whether a contempt proceeding should be initiated, prior to making a determination of whether contempt occurred. The Court removed the separate threshold step, giving district courts broad discretion in judging whether to hold a contempt proceeding so long as the injured party offers a detailed accusation alleging contempt:

In recent times, we have required district courts to make a two-part inquiry in finding a defendant in contempt of an injunction in patent infringement cases. First, the court must determine whether a contempt hearing is an appropriate setting in which to adjudge infringement by the redesigned product. The court may do this by comparing the accused product with the adjudged infringing product to determine if there is "more than a colorable difference" between the accused product and the adjudged infringing product such that "substantial open issues with respect to infringement" exist. Where the court finds that to be the case, a new trial is necessary to determine further infringement and the court may not proceed with a contempt finding. Only in cases where the court is satisfied on the threshold inquiry of the appropriateness of a contempt proceeding can a court inquire whether the redesigned product continues to infringe the claims as previously construed. We conclude that KSM's two-step inquiry has been unworkable and now overrule that holding of KSM. KSM crafted a special rule for patent infringement cases, in that it required a threshold inquiry on the propriety of initiating a contempt proceeding. ***We recognize now that inquiry confuses the merits of the contempt with the propriety of initiating contempt proceedings.*** Moreover, as a practical matter, district courts do not separately determine the propriety of a contempt proceeding before proceeding to the merits of the contempt itself. As a result, ***we will telescope the***

***current two-fold KSM inquiry into one, eliminating the separate determination whether contempt proceedings were properly initiated. That question, we hold, is left to the broad discretion of the trial court to be answered based on the facts presented.*** What is required for a district court to hold a contempt proceeding is a detailed accusation from the injured party setting forth the alleged facts constituting the contempt. As with appeals from findings of civil contempt in other areas of law, we will only review whether the injunction at issue is both enforceable and violated, and whether the sanctions imposed were proper. Allegations that contempt proceedings were improper in the first instance do not state a defense to contempt.

*TiVo Inc. v. EchoStar Corp.*, 646 F.3d at 880-81 (internal citations omitted, emphasis added).

The Court made clear that it would review a trial court's decision to hold contempt proceedings under an abuse of discretion standard. It remains to be seen whether the broader discretion afforded will result in more contempt proceedings, which are arguably more efficient than the patent holder instituting new infringement actions.

The Court then went on to define the "more than colorable differences" test and correct application of it:

We have previously interpreted that inquiry in patent cases as one of colorable differences between the newly accused product and the adjudged infringing product. Thus, the party seeking to enforce the injunction must prove both that the newly accused product is not more than colorably different from the product found to infringe and that the newly accused product actually infringes. We have stated the test for colorable differences as one that requires determining whether "substantial open issues with respect to infringement to be tried" exist. In some cases, that has misled district courts to focus solely on infringement by the newly accused devices in deciding contempt. That is the case here. Today, we reject that infringement-based understanding of the colorably different test. Instead of focusing solely on infringement, the contempt analysis must focus initially on the differences between the features relied upon to establish infringement and the modified features of the newly accused products. The primary question on contempt should be whether the newly accused product is so different from the product previously found to infringe that it raises "a fair ground of doubt as to the wrongfulness of the defendant's conduct." The analysis must focus not on differences between randomly chosen features of the product found to infringe in the earlier infringement trial and the newly accused product, but on those aspects of the accused product that were previously alleged to be, and were a basis for, the prior finding of infringement, and the modified features of the newly accused product. Specifically, one should focus on those elements of the adjudged infringing products that the patentee previously contended, and proved, satisfy specific limitations of the asserted claims. ***Where one or more of those elements previously found to infringe has been modified, or removed, the court must make an inquiry into whether that modification is significant.*** If those differences between the old and new elements are significant, the newly accused product as a whole shall be deemed more than colorably

different from the adjudged infringing one, and the inquiry into whether the newly accused product actually infringes is irrelevant. Contempt is then inappropriate.

*Id.* at 882-83.

In this first inquiry of a contempt proceeding, an infringement analysis is now clearly off-limits. Determining the contours of this standard may prove difficult for district courts going forward. For instance, how will courts determine whether there are colorable differences or whether a modification is “significant” without reference to an infringement analysis? That is, it seems difficult not to consider infringement at all in this stage, particularly given that differences between the current product and product previously found to infringe are not truly made in the abstract, but made in the context of whether the differences would matter with respect to the infringement analysis. For instance, knowing whether the change in an element is significant might require looking at the construction of that element below. The Federal Circuit seems to say that is off-limits, however it is unclear whether consideration of the infringement analysis or reasoning of the previous infringement finding is allowed, provided the district court does not undertake an element-by-element infringement analysis at this phase. How courts will truly avoid an infringement analysis in determining whether there are colorable differences will present a challenge going forward.

Additionally, this delineation requiring analysis of the “colorable differences” test prior to the infringement analysis seems to leave open the possibility that, where in the underlying action literal infringement was found, products that may infringe under the doctrine of equivalents could be found to have “colorable differences” and thus not provide the basis for contempt. Of course, a separate action for infringement may be brought, but it is unclear whether these scenarios can fall under the contempt umbrella.

While the district courts are not to undertake an infringement analysis in determining whether there are “colorable differences,” the Federal Circuit did import an obviousness analysis into the “colorable differences” test:

The significance of the differences between the two products is much dependent on the nature of the products at issue. The court must also look to the relevant prior art, if any is available, to determine if the modification merely employs or combines elements already known in the prior art in a manner that would have been obvious to a person of ordinary skill in the art at the time the modification was made.<sup>FN1</sup>

FN1. We do not suggest that the law on obviousness is binding in contempt proceedings, where, in most cases, a single limitation that has been modified by an infringer is at issue. However, the innovative significance of the modification is best viewed in light of the existing art and from the perspective of one of ordinary skill in the art.

A nonobvious modification may well result in a finding of more than a colorable difference. Where useful, a district court may seek expert testimony in making the determination. The analysis may also take account of the policy that legitimate design-around efforts should always be encouraged as a path to spur further innovation. But an assertion that

one has permissibly designed around a patent should not be used to mask continued infringement. Determining the requisite level of difference is a question of fact.

*Id.* at 882-83 & 883 n. 1 (citations omitted).

The inclusion of this obviousness analysis may lead to confusion in determining the significance of a modification, and the potential need for expert analysis may add considerable cost to a contempt proceeding, assuming parties are not limited to prior expert reports. This analysis may impact the patentee's consideration of whether a contempt proceeding is preferable to initiating a new infringement action.

Under the new standard, if the changes are not "significantly different" and there is not "more than a colorable difference" the inquiry ends and there is no infringement analysis. If more than a colorable difference is not found, then courts are to undertake an infringement analysis, based on the previous claim construction, to determine whether the alleged design-around infringes such that contempt is appropriate.

Conversely, when a court concludes that there are no more than colorable differences between the adjudged infringing product and modified product, a finding that the newly accused product continues to infringe the relevant claims is additionally essential for a violation of an injunction against infringement. Thus, the court is required to evaluate the modified elements of the newly accused product against the asserted claim, on a limitation by limitation basis, to ensure that each limitation continues to be met. In making this infringement evaluation, out of fairness, the district court is bound by any prior claim construction that it had performed in the case. The patentee bears the burden of proving violation of the injunction by clear and convincing evidence, a burden that applies to both infringement and colorable differences.

*Id.* at 883.

While this infringement determination must be based on the previous construction, it is unclear whether any additional term(s) can be construed at this stage if necessary to determine infringement. Additionally, is the patentee stuck with the infringement analysis applied at trial, or can it apply new theories? For instance, if literal infringement was found, can the patentee assert a doctrine of equivalents theory in this stage of contempt proceedings? Would new expert analysis be needed in this infringement phase of the determination?

The Federal Circuit also addressed EchoStar's arguments that the injunction was vague or unlawfully overbroad. Because these arguments were not brought at the trial stage, EchoStar had waived them and could not bring these arguments alleging lack of clarity in the injunction at the contempt stage. This ruling certainly underscores the need and importance for an enjoined infringer to raise issues of clarification or modification of the injunction at the time of entry of the injunction, as they cannot attempt to raise them for the first time in contempt proceedings.

**B. *Therasense, Inc. v. Becton, Dickinson and Company*, 649 F.3d 1276 (Fed. Cir. May 25, 2011) (*en banc*)**

The Court in a six-judge majority tightened the standards for inequitable conduct, cracking down on what is described as the “absolute plague” of inequitable conduct allegations in recent years:

One study estimated that eighty percent of patent infringement cases included allegations of inequitable conduct. Inequitable conduct “has been overplayed, is appearing in nearly every patent suit, and is cluttering up the patent system.” “[T]he habit of charging inequitable conduct in almost every major patent case has become an absolute plague. Reputable lawyers seem to feel compelled to make the charge against other reputable lawyers on the slenderest grounds, to represent their client’s interests adequately, perhaps.” Left unfettered, the inequitable conduct doctrine has plagued not only the courts but also the entire patent system. Because allegations of inequitable conduct are routinely brought on “the slenderest grounds,” patent prosecutors constantly confront the specter of inequitable conduct charges. With inequitable conduct casting the shadow of a hangman’s noose, it is unsurprising that patent prosecutors regularly bury PTO examiners with a deluge of prior art references, most of which have marginal value. “Applicants disclose too much prior art for the PTO to meaningfully consider, and do not explain its significance, all out of fear that to do otherwise risks a claim of inequitable conduct.” “This flood of information strains the agency’s examining resources and directly contributes to the backlog.” While honesty at the PTO is essential, low standards for intent and materiality have inadvertently led to many unintended consequences, among them, increased adjudication cost and complexity, reduced likelihood of settlement, burdened courts, strained PTO resources, increased PTO backlog, and impaired patent quality. This court now tightens the standards for finding both intent and materiality in order to redirect a doctrine that has been overused to the detriment of the public.

*Therasense, Inc. v. Becton, Dickinson and Co.*, 2011 WL 2028255 at \*8-\*9 (citations omitted).

To remedy this plague, the *en banc* Federal Circuit held that evidence of a “deliberate decision” to deceive is required to satisfy the intent element for inequitable conduct, and that when such evidence is circumstantial, intent to deceive must be “the most reasonable inference.” Importantly, the majority also held that evidence of “but-for” materiality is required (the party alleging inequitable conduct must establish that “but-for” the misrepresentation or omission, the patent would not have issued). The Court did, however, make one exception to the requirement of but-for materiality in the case of “affirmative egregious misconduct”: “Although but-for materiality generally must be proved to satisfy the materiality prong of inequitable conduct, this court recognizes an exception in cases of affirmative egregious misconduct... . When the patentee has engaged in affirmative acts of egregious misconduct, such as the filing of an unmistakably false affidavit, the misconduct is material.” Further, the Court made clear that intent and materiality are separate requirements, doing away with the “sliding scale” whereby strong evidence of either intent or materiality could theoretically fill in holes as to the other requirement; no longer can a showing of high materiality make up for a lower degree of intent, or vice versa.

It remains to be seen just how significant the impact of *Therasense* will be and the degree to which it will cut down on the “plague” of inequitable conduct claims. It would certainly seem that the *Therasense* holdings, particularly coupled with the pleading requirements set forth in *Exergen*, have the potential for a significant impact.

It will also be interesting to see if *Therasense* will really reduce the “bury[ing] of PTO examiners with a deluge of prior art references.” It seems that under the heightened standards, demonstrating that a reference was disclosed would destroy but-for materiality, so that applicants may continue to throw in “everything but the kitchen sink” in deciding which references to disclose to the patent office. Perhaps if the numbers of inequitable conduct allegations are reduced, prosecutors’ fear of inequitable conduct will dissipate, but it seems likely that for now over-disclosure may continue, as it appears to provide insulation from inequitable conduct allegations, in addition to serving other purposes. In addition, an open question seems to be whether, in determining but-for materiality, courts will need to examine the reference under the standard applied by the PTO (the broadest reasonable construction).

Once the new provisions providing for supplemental examination procedures under the recently enacted American Invents Act become effective, it would seem that there will now be even further opportunities for disclosures in connection with such proceedings in addition to reexamination proceedings, that should provide the ability to cure potential inequitable conduct issues during prosecution. That is, if the PTO determines that a reference or other information presented in the request for supplemental examination does not raise a “substantial new question of patentability,” then the patent cannot be found unenforceable due to any failure to present that information in the first examination, even if the conduct was intentional, provided that there was not “material fraud.” However, supplemental examination cannot be used where allegations of inequitable conduct were pled in litigation before the supplemental examination was filed.

### III. PATENTABLE SUBJECT MATTER.

Perhaps the most notable trend in patent decisions issuing from the Supreme Court and Federal Circuit this past year was the sheer number of opinions on patentable subject matter in the wake of *In re Bilski*, 130 S. Ct. 3218 (2010). This trend was of the not-so-subtle variety, as patentable subject matter seemed to dominate a large portion of both Courts’ attention.

The Federal Circuit’s most recent § 101 decisions leading up to The Sedona Conference® left a question mark rather than a period at the end of the patentable-subject-matter sentence, reflecting the fractured views in the Federal Circuit post-*Bilski*. The Supreme Court has now weighed in with its decision in *Mayo Collaborative Services v. Prometheus Labs.*, which will hopefully lend clarity and continuity to the patentable subject matter landscape.

#### A. *Mayo Collaborative Services v. Prometheus Laboratories.*, 566 U.S. \_\_\_, 132 S. Ct. 1289 (decided March 20, 2012)

The Supreme Court granted *certiorari* for the second time in *Mayo Collaborative Services v. Prometheus Laboratories*, having already vacated and remanded the case to the Federal Circuit last year for further consideration in light of *Bilski*. The Supreme Court has

now reversed the Federal Circuit's second opinion in this case, issued December 17, 2010.<sup>5</sup> The Court's March 20, 2012 opinion, issued by Justice Breyer, held that the process claimed in Prometheus's patents, described below, is not patent-eligible under § 101.

The patent claims at issue in *Prometheus* are medical method claims directed at administering a drug to treat autoimmune disorders, and determining whether the metabolite level of the drug falls within a range correlated with efficacy but not toxicity. Two patents are at issue:

- The '623 patent, which claims a method for optimizing therapeutic efficacy, comprising the steps of administering the drug, and then determining the level of metabolite, wherein the level of metabolite indicates either a need to increase or decrease the level of drug (depending on where the metabolite level falls given correlations between metabolite levels and efficacy or toxicity);
- The '302 patent, which claims a method of optimizing therapeutic efficacy and reducing toxicity, comprising the steps of determining the level of metabolite, which will give an indication to either increase or decrease the amount of drug in light of the correlation, allowing for calibration proper dosage of drugs to treat autoimmune diseases in light of those correlations. The claims of the '302 patent largely match those of the '623 patent, just without the "administering" step.

The Federal Circuit in December, 2010 found for the second time that the methods in both patents were patentable subject matter, holding that the method claims recite an application of the naturally occurring correlations (i.e., specific treatment steps), and accordingly do not preempt all uses of the natural correlations; further, the Federal Circuit held that the method claims satisfied the "transformation" prong of the machine-or-transformation test because the human body changes the drug into a different state or thing (i.e., a metabolite), which is central to the purpose of the claimed process. 628 F.3d at 1355-56.

The question presented in *Prometheus* appeared to offer an opportunity for the Supreme Court to clarify the patentable-subject-matter analysis, and the interplay between the multiple tests for determining patentable subject matter (namely, the preemption test and the machine-or-transformation test).

In granting *certiorari*, the Supreme Court stated as follows:

This case concerns whether a patentee can monopolize basic, natural biological relationships. The Court has twice granted *certiorari* on the question presented, without yet resolving the issue. Last year, it granted *certiorari*, vacated, and remanded in this case to allow the Federal Circuit to reconsider this question in light of *Bilski v. Kappos*, 130 S. Ct. 3218 (2010). And seven years ago it granted *certiorari* but dismissed the writ as improvidently granted in *Laboratory Corp. of America Holdings v.*

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5 *Prometheus Laboratories, Inc. v. Mayo Collaborative Services*, 628 F.3d 1347 (Fed. Cir. Dec. 17, 2010).

*Metabolite Laboratories, Inc.*, 548 U.S. 124, 135 (2006), because petitioner there had not adequately preserved the question.

The question presented asks:

Whether 35 U.S.C. § 101 is satisfied by a patent claim that covers observed correlations between blood test results and patient health, so that the claim effectively preempts all uses of the naturally occurring correlations, simply because well-known methods used to administer prescription drugs and test blood may involve “transformations” of body chemistry.”

Order Granting Cert., 131, S. Ct. 3027 (June 20, 2011).

A patent cannot monopolize a natural phenomenon or law of nature. Thus, a patent claim that covers all uses of a natural phenomenon or law of nature such that if enforced it would prevent all uses of the naturally occurring phenomenon violates § 101.

It is a likely scenario that the Supreme Court granted *certiorari* for a second chance at *Laboratory Corp.*, where the writ was dismissed as improvidently granted, but Justice Breyer, joined by Justice Stevens and Justice Souter, wrote a dissent addressing the merits. They addressed the § 101 challenge to the patents at issue, which as stated by the dissent claimed a process for helping to diagnose deficiencies of two vitamins, folate and cobalamin consisting of using any test (whether patented or unpatented) to measure the level in a body fluid of an amino acid called homocysteine and then noticing whether its level is elevated above the norm. In no uncertain terms, the dissenting Justices in *Laboratory Corp.* stated that the patents improperly sought to claim a monopoly over a basic scientific relationship (the relationship between homocysteine and vitamin deficiency):

[T]his case is not at the boundary. It does not require us to consider the precise scope of the “natural phenomenon” doctrine or any other difficult issue. In my view, claim 13 is invalid no matter how narrowly one reasonably interprets that doctrine. There can be little doubt that the correlation between homocysteine and vitamin deficiency set forth in claim 13 is a “natural phenomenon.” ... The respondents argue, however, that the correlation is nonetheless patentable because claim 13 packages it in the form of a “process” for detecting vitamin deficiency, with discrete testing and correlating steps.... Why should it matter if the test results themselves were obtained through an unpatented procedure that involved the transformation of blood? Claim 13 is indifferent to that fact, for it tells the user to use any test at all. Indeed, to use virtually any natural phenomenon for virtually any useful purpose could well involve the use of empirical information obtained through an unpatented means that might have involved transforming matter.

548 U.S. at 135-38.

As predicted, the Court in *Prometheus* followed the dissent in *Laboratory Corp.* and denied patent eligibility. At the base of the patent claims at issue in *Prometheus* is the correlation between metabolite levels and toxicity or efficacy. This correlation (the relationship between concentrations of thiopurine metabolite levels in the blood and the dosage of thiopurine drugs that either are too low and therefore ineffective or too high and



therefore harmful) is a law of nature or natural phenomenon that cannot itself be patented. The Court in *Prometheus* determined whether the other portions of the patent claims, such as the step of administering the drug to a patient or calibrating the drug dosage after analyzing the metabolite level, were sufficient application steps such that the claims did not effectively preempt all uses of the natural correlation. What “something else” beyond the natural law is sufficient to avoid preemption and confer patent eligibility? The Court articulated the question as follows:

The question before us is whether the claims do significantly more than simply describe these natural relations. To put the matter more precisely, do the patent claims add *enough* to their statements of the correlations to allow the processes they describe to qualify as patent-eligible processes that *apply* natural laws? We believe that the answer to this question is no. If a law of nature is not patentable, then neither is a process reciting a law of nature, unless that process has additional features that provide practical assurance that the process is more than a drafting effort designed to monopolize the law of nature itself.

*Mayo Collaborative Services v. Prometheus Laboratories, Inc.*, 132 S. Ct. 1289, 1297 (2012) (emphasis in original).

The Court held that the patent claims at issue “effectively claim the underlying laws of nature themselves” and that the additional portions of the claims were not sufficient to confer patent eligibility, stating: “We must determine whether the claimed processes have transformed these unpatentable natural laws into patent-eligible applications of those laws. We conclude that they have not done so and that therefore the processes are not patentable.” In reaching this determination, the Court reviewed its precedent “warn[ing] us against upholding patents that claim processes that too broadly preempt the use of a natural law.” Applying this principle to the claims at issue, the Court determined that there was no other use for the natural correlation beyond the methods patented, and accordingly the claims improperly attempted to monopolize a natural law itself:

Anyone who wants to make use of these laws must first administer a thiopurine drug and measure the resulting metabolite concentrations, and so the combination [of steps in the process] amounts to nothing significantly more than an instruction to doctors to apply the applicable laws when treating their patients.... To put the matter more succinctly, the claims inform a relevant audience about certain laws of nature: any additional steps consist of well-understood, routine, conventional activity already engaged in by the scientific community; and those steps, when viewed as a whole, add nothing significant beyond the sum of their parts taken separately.

*Id.* at 1298.

At bottom, the Court ruled that the natural correlation itself *is* the invention or discovery that *Prometheus* attempted to patent, and the steps applying the natural correlation were mere “post-solution activity” that was “conventional or obvious” and not sufficient to confer patent eligibility. “Beyond picking out the relevant audience, namely those who administer doses of thiopurine drugs, the claim simply tells doctors to: (1) measure (somehow) the current level of the relevant metabolite, (2) use particular

(unpatentable) laws of nature (which the claim sets forth) to calculate the toxicity/efficacy limits, and (3) reconsider the drug dosage in light of the law.

*Id.* at 1299.

The Court also reversed the Federal Circuit's determination that there was sufficient "transformation" under the machine-or-transformation test to confer patent eligibility. Referring back to *Bilski*, the Court stated: "[I]n stating that the 'machine-or-transformation' test is an 'important and useful clue' to patentability, we have neither said nor implied that the test trumps the 'law of nature' exclusion. That being so, the test fails here." *Id.* at 1303 (emphasis added, internal citations omitted).

While the Court in *Prometheus* provided further guidance following *Bilski*, certain critical questions remain, which the Federal Circuit will need to address soon, as the Supreme Court has already remanded multiple cases to the Federal Circuit for further consideration in light of *Prometheus* (discussed below). First, the Court did not delineate or articulate the precise interaction between the "preemption test" and the "machine-or-transformation" test. Is the preemption test the dominant analysis, for which the machine-or-transformation test is merely informative as a "useful and important clue"? It seems that the preemption test, which embodies the policy underlying § 101 should be the dominant analysis, in that if a claim fails the preemption test, it runs afoul of the policy of the statute, which precludes the patenting of laws of nature, natural phenomena, and abstract ideas. If a claim fails the preemption test, is there any need for the machine-or-transformation test, which arguably should not be able to rescue a claim failing the preemption test? Is the machine-or-transformation test applicable in some contexts but not others? The Federal Circuit will have to grapple with these questions in the upcoming term, as will the PTO in developing policy regarding § 101 rejections.

Another question left in the wake of the *Prometheus* decision relates to the apparent importation of novelty or obviousness analysis into the § 101 inquiry invited by the Court's opinion. In finding that the application steps were not sufficient to confer patent eligibility, the Court stated examined the extent to which the steps (other than the natural correlation) were novel or well-known: "[T]he steps in the claimed processes (apart from the natural laws themselves) involve **well-understood, routine, conventional activity previously engaged in by researchers of the field.**" *Id.* at 1294 (emphasis added). Later in the opinion, the Court acknowledged: "We recognize that, in evaluating the significance of additional steps, the § 101 patent-eligibility inquiry and, say, the § 102 novelty inquiry might sometimes overlap." *Id.* at 1304. Does this conflation of the § 101 and § 102/103 analyses create the potential for confusion? It remains to be seen how courts will apply this portion of the *Prometheus* opinion

#### **B. *Association for Molecular Pathology v. Myriad Genetics, Inc.*, 132 S. Ct. 1794 (Mar. 26, 2012)**

On March 26, 2012, the Supreme Court vacated the judgment of the Federal Circuit below (*Association For Molecular Pathology v. U.S. Patent and Trademark Office*, 653 F.3d 1329 (Fed. Cir. July 29, 2011)) and remanded the case to the Federal Circuit for further consideration in light of *Mayo Collaborative Services v. Prometheus Laboratories, Inc.*, 566 U.S. —, 132 S. Ct. 1289 (2012).

In the now vacated opinion written by Judge Lourie,<sup>6</sup> the Federal Circuit addressed the holdings from the S.D.N.Y. regarding whether isolated gene sequences of the BRCA1 and BRCA2 genes, which are linked to breast cancer, and diagnostic method patents involving the BRCA genes, fall within patentable subject matter under § 101. The majority held that:

(1) the district court erred in holding that composition of matter patents on isolated DNA sequences were invalid under § 101 because the isolated DNA exists in a distinctive chemical form from the native DNA found in the body, as the isolated sequences are manipulated (either cleaved or synthesized) and are thus markedly different molecules than those found in the body;

(2) the district court correctly held that the method claims for comparing or analyzing gene sequences were invalid under *Bilski*, as the comparison of genes is simply an abstract mental process, and the limitation of the method to the BRCA field of use cannot rescue the claimed methods from invalidation under § 101: “Although the *application* of a formula or abstract idea in a process may describe patentable subject matter, Myriad’s claims do not apply the step of comparing two nucleotide sequences in a process. Rather, the step of comparing two DNA sequences is the entire process claimed.”

(3) the district court erred in holding that Myriad’s claims directed to screening potential cancer therapeutics via changes in cell growth rates were invalid, since the method claims involve the transformative steps, critical to the purpose of the claimed process, of growing host cells transformed (a term of art) with an altered BRCA1 gene in the presence or absence of a potential cancer therapeutic, determining the growth rate, and then comparing the host cells’ growth rate; thus the process involves physical manipulation of the cells, not just the process of comparing two cells’ growth rates (and thus is not simply an abstract mental process).

The result under the previous Federal Circuit opinion is that the composition of matter claims, arguably the broadest claims, are upheld as patentable. It appears that the Federal Circuit will reexamine its analysis of the patentability of the composition of matter claims for isolated DNA sequences. Indeed, the Federal Circuit’s order regarding briefing on remand<sup>7</sup> requests briefing on the following issues: “What is the applicability of the Supreme Court’s decision in *Mayo* to Myriad’s isolated DNA claims and to the method claim 20 of the ‘282 patent [the screening method]?”

It appears that the second holding regarding the method claims for comparing gene sequences, which lack any application step and have already been held unpatentable (because “the step of comparing two DNA sequences is the entire method claimed”) will likely not be affected by the Supreme Court’s holding in *Prometheus*.

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6 Judge Moore concurred in part, opining that short isolated DNA segments are distinct from long DNA sequences and may not be patentable. Judge Bryson concurred in part and dissented in part, opining that isolated genes are not materially different from native genes, and just as there is no transformation in “snapping a leaf from a tree,” there is no transformation in isolating DNA sequences.

7 2012 WL 1500104 (Apr. 30, 2012).

It is likely, however, that the Federal Circuit's third holding regarding the screening method claims will be critically scrutinized on remand. Are the application steps in the method screening claims sufficient to avoid a determination that the claim preempts all uses of an abstract mental process? Under *Prometheus*, an application step confers patent eligibility only if it sufficiently limits the abstract idea to avoid conferring monopoly on the idea itself. Are there other uses for the abstract idea outside of the method claimed? Given that simply adding a "wet lab" step no longer appears sufficient under *Prometheus* to confer patent eligibility, can clever drafting no longer reliably steer applicants clear of § 101?

**C. *WildTangent, Inc. v. Ultramercial, LLC*, \_\_\_ S. Ct. \_\_\_, 2012 WL 369157 (May 21, 2012)**

On May 21, 2012, the Supreme Court vacated the judgment of the Federal Circuit (*Ultramercial, LLC v. Hulu, LLC*, 657 F.3d 1323 (Fed. Cir. Sept. 15, 2011)) and remanded the case to the Federal Circuit for further consideration in light of *Mayo Collaborative Services v. Prometheus Laboratories, Inc.*, 566 U.S. —, 132 S. Ct. 1289 (2012).

In the now-vacated Federal Circuit opinion, written by Chief Judge Rader, the Federal Circuit addressed a method claim for monetizing and distributing copyrighted products over the internet where the consumer receives the copyrighted product for free in exchange for viewing an advertisement and the advertiser pays for the copyright content. The Federal Circuit found this claim to be eligible for patent protection, reversing the district court, which had granted the accused infringer's motion to dismiss on § 101 grounds.

The Court previously reasoned, after placing the claimed invention in the "process" category, that the invention was not an unpatentable abstract idea but a patentable application of an abstract idea. This determination was not by virtue of the machine-or-transformation test, but because of the application of specific and complicated steps for applying the abstract idea; additionally, the finding of validity appeared in part due to the fact that the patent was an improvement patent:

[I]nventions with specific applications or improvements to technologies in the marketplace are not likely to be so abstract that they override the statutory language and framework of the Patent Act." *Research Corp.*, 627 F.3d at 869. The '545 patent seeks to remedy problems with prior art banner advertising, such as declining clickthrough rates, by introducing a method of product distribution that forces consumers to view and possibly even interact with advertisements before permitting access to the desired media product. '545 patent col.2 ll.14–18. ***By its terms, the claimed invention purports to improve existing technology in the marketplace. By its terms, the claimed invention invokes computers and applications of computer technology....*** [T]he mere idea that advertising can be used as a form of currency is abstract, just as the vague, unapplied concept of hedging proved patent-ineligible in *Bilski*. However, the '545 patent does not simply claim the age-old idea that advertising can serve as currency. Instead the '545 patent discloses a ***practical application of this idea***. The '545 patent claims a particular method for monetizing copyrighted products.... Viewing the subject matter as a whole, the invention involves an ***extensive computer interface***. This court does not define the level of programming complexity required before a computer-implemented method can be

patent-eligible. Nor does this court hold that use of an Internet website to practice such a method is either necessary or sufficient in every case to satisfy § 101. This court simply finds the claims here to be patent-eligible, in part because of these factors.... The digital computer may be considered by some the greatest invention of the twentieth century, and both this court and the Patent Office have long acknowledged that “improvements thereof” through interchangeable software or hardware enhancements deserve patent protection. Far from abstract, advances in computer technology – both hardware and software – drive innovation in every area of scientific and technical endeavor.

*Ultramercial, LLC v. Hulu, LLC*, 2011 WL 4090761 at \*4-\*6 (emphasis added).

Is the *Research Corp.* reasoning (that “inventions with specific applications or improvements to technologies in the marketplace are not likely to be so abstract that they override the statutory language and framework of the Patent Act”) applicable after the *Prometheus* decision? After *Prometheus*, it would also appear that the level to which a computer is required to perform the steps is no longer the correct line of distinction between patent-eligible claims and claims failing the patentable subject matter test. Rather, under the preemption doctrine applied in *Prometheus*, the relevant distinction is not whether application steps are purely mental or performed by a computer, but instead whether the application steps add enough to the abstract idea such that all uses of the abstract idea are not monopolized. It will be of interest to see how the Federal Circuit applies *Prometheus* in a different substantive area outside of the biology context, but it seems the Federal Circuit will need to apply the broad principles of *Prometheus*, and contend with the fact that the Court in *Prometheus* determined that physical application steps were not necessarily sufficient to confer patentability under § 101.

***D. Classen Immunotherapies, Inc. v. Biogen IDEC, 659 F.3d 1057 (Fed. Cir. Aug. 31, 2011)***

In *Classen*, a Federal Circuit panel addressed § 101 challenges to three patents that covered a wide range of infant immunization methods and schedules aimed at lowering the risk for development of a chronic immune-mediated disorder. This was the second time the Federal Circuit was presented with the question of whether these patents fell within patentable subject matter, being handed the case again after the Supreme Court vacated and remanded the decision following *Bilski*. While not an *en banc* decision, the Federal Circuit Judges’ viewpoints on patentable subject matter presented in *Classen* encapsulate the § 101 debate and illustrate the fracture at the Federal Circuit.

The majority opinion, written by Judge Newman, carved a § 101 boundary dividing the three patents, finding that two of the patents (the ’139 and ’739 patents) met the requirements of § 101, while the third (the ’283) did not. The difference discerned between the two patents found to fall within § 101 and the ’283 patent was a tangible application step. In plaintiff’s own words, the ’139 and ’739 patents covered uses where “a health care provider reads the relevant literature and selects and uses an immunization schedule that is of lower risk for development of a chronic immune-mediated disorder,” while the ’283 patent did not involve the step of selecting an immunization schedule, and thus could be infringed when someone merely reviews the relevant literature. The majority opinion found that although the ’139 and ’739 patents included a mental step, this was not fatal to § 101 eligibility because the claims of these patents also included a physical, real-

world step (a “specific, tangible application”). The ’283 patent did not similarly include any tangible step and was invalidated.

*Classen* presents a question currently at the forefront of the § 101 debate: What about preemption? If the patent claims as drafted may effectively monopolize all uses of an abstract idea or natural phenomenon, should preemption preclude patentability? Is an abstract idea or mental step “plus” any tangible step enough to satisfy § 101, even if it allows monopoly on (preempts) all potential uses of the abstract idea or natural correlation? The absence of a preemption analysis in the *Classen* majority opinion is notable, particularly in light of *Classen’s* overlap with *Prometheus*. Would the tangible application step in *Classen* pass muster under the Supreme Court’s analysis in *Prometheus*? Can this holding somehow be squared with the *Prometheus* decision? Will this decision be challenged in light of the Supreme Court’s decision in *Prometheus*?

Judge Moore previews this issue in dissent, opining that the claims of all three patents covered only abstract ideas or principles, which cannot be torn from the public domain, stating: “Having discovered a principle – that changing the timing of immunization may change the incidence of chronic immune mediated disorders – *Classen* now seeks to keep it for himself.” The real-world immunization step, in Judge Moore’s opinion, is mere post-solution activity that does not transform the unpatentable abstract idea or correlation into patentable subject matter by providing meaningful limits, as the patents involving the immunization step still improperly grant monopoly on the principle itself.

While Judge Moore agrees with the majority that this case is not analogous to *Prometheus*, as the now-vacated Federal Circuit opinion in *Prometheus* determined there was physical transformation in *Prometheus*, she notes the majority’s lack of consideration of the preemption analysis at issue in *Prometheus*: “There is no consideration of the extent of preemption by these staggeringly broad and abstract claims.” While the preemption line is difficult to draw, Judge Moore maintains that it is an important one, noting her disagreement with where the majority drew the line:

While I confess the precise line to be drawn between patentable subject matter and abstract idea is quite elusive, at least for me, this case is not even close. In the ’283 patent, *Classen* claims the scientific method as applied to the field of immunization. No limitations exist on the type of drug to immunize with, the schedules that should be used for the immunization, the type of chronic immune disorder to look for, or any limitation on the control group. It is hard to imagine broader claims. It is harder to imagine a more conceptually abstract claim in the immunization area. *Classen’s* claims are directed to a thought apart from any concrete realities, specific objects or actual instances. This is very much like patenting  $E=mc^2$ . Compare any two schedules to determine which one has fewer instances of immune disorders. Compare two substances to determine which one tastes sweeter. Compare two cups of coffee to determine which one is stronger. Actually these examples are more concrete than the *Classen* claims in that I tell you what to look for – sweetness or strength. The *Classen* claims do not even specify which immune disorder should be studied. Likewise the representative claim from the ’139 and ’739 patents specifies no specific immune disease, drug, or schedule. These claims cover any kind of comparison between any two schedules, using any drugs and comparing the incidence of any chronic immune disease. After the user performs this completely abstract

mental comparison, then the user should immunize the subject with the drug they choose on the schedule they deem lower risk.

*Classen Immunotherapies, Inc. v. Biogen IDEC*, 2011 WL 3835409, at \*20.

Perhaps the most interesting portions of *Classen*, however, are the “additional views” presented by Chief Judge Rader, joined by Judge Newman (who authored the majority opinion), which take a step back from the § 101 debate and critique the existence of the debate itself. In short, Chief Judge Rader notes the “rising number of challenges under 35 U.S.C. § 101” brought before the Court, and urges the Court to decline future invitations to delve into § 101:

Subject matter eligibility under section 101 has become the “substantive due process” of patent law – except that reading non-procedural requirements into the constitutional word “process” has more historical and contextual support than reading abstractness into the statutory word “process” because Title 35 already contains ample protections against vague claims. *See* 35 U.S.C. § 112. Indeed it is difficult to “invent” any category of subject matter that does not fit within the four classes acknowledged by Title 35: process, machine, [article of] manufacture, or composition of matter. This court should decline to accept invitations to restrict subject matter eligibility. In order to highlight some public policy reasons that the statute places few, if any, limits on subject matter eligibility, these additional views are offered. The patent eligibility doctrine has always had significant unintended implications because patent eligibility is a “coarse filter” that excludes entire areas of human inventiveness from the patent system on the basis of judge-created standards. For instance, eligibility restrictions usually engender a healthy dose of claim-drafting ingenuity. In almost every instance, patent claim drafters devise new claim forms and language that evade the subject matter exclusions. These evasions, however, add to the cost and complexity of the patent system and may cause technology research to shift to countries where protection is not so difficult or expensive.

*Id.* at \*13.

Chief Judge Rader commented further on “claim drafting evasion,” stating: “Eligibility then becomes a game where lawyers learn ingenious ways to recast technology in terms that satisfy eligibility concerns.” While potential for skirting requirements with careful drafting, and a corresponding increase of cost and complexity in the patent system are valid concerns, how are §101 challenges different from other patentability requirements (§§ 102, 103, and 112) in this regard?

Also, how do litigants square Chief Judge Rader’s criticism of an overabundance of patentable-subject-matter challenges with the traction § 101 appears to be gaining traction among the courts, including the Supreme Court?

Another interesting issue is the juxtaposition of two of the Court’s recent cases against each other, as they represent different approaches and different precedent in different fields. The majority in *Classen* found that the claims of the ’139 and ’739 patents met the requirements of Section 101 simply because the physical step of vaccinating the

patient was added. However, in *CyberSource* (discussed next), the *Beauregard* claims applying an otherwise abstract idea to a computer readable medium were invalidated under Section 101.

**E. *CyberSource Corp. v. Retail Decisions, Inc.*, 654 F.3d 1366 (Fed. Cir. Aug. 16, 2011)**

In *CyberSource*, two types of claims were at issue, a standard method claim and a method claim directed at a computer readable medium drafted in *Beauregard* form (named after *In re Beauregard*, 53 F.3d 1583 (Fed. Cir. 1995)). The patent claims a method for validating online credit card purchases, using IP address information to prevent fraud by triggering an alert if the buyer was attempting to make a large internet purchase through an IP address that had been previously used for a fraudulent transaction.

The Court held that under the machine-or-transformation test, the claim as written does not require use of a machine or a physical transformation to a different state or thing. The method comprises the rather abstract processes of a) obtaining information about other transactions that have utilized an Internet address that is identified with the credit card transaction; b) constructing a map of credit card numbers based upon the other transactions, and; c) utilizing the map of credit card numbers to determine if the credit card transaction is valid. The Court invalidated under *Bilski*, finding that the data gathering steps were insufficient to overcome § 101, and that mention of the internet did not rescue the otherwise ineligible subject matter. The Court looked beyond the machine-or-transformation test, considering the broader policy behind § 101 that mental processes un-tethered to real-world applications are not patentable, and finding the method to be a mental process because it can be performed “by a human using a pen and paper.” “[T]he application of human intelligence to the solution of practical problems is not in and of itself patentable.”

The *Beauregard* claims met a similarly decisive end, the *CyberSource* Court finding the different form was “nothing more than a computer readable medium containing program instructions for executing the [method claim the Court invalidated].” Tying the method claim to software, and the storage device for the software (a “computer readable medium” which *CyberSource* argued is directed at a man-made article and *per se* patentable) did not render it patentable just by placing the invention in a different category, as the underlying invention does not meet the requirements of § 101:

Regardless of what statutory category (“process, machine, manufacture, or composition of matter,” 35 U.S.C. § 101) a claim’s language is crafted to literally invoke, we look to the underlying invention for patent-eligibility purposes. Here, it is clear that the invention underlying both claims 2 and 3 is a method for detecting credit card fraud, not a manufacture for storing computer-readable information.

*CyberSource Corp. v. Retail Decisions, Inc.*, 2011 WL 3584472 at \*7.

If the method can be performed with a paper and pencil, claiming to perform the mental task on a computer or over the internet or storing it on computer readable media will not make it patent eligible. The result, that an abstract idea or purely mental process (that could be performed without the use of a computer) is unpatentable even when restricted to a computer, seems to be the right one. However, going forward, how are courts to apply the “underlying invention” analysis? Or is this analysis superseded by *Prometheus*?



## IV. COMING ATTRACTIONS

**Federal Circuit En Banc Rehearing Granted in *Akamai v. Limelight* (en banc rehearing petition granted April 2011) and *McKesson Technologies* (en banc rehearing petition granted May 2011). Oral argument was heard in both cases in November, 2011.**

*Akamai* and *McKesson*, which will soon be decided *en banc*, deal, at least in part, with the issue of direct infringement of method claims and joint infringement. Joint infringement is of course a species of direct infringement, which is a strict liability “offense” with no level of knowledge or intent required. Indirect infringement, on the other hand, requires some level of knowledge or intent for a finding of liability.

To be liable for direct infringement of a method claim, the accused infringer must generally perform each element or step of the claimed method. Similarly, to establish inducement of a method patent, there still needs to be the prerequisite of direct infringement by the induced party, which for a method patent requires performance of each step by a single actor. The only previously recognized exception to this was where an agency or contractual relationship existed such that another party was performing steps on behalf of the accused infringer, essentially acting as a single actor under agency principles. (For example, this exception was recognized in the now-vacated opinion in the Federal Circuit’s first decision in *Akamai*, at 629 F.3d 1311).

The Federal Circuit will likely be striving to strike the correct balance between finding liability for infringing activity, while still protecting innocent actors. To protect innocent actors, should a high degree of control should be required, or should perhaps an intent requirement be added? As the Patent Act makes no reference to liability for direct infringement by multiple actors or parties, this is uncharted territory.

In *Akamai* (rehearing of *Akamai Techs, Inc. v. Limelight Nets., Inc.*, 629 F.3d 1311 (Fed. Cir. 2010)), the Court presented the following question for briefing:

If separate entities each perform separate steps of a method claim, under what circumstances would that claim be directly infringed and to what extent would each of the parties be liable?

In *McKesson* (rehearing of *McKesson Technologies Inc. v. Epic Systems Corp.*, — F.3d —, 2011 WL 1365548 (Fed. Cir. Apr. 12, 2011)), the Court presented the following questions for briefing:

1. If separate entities each perform separate steps of a method claim, under what circumstances, if any, would either entity or any third party be liable for inducing infringement or for contributory infringement? See *Fromson v. Advance Offset Plate, Inc.*, 720 F.2d 1565 (Fed. Cir. 1983).
2. Does the nature of the relationship between the relevant actors – e.g., service provider/user; doctor/patient – affect the question of direct or indirect infringement liability?

*Akamai* and *McKesson* pose the following questions: Under what circumstances, if any, can a method claim be directly infringed if separate entities perform separate steps of the method claim? If liability exists when no single party has performed every step of a method claim, to what extent would each of the joint infringers be liable? Under what circumstances should an alleged infringer or third party be liable for inducing infringement or contributory infringement when separate entities perform separate steps of a method claims? What level of control should be required to find inducement?

One interesting note is Judge Newman's dissent in the first *McKesson* opinion, where she expresses concern that "interactive" methods cannot be adequately protected absent findings of infringement of method claims by multiple actors, stating:

Today's holding, and the few recent cases on which it builds, have the curious effect of removing from patent eligibility the burgeoning body of interactive computer-managed advances. A patent that cannot be enforced on any theory of infringement, is not a statutory patent right. It is a cynical, and expensive, delusion to encourage innovators to develop new interactive procedures, only to find that the courts will not recognize the patent because the participants are independent entities.

*McKesson Technologies Inc. v. Epic Systems Corp.*, — F.3d — (Fed. Cir. Apr. 12, 2011), slip op. at 17.

What is the proper balance between protecting innocent actors, and avoiding the issue Judge Newman points out? Additionally, might the solution be in drafting the claims differently, such as drafting a mixture of systems and method claims?

# AMERICA INVENTS ACT: THE 5 NEW POST-ISSUANCE PROCEDURES

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## AUTHOR'S NOTE

Patent reform legislation has been before Congress since 2005 and has gone through many permutations and iterations as the political winds and developments in the courts have buffeted and shaped the proposed legislation. The law, America Invents Act, was finally passed on September 9, 2011, and signed into law on September 16, 2011 by President Obama. In the tradition of The Sedona Conference® on Patent Litigation of being on the cutting edge of the law, this legislation has been selected for deep dialogue on the first day, October 13, in the 2011 conference. This paper addresses the 5 provisions of the legislation that involve post issuance proceedings of a patent before the United States Patent & Trademark Office. The 5 provisions are in addition to a modified form of the current *ex parte* reexamination proceeding that continues forward from the current reexamination system. This paper subscribes to a neutral Swiss approach of presenting all sides of an issue and does not advocate for any particular view so that full and deep dialogue may ensue. Several of the authors devote substantial portions of their practices to the current reexamination procedures and/or the patent interference procedures in place at the PTO and have tapped into that experience in the preparation of this paper. However, the views expressed herein are for purposes of Sedona dialogue and do not necessarily reflect the individual views of the authors.

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## I. INTRODUCTION

This paper addresses the post issuance provisions of the America Invents Act (“AIA”). There are 5 new provisions along with an extension of the current *ex parte* reexamination process that the United States Patent and Trademark Office (“Office” or “PTO”) will now have to interpret and implement. To say this is going to be a daunting task for the Office and its stakeholders is an understatement. In addition to the very substantial staffing requirements that these provisions of the AIA impose on the Office, the new discovery procedures that are created put the Office into uncharted territories it has never been in before. Moreover, despite transitional periods in the AIA for implementation, the current *ex parte* and *inter partes* reexaminations ongoing at the Office, of which there are thousands, will still have to be completed under the current reexamination procedures. New rules will have to be drafted, published for comment, and implemented in order for the new provisions to go into action. It is thus clear to see that the Office needs all of the best advice and guidance it can get from the most informed segments of the patent community. It is fortuitous that this legislation was enacted just before the final preparation for the Sedona Patent Litigation Conference 2011 to allow this paper and the Sedona dialogue that it will support on October 13-14, 2011 to generate some initial guidance that the Office can use in its implementation and rule making process. We also thank Director Kappos for being on the faculty and for his sharing of initial Office views as well as Chief Judge James Smith for being a participant of this conference views.

## II. POST-GRANT REVIEW AND *INTER PARTES* REVIEW

Following enactment of the AIA, the primary vehicles for litigating patentability at the PTO are the new Post-Grant Review (“PGR”) and *Inter Partes* Review (“IPR”) proceedings. PGR and IPR proceedings share many important similarities. But the key differences highlight the different roles they were envisioned to fill. For instance, PGR has a wider scope than IPR and appears to fulfill the role of immediate and proactive review of newly-issued patents that are of potential concern to competitors. Effective use of PGR will likely require close monitoring of pending applications and issued patents. IPR, on the other hand, is narrower in scope and appears to fulfill the role of the current *inter partes* reexamination (“IPX”) as a vehicle for accused infringers or corporate competitors to challenge patentability before the PTO.

### A. Overview of Post-Grant Review (PGR) Under the AIA

Post-grant review (PGR) will provide a new mechanism for challenging patents before the Office, and it expands the grounds on which a petitioner may challenge patents. With this additional opportunity for challengers comes increased vulnerability and uncertainty for patent owners. It remains to be seen what effect PGR will have on the valuation, enforcement, and licensing of patents. Will the possibility of PGR make it more difficult for patent owners to obtain venture capital funding before the end of the window for PGR? Will PGR proceedings under the AIA become such a burden on patentees that they have the unintended effect of stifling innovation or job creation? How will the impact of PGR proceedings in the U.S. compare with the impact of opposition proceedings on patents outside of the U.S.? Undoubtedly, the creation of PGR proceedings will affect the business practices of patent owners and their competitors, as they seek to minimize risks and maximize opportunities created under the AIA.

## 1. *Grounds for PGR*

By statute, the time window for initiating PGR will be limited. A petition for PGR may be filed within nine months after (i) the date of grant of a patent or (ii) of the issuance of a reissue patent. However, if a patent is reissued outside of the first nine months after grant, PGR cannot be initiated with respect to claims that were narrowed or remained of the same scope in the reissued patent. Claims that were broadened in a reissue application will be eligible for PGR. Thus, a patent owner who contemplates seeking a broadening reissue patent within the first two years following grant of the patent should remain aware of the risk created by potentially reopening the door to PGR. Such a patent owner should ask itself whether the potential benefits of a reissue outweigh the risk of exposing the patent to an additional attack via PGR. The patent owner also should consider whether its objectives could be met by seeking *ex parte* reexamination of its own patent or by requesting supplemental examination.<sup>2</sup> A potential challenger of a patent that is reissued must be poised to seize the additional opportunity that arises upon reissuance of a patent. Prior to reissuance of the patent, the challenger should consider whether its objectives could be met simply by protesting the reissue application under Rule 291. Given the greater opportunity to remain involved in a PGR proceeding than in a protest, PGR would likely be the preferred option when it is available.

PGR proceedings can first be filed at one year after enactment of the AIA, i.e., on September 16, 2012. PGR will initially be available only for a limited subset of patents, namely (i) certain business method patents<sup>3</sup> and (ii) patents that are involved in an interference as of the September 16, 2012 effective date. PGR will later become available for patents that issue from applications filed on or after 18 months after the date of enactment, i.e., so-called “first-to-file” patents issuing from applications filed after March 16, 2013. Given that it may take 3-4 years for such patents to issue, the floodgates for PGR will not be fully open until approximately 2016 or 2017. Gradually opening the door to PGR is probably good for all involved. Patent owners and their competitors will be able to learn from the Office’s treatment of the early PGR cases. And, the Office will have more time – although not a lot of time – to establish its policies and procedures relating to PGR, as well as to build its staff and infrastructure to handle PGR proceedings.

In considering the statute, one must wonder why Congress felt it important to apply PGR essentially only to “first-to-file” patents, rather than to all patents that are issued after the effective date. If PGR is meant to create a checks-and-balances system to guard against improperly issued patents, one might argue that a need for such a system exists even with “first-to-invent” patents. If, on the other hand, switching to a first-to-file system were expected to increase the need for post-grant scrutiny of patent claims, it would beg the question as to why switch systems.

What effect will the nine-month PGR window have on patent owners and their competitors? Corporate competitors and others who may wish to challenge a patent via PGR will have increased incentive to monitor prosecution of important patent applications and reissue applications so as not to “miss the boat” for PGR. Additionally, a patent applicant will have increased incentive to ensure that original prosecution of the patent includes a thorough examination of the application and full consideration of the art. During the first nine months post-issuance, some patent owners may be more hesitant to assert their patents than they would have been in a pre-PGR era, so as to minimize the

<sup>2</sup> For a discussion of supplemental examination, see Section V below.

<sup>3</sup> For a discussion of the transitional proceedings relating to business method patents, see Section III below.

likelihood of becoming a target for PGR. If one finds that there is a spike in the number of patent infringement suits filed just after nine months post-issuance, such data would suggest that the possibility PGR has had a chilling effect on the initiation of district court litigation. Potential infringers, on the other hand, may have increased incentives to engage in licensing discussions early on in the life of a patent or prior to issuance of the patent. Armed with information as to whether reasonable licensing terms may be available, the potential infringer can then factor such information into the calculus for determining whether to seek PGR.

PGR opens the door for challenging patentability on any ground for invalidity. Additionally, the AIA will allow PGR to be instituted to resolve novel or unsettled legal questions that are important to other patents and applications. Thus, PGR will be an attractive option for many would-be challengers.

### *a. PGR Based on Unpatentability*

Under the AIA, a petitioner may request to cancel as unpatentable one or more claims of a patent on any ground for invalidity under 35 U.S.C. §282. Thus, PGR not only permits attacks based on prior art patents or printed publications, but it also permits attacks based on, for example, non-statutory subject matter, lack of enablement, lack of written description, lack of utility, prior public use, or prior sale or offer for sale. Accordingly, patents that fail to claim statutory subject matter or that fail to comply with the utility requirement will be vulnerable to challenges via PGR. Additionally, a reissue patent can be attacked as being improper under 35 U.S.C. §251. This new mechanism for attacking patents at the Office may, for example, lead to an increase in challenges to patents that fail to meet *Bilski's* test for patent-eligible subject matter. As the Federal Circuit and the Supreme Court address statutory subject matter and other legal requirements, PGR will undoubtedly become a vehicle to challenge patents based on recent refinements in the law.<sup>4</sup>

The AIA also provides that patentability may be challenged under any requirement of section 112 except for failure to disclose the best mode. Thus, unlike in current reexamination practice, a challenger will be able to directly nullify patent claims based on lack of enablement or lack of an adequate written description.<sup>5</sup> The ability to challenge patent claims based on lack of enablement may be particularly attractive for competitors in the life sciences, rather than in the electrical or mechanical arts, because of the perceived higher level of unpredictability in the life sciences. The creation of PGR proceedings may incentivize patent applicants in the life sciences to obtain more scientific data prior to filing a patent application, in order better to shield against a §112 attack. On the other hand, with the shift to a first-inventor-to-file system, such an applicant may be willing to risk the §112 attack so as not to become the second-inventor-to-file. Additionally, certain patents in the life sciences are particularly prone to attack for lack of an adequate written description, e.g., patents that seek to claim a genus of compounds by describing their function without adequately describing their structures. Such patents will be attractive targets for attack via PGR. While patent reexaminations have been more prevalent in the electrical and mechanical arts than they have been in the life sciences arts,

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<sup>4</sup> PGR undoubtedly will become a tool for forcing modification of Office examination practice on a new point of law as an outgrowth of a PGR of a particular patent. Thus, the petitioner will be acting as a "private attorney general" urging change in examination practice and procedure that sidesteps PTO rule-making procedures.

<sup>5</sup> In reexamination practice, a requester may argue that the patent claims are not entitled to an earlier priority date on the grounds that the earlier application fails to satisfy the requirements of § 112. The requester may then cite intervening prior art patents or publications that form the basis for the requester's proposed rejections. Similar priority attacks will likely be acceptable in PGR. Following claim amendments, a petitioner can also challenge the amended portion of claims or new claims under § 112.



PGR may become the post-issuance tool of choice for competitors in the life sciences, in view of the additional grounds for attacking patents.

PGR can also be initiated on the ground that the patent fails to comply with any requirement 35 U.S.C. §251. Thus, a petitioner may challenge a reissue patent on the ground that it is a time-barred broadening reissue patent. Section 251 also recites other requirements, e.g., that there was an error in the patent. Will a petitioner be able to challenge patentability on the ground that there was no such error?<sup>6</sup> More generally, will the bases for challenging patents as unpatentable in PGR *identically* align with the bases for challenging patent validity in district court?<sup>7</sup>

***b. PGR based on a novel or unsettled legal question that is important to other patents or patent applications.***

Under the AIA, PGR will also provide a forum in which the Office can bring clarity to novel or unsettled legal questions that are important to a number of patents or patent applications. Thus, PGR can be initiated when a patent presents a novel or unsettled legal question. Because the AIA identifies such questions as an “additional ground” for instituting PGR, beyond the unpatentability bases discussed above, PGR opens up a whole new avenue for initiating a post-issuance challenge to a patent. It remains to be seen what will constitute such a novel or unsettled legal question that warrants PGR. Must the petitioner establish that at least one claim is unpatentable, even though the question of law is unsettled or novel?<sup>8</sup> Will the resolution of such a question lead to cancellation of the involved patent claims? Or will such resolution have only a prospective effect on future patents or applications? Should any form of compensation be provided to a patent owner who had complied with all existing laws but whose patent was subjected to PGR on this basis? One might argue that the answer should be “no,” because the patent is presumptively valid and enforceable in district court. On the other hand, will a court be more likely to stay a litigation that involves a patent that has the “cloud” of a novel or unsettled legal question hanging over it?

The AIA indicates that the novel or unsettled legal question must be important to other patents and applications. But this provision begs the question of how many other patents or patent applications must be affected by resolution of the novel or unsettled legal question. What metrics will the Office use in defining the scope of PGR challenges that can be instituted under this aspect of the AIA? How will a petitioner establish that the legal question is important to other patents and applicants? Additionally, does this provision in the AIA inherently and inadvertently give the Office the authority to *create* new law in the process of resolving such novel or unsettled legal questions? If resolution of the legal question is important to a number of other patents and applications, should the Office resolve the issue even if the involved parties settle the PGR? Although the AIA seeks to bring clarity to the law by providing for PGR on this basis, the current lack of guidance as to how this provision in the AIA will be applied leaves uncertainty for all involved.<sup>9</sup>

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6 A tactical question is how will such evidence be adduced from the patent owner?

7 Of course two critical questions are whether the Office will use the same claim construction and burden of proof standards as used in district court?

8 Undoubtedly the Office implementing rules will require specificity to support such bases, otherwise it will be pleaded as a standard catch-all in all petitions.

9 Since the Director of the PTO and the Director of Patents are members of the new Patent Trial and Appeal Board (PTAB), they will have opportunity to directly control this decision-making. Thus, the question of how will the Solicitor's Office fit in to this process will need to be addressed.

## 2. *Instituting PGR*

In response to a petition for PGR, a patent owner may file a preliminary response, explaining why PGR should not be instituted. Such an explanation may be based on the failure of the petition to meet any requirement of the statute relating to PGR. Will the Office consider such a preliminary response in determining whether to initiate PGR? The AIA states that PGR will be instituted if the Director determines that the information presented in the petition, *if such information is not rebutted*, would demonstrate that it is more likely than not that at least 1 of the claims challenged in the petition is unpatentable.<sup>10</sup> If a patent owner files a preliminary response, will the Office simply ignore it before deciding whether to institute PGR? If the Office does review the preliminary response before instituting PGR, how can the Office adequately apply the “if-not-rebutted” standard for deciding whether to institute PGR? Because a preliminary response is optional, a patent owner must decide whether to file one. Assuming the Office will consider such a response before instituting PGR, there will be significant incentives for patent owners to file the response, hoping that PGR will not be instituted. On the other hand, if the response is merely placed in the file for later consideration, a patent owner may be less inclined to file the preliminary response. Such hesitancy may be based on a concern against prematurely taking a position in the case, e.g., with respect to claim construction, prior art or novel legal theory.

The Office’s decision whether to institute PGR is final and non-appealable.<sup>11</sup> Additionally, the Office may consolidate multiple PGR proceedings into a single review. What parameters will the Office use to determine whether to consolidate multiple reviews? How will the Office juggle such multi-party “PTO litigation” so as to ensure justice for all involved parties and the public?<sup>12</sup>

## 3. *Impact of PGR*

Because PGR may be initiated on numerous grounds that do not form the basis for challenging patents in reexamination, PGR will likely be an attractive mechanism for challenging patents. PGR may shift more litigation away from district courts and to the PTO. An advantage of such PTO litigation is that the challenger does not need to meet the standing requirements of a U.S. district court. For some companies, this ability to nullify a patent at an early stage – before the company continues to invest substantially in a project – may provide a strong incentive to engage in PTO litigation. Will such an incentive be greater in the biotech and pharmaceutical areas than it is in other technical areas, because the research & development and regulatory costs for bringing a new biotech or pharmaceutical product to market can be enormous and must generally be incurred before a justiciable case or controversy arises?<sup>13</sup>

How will the ability to petition for PGR affect licensing discussions? During the time window for PGR, a patent owner may be hesitant to be overly aggressive in its efforts to out-license its patent in view of a concern that a potential licensee will petition for PGR.<sup>14</sup> Conversely, a potential licensee should bear in mind the possibility of petitioning

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10 Everyone is keen to know how the Office will define this threshold standard.

11 This makes administrative sense except perhaps for the novel legal theory basis.

12 It can be argued that the Office must expand the discovery and hearing process in a linear fashion based on the number of granted petitions, otherwise due process will not be met.

13 Some speculate that the dominant players in specific electronic channels may become early adopters of a PGR strategy as a way to control the IP of that channel.

14 Some argue that blanket or package licenses will not be allowed to contain prohibitions against the use of PGR of future issued patents by the petitioner.

for, or threatening to petition for, PGR in response to aggressive licensing tactics, or in anticipation of such aggressive tactics. Just as “pocket” reexamination requests sometimes are used to pressure the patent owner to agree to more generous licensing terms, “pocket” PGR petitions may be used. Moreover, PGRs can be settled more easily than reexaminations, and because they can be settled without creating an estoppel, a potential infringer will likely be more inclined to petition for PGR than it was to seek *inter partes* reexamination. Will the ability to petition for PGR and settle PGR proceedings lead to more PTO litigation involving patents held by non-practicing entities (NPEs)? An NPE who skillfully runs an out-licensing campaign without creating declaratory judgment jurisdiction may nonetheless find its patent increasingly vulnerable to attack at the PTO.<sup>15</sup>

#### ***4. Impact on Litigation***

To a limited degree, the AIA seeks to control and clarify the relationship between PGR and other proceedings. The bases for this legislative construct is the real concern not to repeat the creation of the “parallel universe” that currently exists between district court and USITC enforcement and concurrent reexamination. For example, PGR may not be instituted if, before filing for PGR, the petitioner (or its real party in interest (RPII)) filed a civil action “challenging validity of a claim of the patent.” Will PGR be precluded even if the claims that are challenged in the civil action differ from those challenged in the PGR petition? A patent owner would likely argue that the answer is “yes” and that the petitioner must pick one of the two forums in which to fight. Indeed, if the petitioner or its RPII files a civil action on or after the date of filing a petition for PGR, the civil action will be automatically stayed for a period of time. Unlike a civil action challenging validity, an action asserting non-infringement or unenforceability will not preclude PGR. Similarly, a counterclaim of invalidity does not preclude PGR. Finally, a patent owner who wishes to obtain a preliminary injunction against an accused infringer is incentivized under the AIA to file suit shortly after issuance of the patent. If the suit is filed within 3 months of the grant of the patent, and if the patent owner moves for a preliminary injunction, the AIA precludes a court from staying its consideration of the motion for preliminary injunction on the basis that PGR has been sought or instituted. Will this three-month provision incentivize patent owners to bring suit quickly after issuance of a patent?<sup>16</sup>

#### ***B. Overview of Inter Partes Review (IPR)***

Patents that are eligible for *inter partes* review (IPR) are those that issued before, on, or after September 16, 2012. Thus, unlike in *inter partes* reexamination (IPX), patents that issued from applications filed prior to November 29, 1999, will be included among the patents eligible for IPR.<sup>17</sup> Additionally, the universe of patents that are eligible for IPR is larger than the universe of patents that are eligible for PGR, which mostly is limited to first-to-file patents and certain business method patents. The time window for filing a petition to institute PGR opens upon the later of (i) nine months from issuance of the patent or (ii) the date of termination of a PGR on the patent. Although widespread use of the PGR may not be feasible until around 2016 or 2017, as discussed above, IPR may be widely used as soon as it becomes available on September 16, 2012.<sup>18</sup>

<sup>15</sup> This “nuclear winter” approach against NPEs is currently being used in reexaminations, especially *inter partes* reexaminations. Whole portfolios are being subject to reexamination. One can legitimately ask if such strategy should be condoned by the Office and allowed to occur in PGR?

<sup>16</sup> The high standard to obtain a preliminary injunction of an unlitigated patent will undoubtedly deter the use of this provision, even though on paper it has the appearance of protecting the rights of the patent owner.

<sup>17</sup> This will undoubtedly decrease the use of *ex parte* reexamination by third-party requesters.

<sup>18</sup> In drafting this legislation, Senate staffers were concerned if they were opening a flood gate of IPRs after September 16, 2012. Time will tell if this was fact or fiction.

### *C. Comparison of Inter Partes Review (IPR) with Other Proceedings*

Savvy companies need to stay on top of troublesome patents that are about to issue. Why? Unlike in PGR, a petitioner in IPR can challenge patentability only on a ground that can be raised under 35 U.S.C. §§ 102 or 103 and only on the basis of prior art patents and printed publications.<sup>19</sup> If the best arguments against patentability arise under § 112, 101, etc, a challenger would be remiss if it missed the nine-month deadline for PGR. However, if one has missed the PGR deadline, or if the troublesome patent is not eligible for PGR, IPR may remain the best option. Additionally, if a petitioner wants to reserve certain invalidity arguments under §112 or §101 for use in a later district court action, it may wish to utilize IPR rather than PGR in view of the estoppel provisions of the AIA.

The main challenge with IPR – for now – is simply uncertainty. IPR brings with it a new standard for initiation, and the contours of this new standard have yet to be shaped by the adversarial process. While IPR will replace *inter partes* reexamination (IPX) from September 16, 2012, the Office has begun applying the IPR threshold to order IPX for requests filed after September 11, 2011.<sup>20</sup> With this shift in standard, we have ventured into waters that are somewhat uncharted.

To initiate IPR, the information presented in the petition must show that there is a reasonable likelihood that the petitioner would prevail with respect to at least one of the claims challenged in the petition. Will it be easier or harder to meet the “reasonable likelihood of prevailing” standard than it was to meet the “substantial new question of patentability” (SNQ) standard that was previously used in IPX and which continues to be used in *ex parte* reexamination (EPX)? Does the new standard simply constitute a distinction without a practical difference?

Under the new standard, there is no need for a “new” question of patentability. But has that really changed the standard? Perhaps not! It is clear that an IPR petition can be based on art previously considered during original prosecution. But it would be difficult to convince the Office to initiate IPR by making bare assertions that the original Examiner erred in his or her analysis. Thus, as a practical matter, a petitioner will need to bring something “new” to the patentability analysis. In considering the IPR standard, what exactly does “prevail” mean? Does “prevail” mean that at least one claim must be rejected? Or cancelled or substantially amended? If the phrase “reasonable likelihood that the petitioner would prevail” amounts to the establishing that the Office should issue a rejection, the AIA does not significantly change the burden on the third-party challenger. In IPX, a third party requester would propose rejections over the prior art, with the hope that the PTO would adopt such rejections. In IPR the petitioner will have a similar burden to establish unpatentability of the challenged claims. In unusual instances in IPX, the petitioner established that there was an SNQ and the PTO ordered reexamination without adopting any of the proposed rejections. Under IPR, it seems that such unusual instances would be avoided, since the challenger effectively must establish unpatentability before the proceeding will be instituted.

Will potential patent challengers be inclined to wait and see how the Office handles IPX requests filed under the new IPR-like standard before deciding to initiate IPX or wait to initiate IPR? A potential challenger to a patent should ask itself whether it is

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<sup>19</sup> This parallels the basis for instituting the current IPX with the changes brought under the new first-inventor-to-file regime.

<sup>20</sup> As of the date of this paper at the end of September 2011, the Office has not yet issued guidelines for this new standard.

better off challenging a patent under IPX or under IPR. In making such a determination, the potential challenger should bear in mind that, beginning on September 16, 2012, the patent owner that potentially faces IPR will be given a chance to file a preliminary response to the petition for IPR. Thus, the patent owner will be able to provide reasons why no IPR should be instituted, and the Office must consider such a preliminary response before determining whether to institute IPR. In view of the shifting standards, some competitors may delay filing IPX until they get a sense for the new IPR-style standard, but then rush to file a request for IPX before the patent owner gains the right to file a preliminary response and before IPX proceedings disappear in favor of IPR proceedings.

A patent owner's response to a petition for IPR is optional. Should the patent owner always rush in? It may be that the patent owner can convince the Patent Trial and Appeal Board ("PTAB") that the petition is not reasonably likely to prevail, thus precluding initiation of the IPR: a great outcome for the patent owner. But what if the Office initiates IPR regardless of the patent owner's preliminary response? The response may have characterized the invention or the art in a way that can come back to needlessly disadvantage the patent owner later in the IPR or in another proceeding.

Once the switch to IPR happens, the Director has the authority to impose a limit on the number of IPRs that may be instituted during each of the first 4 years of implementation. The limit can be reached if the number of IPR implemented in each year equals or exceeds the number of *inter partes* reexamination requests filed in the last fiscal year (2010) ending before the effective date of the act.<sup>21</sup> We believe that limit will be around 270. How will the Office impose the limit? What will happen to petitions on file that have not yet been implemented when the limit is reached? Will the Office publish the limit with a running total of petitions filed to date so potential petitioners can keep track? Or will the Office just let the public know when its limit has been reached, with no warning?

#### ***D. Impact of IPR on related litigation and vice versa***

##### ***1. Civil action filed first, then IPR***

IPR may not be instituted if, before the date on which the petition is filed, the petitioner or real party in interest filed a civil action challenging the validity of the patent. Here, it seems that the AIA seeks to ensure that a petitioner who first challenges the validity of a patent in a civil action cannot have two bites at the same apple in different forums. Of course, one party's filing of a civil action would not preclude a second party from challenging the same patent via IPR. Thus, a patent could still face multiple challenges in different forums. In addition, a civil action challenging the enforceability of a patent or asserting non-infringement has no impact on the filing of an IPR.

IPR cannot be sought more than one year after the date on which the petitioner, its real party in interest, or a privy of the petitioner has been served with a complaint alleging infringement of the patent. Thus, when IPR replaces IPX, it may foreclose the option for a PTO-based *inter partes* proceeding for defendants that are involved in suits in which the complaint was served prior to September 16, 2011. If the defendants to such suits wish to participate in an *inter partes* proceeding at the PTO, they should consider requesting IPX before September 16, 2012, provided the patent is eligible for IPX (i.e.,

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<sup>21</sup> This was done by Congress to make sure the PTO would be able to staff up for an unanticipated level of IPR filings. Time will tell if this IPR limit will be exceeded in the first 4 years, but with the current level of IPX filings, the limit may in fact be a big issue.

patents filed on or after November 29, 1999). So, certain defendants wishing to pursue an *inter partes* challenge at the PTO must file a request for IPX before September 16, 2012, or risk losing the option altogether. Because IPX can be based only on prior art patents and printed publications, a diligent challenger should be able to prepare its IPX request while it remains an option. Likewise, a defendant served with a complaint for patent infringement after September 16, 2011, may utilize IPR as of September 16, 2012, even for patents filed *prior* to November 29, 1999. Thus, under the AIA, accused infringers will be able to initiate *inter partes* PTO challenges to an earlier class of issued patents than they previously could, since IPR does not impose date restrictions on the patents that can be attacked. The accused infringer must remember to seek IPR within one year of service of the infringement complaint. Again, a potential challenger must stay on top of such deadlines so as not to miss out on an opportunity to engage in PTO litigation.

An accused infringer who wishes to petition for IPR within one year of being served with a patent infringement complaint may find that it has its hands tied. As discussed above, IPR cannot be instituted until after the later of nine months from issuance of the patent or the conclusion of PGR. Conclusion of the PGR proceeding may not occur until after expiration of the one-year period for seeking IPR after having been served with a complaint. Should such an accused infringer seek to be joined in any ongoing PGR if the time window for doing so is still open? Some would say “no” and that the accused infringer should just save its defenses for the civil action. Others would encourage the accused infringer to seek to be joined because of the differences in standards and technical sophistication in the PTO versus district court.

## ***2. IPR filed first, then civil action***

If a petitioner first challenges a patent in an IPR proceeding, once the IPR petition is filed, if the same petitioner then files a civil action challenging the same claims on validity, the civil action will automatically be stayed until (i) the patent owner moves the court to lift the stay; (ii) the patent owner files a suit or counterclaim alleging that petitioner infringes the patent; or (iii) the petitioner moves the court to dismiss the civil action. It is not stated what, if any, burden the movant must meet in order to convince the court to lift the stay. Is a simple request sufficient or will the court require more? Also, how might this standard differ between courts? In any event, the AIA seeks to limit the petitioner’s ability to attack the patent in multiple forums.

## ***E. Issues Common to PGR and IPR***

With new options available for post-grant challenges to patents before the PTO, a potential challenger must carefully balance the pros and cons of each available option. For example, if one’s best arguments rely upon prior art patents and printed publications, rather than §112, one should consider waiting for the IPR window to open, rather than petitioning for PGR? However, doing so is not without risk. If one waits, another party may come along and petition for PGR in the interim, thus likely pushing back the date on which IPR could be initiated. If such a date is pushed back too far, a defendant in a patent infringement suit may find that it will miss out of the opportunity to seek IPR (because of the requirement that IPR be initiated within one year of service of the complaint). Additionally, the AIA appears to give the PTO broad authority, in considering whether to institute EPX, PGR or IPR, to consider whether the same prior art or arguments previously were presented to the Office. What parameters and criteria will the PTO consider in determining whether to refuse instituting or ordering a proceeding? What recourse, if any,

will a dissatisfied petitioner have? In any event, a potential challenger likely should not assume that a proceeding it seeks to initiate will necessarily move forward at the PTO. In view of the heavy workload that the PTAB is expected to face, one must wonder whether it will freely exercise its statutorily granted authority to refuse to institute proceedings that raise old art and arguments.

### ***1. Administrative considerations***

The fee for filing a petition for PGR has not yet been set. By statute, the fee must be in an amount that the Director determines is reasonable when considering the aggregate cost of the PGR. It would not be surprising if the fee for PGR were to be similar to the fee for *inter partes* reexamination, which is currently \$8800 per request. While such a dollar amount is one of the highest fees paid to the PTO, it is modest compared with the overall costs including attorney's fees of challenging a patent via *inter partes* reexamination or compared with what the overall costs for PGR are likely to be. Moreover, the PTO is still grappling with the huge problem of fee diversion not having been stopped in the AIA. However, in setting the fee for PGR, the PTO will need to consider the costs of hiring and training an adequate corps of Administrative Patent Judges (APJs) to handle this new proceeding. Whether the PTO will be able to handle the increased workload brought upon by PGR remains to be seen and it remains one of the biggest areas of concern for practitioners. Already, the PTO has announced that it seeks to hire 100 new APJs who have a combination of professional and technical qualifications, e.g., bar membership along with a technical degree and comprehensive patent experience.<sup>22</sup> In hiring new APJs, should the PTO maximize its talent pool by including APJs who work remotely? If so, would such telecommuting stifle communication between members of the three-judge panel adjudicating the PGR?

### ***2. Decision on a petition to institute PGR or IPR***

The Office must decide whether to institute a PGR or IPR within 3 months after receipt of the patent owner's preliminary response, or, if no patent owner response was filed, within 3 months of the last date upon which the response could have been filed. The AIA's lack of an explicit time period in which the patent owner must provide its preliminary response makes it unclear, for now, how long a petitioner will have to wait for a decision from the Office as to whether to initiate PGR or IPR. A time period of somewhere between 1-2 months seems reasonable for a patent owner's preliminary response; a patent owner currently has 2 months in which to file an optional patent owner's statement in EPX.

The Office's decision whether or not to initiate a PGR or IPR is final and not appealable. So what recourse does a petitioner have if PGR or IPR is not initiated? Like with IPX, can the petitioner request that the Director review the denial? What if PGR or IPR is sought for all claims, but the Office institutes it for only some? Can the petitioner appeal the decision on the non-rejected claims?

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22 See, [www.usajobs.gov](http://www.usajobs.gov), e.g., <http://jobview.usajobs.gov/GetJob.aspx?JobID=102560198&JobTitle=Administrative+Patent+Judge+%28Biotechnology%29&q=administrative+patent+judge&where=&cx=0&cy=0&cbid=3876&cvw=b&FedEmp=N&FedPub=Y&AVSDM=2011-09-19+14%3a46%3a00> (last accessed September 27, 2011).

### ***3. Joinder of Additional Parties***

If a PGR or IPR is instituted, the Director has the discretion to join as a party to that proceeding any person who properly files a petition that the Director determines warrants institution of PGR or IPR. The AIA does not specify a time period by which the second or any additional parties must be joined. While joinder may make sense if the first proceeding has not moved too far along, we must wait to see if (and hope that) the Office takes a sensible approach here. Under the AIA, the PTO can adjust the time periods for making a final determination in a case if it has joined multiple parties in PGR or IPR. But will this provision of the AIA lead to multi-year, multi-party PGRs and IPRs? What is the likelihood that we will see multi-party PGR or IPR proceedings? In view of the estoppel provisions, would not a second potential challenger be inclined to be a “free rider” and hold off on bringing its own action?

### ***4. Patentee’s Motion to Amend Claims***

A patent owner may file, by right, only one motion to amend its claims during PGR or IPR. Such a motion may seek to cancel any challenged patent claim or propose a reasonable number of substitute claims for each challenged claim. Note, the patent owner has no right merely to amend claims, but instead has the right to file one motion to amend. What is the rationale behind making the patent owner *move* to cancel or substitute its claims? By requiring that such an amendment be made by motion, the AIA suggests a greater burden upon a patent owner who seeks to amend claims in PGR or IPR than in IPX, EPX or *ex parte* prosecution.<sup>23</sup> The AIA does not specify what would be a “reasonable” number substitute claims. The Act is clear that any amendment may not enlarge the scope of the claims or add new matter.

Once the patent owner has used its right to one motion to amend, additional motions to amend may be permitted upon the joint request of the petitioner and the patent owner to materially advance the settlement of the IPR proceeding. Additional motions to amend the claims may also be permitted by “regulations prescribed by the Director.” Whether such regulations will exist and what form they may take, remains to be seen.

### ***5. Discovery***

IPR and PGR will both be adjudicated by the PTAB, and it is clear there will be discovery in both proceedings. However, the AIA has distinct differences in what discovery is available in each case.

Under the AIA, the Director must set forth standards and procedures for discovery of relevant evidence in both PGR and IPR. That discovery will be limited to evidence directly related to factual assertions advanced by either party during PGR. Thus, the AIA seeks to confine the scope of discovery to something narrower than what is available in a typical district court proceeding. In contrast, for IPR, discovery will be limited to (a) depositions of witnesses who submitted affidavits or declarations; and (b) what is otherwise necessary in the interests of justice. This contrasting language suggests that discovery could be broader in PGR than in IPR.

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<sup>23</sup> This is one of the most controversial provisions of the AIA.



If interferences are any example, it seems likely that the PTAB will essentially limit discovery in IPR to depositions of affiants or declarants. Although additional discovery may be available in current interferences, the BPAI has generally been loath to grant it, begging the question as to whether the PTAB will similarly be unlikely to grant additional discovery. Parties to PGR or IPR might argue that the PTAB should be more liberal in granting discovery than the BPAI typically has been in interferences. In interferences, a dissatisfied party can seek judicial review in U.S. district court and seek additional discovery in that tribunal. In contrast, a party dissatisfied with the outcome of PGR or IPR has recourse only at the CAFC and thus will not have a further opportunity for discovery and to build the administrative record. It is difficult to imagine that discovery will be granted at the Office as leniently as it is in district court. But if it were, that would seem to defeat one of the purposes of PGR and IPR, *viz.* to provide a forum for litigating the patent at less expense and greater speed than in district court.

For IPR, discovery will be limited to (a) depositions of witnesses who submitted affidavits or declarations; and (b) what is otherwise necessary in the interests of justice. With regard to (b), it will be interesting to see what may be deemed to be “otherwise necessary in the interests of justice.” If interference practice is illuminating, then, for the reasons discussed above for PGR, option (b) will provide little, if any, avenue to obtain discovery.

With regard to (a), the Office may choose to mirror interference practice for depositions, for example, limiting objections in the same way as in an interference. Additionally, attorney-expert communications may also enjoy the same privilege afforded in interference practice. An automatic privilege, of course, fosters easier discussions with expert witnesses. It also prevents nit-picking discovery, or other minimally productive practices that arise from attempting to delve into attorney-expert discussions.

Will the PTAB style depositions like those in district court? Is a petitioner more likely for example to video depositions (a practice uncommon in interferences)? And if so, how likely is the PTAB to watch those videos? Again, will the PTAB impose time constraints on deposition length like the limits under the FRCP? Or will it follow interference practice where no such time limit exists? If the PTAB does chose to follow deposition practices akin to those of interferences, will a deposition only be for discovery purposes, or will it become part of the “trial record” as it is in interferences?

If PGR and IPR practice parallels that of interference practice, requests for discovery will be made by motion. Additionally, the AIA provides for the possibility of sealing evidence. How successfully can one seal evidence filed at the Office? What safeguards can the Office put in place?

## ***6. Protective orders***

Under the AIA, the Director must prescribe regulations providing for protective orders governing the exchange and submission of confidential information. What kind of protectable information might be relevant to adjudication of the PGR or IPR? Perhaps a patent owner will wish to provide sensitive business information that is germane to the issue of commercial success or other non-obviousness objective evidence. What protectable information might a petitioner wish to use in a PGR or IPR? Providing for protective orders represents a new paradigm for the PTO, which over the years has become increasingly transparent in its interactions. The provision for protective orders must be

carefully balanced against the public's need to understand the bases for confirming (or canceling or amending) the rights of a patent owner. From the public's perspective, such a need may be just as great, if not greater, during PGR or IPR than it is during original *ex parte* prosecution, because the stakes will generally be higher in PGR and IPR and the patent is of significant commercial importance. From the public's perspective, a patent owner or third party petitioner arguably should have to "pay the price" of playing the patent game by publicly disclosing the information that is relied upon for determining the patentability or unpatentability of the patent under review. The AIA states that the Director shall prescribe regulations ensuring that any information submitted by the patent owner in support of any amendment entered under subsection (d) of the AIA is made available to the public as part of the prosecution history of the patent. Such a provision seems to cut against widespread use of protective orders. However, from the patent owner's and challenger's perspectives, such protective orders may prove necessary to render the PTO a viable alternative forum to district courts for adjudicating patent issues.

### ***7. Time limits for resolution of PGR or IPR***

By statute, and with few exceptions, a final determination in PGR or IPR must be made within one year from institution of the proceeding. Where good cause is shown, the Director may extend the period for an additional 6 months. In situations in which multiple parties have been joined together into a single PGR, the Director may further adjust the time periods for making a final determination of the PGR. Many patent owners and potential challengers question whether the PTO will be adequately staffed to meet the one-year deadline in a manner that provides justice and due process to the involved parties and the public. Also, what will constitute "good cause" that will permit extension of the deadline by 6 months? Will the parties have the opportunity to argue that such good cause exists or will it be determined just by PTO fiat? The parties may find that there is a need for additional discovery or for the production of laboratory test results that takes time; perhaps such grounds constitute good cause. Will an extension of the final deadline allow for an extension of intermediate deadlines for obtaining discovery, or filing motions, oppositions, etc.? Will the one-year standard time limit for resolution of the case cause district courts to be more likely to stay a litigation pending resolution of the PGR or IPR than they have been to stay a litigation pending resolution of a reexamination? Such a short time for resolution of PGR and IPR suggests that the proceedings must move swiftly once they are initiated. Accordingly, an owner of a valuable patent in a competitive field should be prepared to face an attack immediately upon issuance of the patent. Such preparation may involve ensuring that the owner has a strong professional relationship with the inventor(s), retaining potential experts (who typically will be distinct from experts used in other related proceedings), and securing any additional evidence that may be germane to patentability (e.g., commercial success, unexpected results, etc.).

### ***8. Estoppels***

As with *inter partes* reexaminations, estoppels may arise in both PGR and IPR. The speed with which such estoppel arises is likely to be a significant factor in determining whether potential challengers are willing to utilize either new form of PTO litigation. The estoppel may arise against the petitioner, the real party in interest (RPII), or a privy of the petitioner. The estoppel may arise in later actions before the PTO, in civil actions in district court and/or in proceedings before the U.S. International Trade Commission ("USITC"). At the PTO, the petitioner, RPII or privy of a petitioner who institutes PGR or IPR of a claim that results in a final written decision may not request or maintain a

proceeding before the PTO with respect to that claim on any ground the petitioner raised or reasonably could have raised during the PGR or IPR. Given that the estoppel provision refers to grounds that *reasonably* could have been raised, and this language differs from the “raised or could have raised” standard used during *inter partes* reexamination, one must ask how the two standards are meant to differ. For example, could one have “reasonably” raised a prior art challenge based on a difficult-to-find, obscurely catalogued foreign dissertation or commercial document? If, during the course of a PGR, a petitioner uncovers through discovery information that may form the basis for challenging a claim on a ground not presented in its original petition, must the petitioner seek to raise the unpatentability ground at that time? If so, the petitioner risks running afoul of the estoppel? If not, arguably the petitioner reasonably could have raised the ground and would also create an estoppel.

Because written description and enablement, for example, cannot be challenged via IPR, unlike in PGR, an IPR petitioner is still free to challenge the patent in a later civil action based on invalidity for lack of written description, lack of enablement, lack of utility, prior public use, etc. The patent could also be challenged as unenforceable in civil litigation. Of course, non-infringement also remains as a defense in a civil litigation.

One interpretation of the plain language of the AIA is that the estoppel arises as soon as the PTO issues its final written decision, without consideration of any appeals. If such an interpretation is the correct interpretation, the estoppel would arise much sooner in PGR or IPR than it has in *inter partes* reexamination, where the estoppel arises only after all appeals are final. The AIA states that a petitioner “may not assert” in a civil action or at the ITC that a claim is invalid on any ground the petitioner raised or reasonably could have raised during PGR or IPR. Does this language preclude a petitioner from *maintaining* such a ground if it had previously been asserted? Note that the estoppel before the PTO precludes the petitioner from requesting *or maintaining* a proceeding before the PTO on such a ground. Thus, a petitioner may point to this difference in language to argue that the AIA does not preclude maintaining such a ground in district court or at the ITC. The speed with which the estoppel takes effect will be an important consideration for parties that contemplate seeking PGR or IPR. While the statute may be intended to preclude a petitioner from having two bites at the apple, potential petitioners will certainly seek to maximize their opportunity to make similar arguments in multiple forums.

Unlike in *inter partes* reexamination, the parties to PGR or IPR may file a joint request to settle and terminate the proceeding prior to the PTO deciding the merits of the proceeding.<sup>24</sup> Such settlement and termination of the proceeding will prevent any estoppel from arising as to the settling petitioner, its RPII or privies. It will be interesting to see whether such settlement provisions that preclude estoppel will lead to the increased use of PGR or IPR as negotiating tools, as compared with reexaminations. A party to *inter partes* reexamination had little incentive to settle once the reexamination “bomb” had been dropped, since the PTO typically would simply continue the reexamination as a *de facto ex parte* reexamination if the third party requester abandoned the case. Thus, potential third-party requesters of reexaminations sometimes showed up at the negotiation table with a reexamination request in their pockets (i.e., a so-called “pocket reexam”) to pressure the patent owner into offering more reasonable licensing terms. Will the possibility of settling PGR or IPR without estoppel make the potential petitioner more likely to file the petition rather than to keep it in his or her back pocket? Because the PTO will terminate settled

<sup>24</sup> This is a major change from current reexaminations which cannot be terminated by the parties unless the concurrent litigation has reached a certain point concerning the bases for the reexamination.

proceedings, provided that a final decision had not yet been made, one must wonder whether such settlements will be more likely to be collusive. Access to settlement agreements for PGR and IPR will be limited to Federal agencies and persons showing good cause. Should an agency such as the Federal Trade Commission review settlement agreements for PGR and IPR proceedings in high-stakes cases (e.g., as it does for ANDA litigations)? For PGR that is instituted based on a novel or unsettled legal question that is important to other patents, should a timely settlement between the parties lead to an automatic termination of the PGR? Would the public's interests be better served by continuing the proceeding to resolve the novel or unsettled legal question?

#### ***F. Parallels with Interference Practice***

Interference proceedings likely provide the best paradigm for how PGR and IPR will be adjudicated. Interferences are contested cases that are adjudicated by the BPAI, the predecessor tribunal for the PTAB, which will adjudicate PGR and IPR. All three proceedings are held before a three-judge panel of Administrative Patent Judges (APJs). Most day-to-day proceedings in interferences are handled by one of the APJs, whereas the remaining two APJs typically do not become heavily involved until late in the proceeding.

In interferences, the APJs do not issue office actions the way that patent examiners do in *ex parte* prosecution or at the CRU. Rather, the APJs decide motions filed by the parties and consider oppositions and replies thereto. Because the AIA states that a patent owner may file a response to a petition after PGR or IPR has been instituted, and the patent owner may *move* to amend its claims, the statute suggests that PGR and IPR will also involve a process akin to motions practice used in interference proceedings. An additional similarity comes via the use of affidavits or declarations to provide factual evidence and expert opinions. The practice of filing such motions, oppositions and replies, supported by factual evidence and expert opinions, is routine in interference practice. In this regard, interferences can be very litigious in nature, and it seems likely that PGR and IPR will be similarly litigious.

The PTAB will likely look to interference practice as a model for obtaining and handling evidence. In interferences, the Federal Rules of Evidence apply, but the Federal Rules of Civil Procedure do not. It seems logical that PGR and IPR will be similar in this regard. But will the new corps of APJs be adequately trained to consider whether the evidence of record complies with the Federal Rules of Evidence? In interferences, evidence is almost never excluded from the record. Will the same be true in PGR and IPR? Will the APJs be adequately trained and sufficiently experienced to assess the credibility and reliability of competing witnesses? In nearly every PGR or IPR proceeding, one can expect that at least two well-credentialed experts will offer conflicting opinions. PGR and IPR will be viewed as viable alternatives to district court litigation only if the PTO handles the evidence it receives in a logical, just and predictable manner. Will depositions in PGR and IPR more closely resemble those in interferences or those in district court litigation? In interferences, there are notable constraints on communicating with the witness and on making objections. Will the PTAB impose similar constraints in PGR and IPR? Additionally, an entire interference proceeding is considered to be "trial," and there is rarely live testimony before an APJ. Instead, essentially all testimony is provided via a written affidavit or declaration, with subsequent cross-examination at deposition. Thus, depositions in interferences are not pre-trial exercises to prepare one for trial. Will depositions in PGR and IPR be treated in the same manner? Given the short timeframe for reaching a final determination in PGR and in IPR, it seems that it would be necessary to treat the entire proceeding as trial, just as it is in interference practice.

Just as in interferences, PGR and IPR will culminate in an oral hearing before the Board. Each party in an interference is typically allotted 20-30 minutes for presentation and questioning related to its entire case, which generally has played out of the course of the previous year.<sup>25</sup> Thus, an interference decision is founded heavily on the paper record provided to the Board. As with interferences, it seems unlikely that oral hearings in PGR or IPR will involve live testimony. Given the substantial time pressures the APJs will be under to resolve PGR and IPR proceedings, it seems unlikely that the PTAB will be able to allow lengthy hearings.

### **G. Conclusion**

We are entering into a brave new world in which valuable patents will be subjected to new forms of post-issuance scrutiny at the PTO. As always, change brings uncertainty and uncertainty generally has a negative impact on business. As stakeholders in the patent system, we must work together to assist the PTO and courts in working through the myriad issues and unintended consequences that may arise in the wake of the AIA.

## III. TRANSITIONAL PROCEEDINGS UNDER SECTION 18

Section 18 of the AIA provides a post-grant review proceeding specifically for certain types of business method applications. Proponents of Section 18 believe that the AIA will solve the problem of overly broad method patents that issued within the first several years after the Federal Circuit's 1998 decision in *State Street*.<sup>26</sup> At that time, proponents of the legislation argue, the PTO was still building its prior art databases and determining best practices to use in the examination of business methods. Combined with the PTO's allowance-friendly culture at the time, it is argued that the lack of readily available prior art resulted in a large number of business method patents being inappropriately issued. Opponents of Section 18 argue that the AIA singles out a certain area of technology for additional scrutiny using art that is unavailable to a petitioner in other types of post-grant review in an unprecedented manner. They argue that this goes against the traditional understanding that all patents carry equal weight. Further, due to the uncertainty surrounding patent enforceability, opponents argue that Section 18 essentially degrades business method technology to second class status and strips appropriately granted patents of their value.

Interestingly enough, even though Section 18 has been referred to by many as the "business method review" section, the Section 18 proceeding is actually limited to only a particular type of business method patent that affects a particular type of petitioner in particular circumstances. Section 18 is widely considered to be a "bailout" to the financial sector in response to the \$400 million judgment awarded to Data Treasury against large banks and other financial institutions who were accused of infringing its patents, even after reexamination of those patents.

If Section 18 was meant as to be an avenue for defendants to continue challenging patents that have already survived reexamination, then Section 18 will succeed in providing those defendants with yet another weapon in their arsenal for attacking their accusers and

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<sup>25</sup> Some practitioners may argue that if the PTAB limits the oral hearing to such a short time, the essential nature of a fact-finding hearing will be lost and the parties will be deprived of their ability to put on their case in a full and complete manner. This arguably would undermine the whole purpose of these new proceedings. Thus, the PTO should create rules that foster full and complete hearings and not the super short interference-type hearings of the BPAI.

<sup>26</sup> *State Street Bank & Trust Co. v. Signature Fin. Group, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998).<sup>1</sup> 35 U.S.C. § 257(a).

discouraging litigation by patentees. If Section 18 was intended to solve the bigger problem of overly broad and abstract business method patents, however, it likely does not achieve that goal because of the narrow scope of patents that are actually eligible for the Section 18 proceeding. The following sections explore the eligibility requirements for a Section 18 proceeding, the grounds for which a Section 18 proceeding can be initiated, and Section 18's effect on litigation.

### ***A. Eligibility for Transitional Proceeding***

Indeed, when considering the large number of patents that are traditionally thought of as “business method patents,” the patents that can actually be reexamined via a Section 18 proceeding are a small subset of that group.

#### ***1. Petitioner qualifications***

To use the Section 18 proceeding, a petitioner must meet a stringent set of requirements. First, the petitioner must have been sued for infringement of the patent, or at least charged with infringement under that patent. It is unclear where the line will be drawn regarding who has been “charged with infringement.” At one end of the spectrum, “charged with infringement” may mean that a petitioner has been served with process, even if the actual civil action has not yet been filed. At the other end of the spectrum, “charged with infringement” may simply mean that a petitioner has been threatened by a patentee's implication of infringement, similar to the current standard for finding a basis for a declaratory judgment action.

Assuming that the petitioner meets that first hurdle, the availability of the proceeding also depends on whether the petitioner started the battle, or was just brought into the battle by virtue of the lawsuit. That is, to use a Section 18 proceeding, the petitioner cannot have filed a civil action challenging the validity of the patent. For example, if the petitioner filed a declaratory judgment action against the patent holder, the Section 18 proceeding would not be available to the petitioner. The Section 18 proceeding *is not* barred by a counterclaim challenging validity, though, so a defendant in a lawsuit is not required to choose between the Section 18 proceeding and pursuing what is often an important defense in the co-pending infringement suit.

#### ***2. Timing qualifications***

Section 18 of the AIA goes into effect on September 16, 2012 (one year from the date of enactment), so the procedure is not available to petitioners before that date. Section 18 also includes a sunset provision, meaning that it will expire on September 16, 2020 (8 years from the effective date), unless Congress extends this provision.

Even if the petitioner meets the requirements for filing a Section 18 proceeding, a Section 18 proceeding cannot be requested when a PGR procedure is available to the petitioner. As discussed above, PGR is available for all patents for the first nine months after a patent issues, and any issue provided for by paragraphs (2) and (3) of section 282(b) can serve as the basis for the post-grant review. Given the wide scope of PGR, Congress is clearly trying to incentivize challenging a patent early on instead of later through a Section 18 proceeding. After 9 months have passed after issuance, though, a Section 18 proceeding may be instituted. Importantly, Section 18 applies to all issued patents, not just those that issued after the enactment date or the effective date of the AIA.

### ***3. Applies only to a “covered business method patent”***

Even if the petitioner meets all the qualifications set out by the AIA, and satisfies the required timing, the patent itself must meet its own set of qualifications in order for the petitioner to take advantage of the Section 18 procedure. For the 8-year period in which Section 18 proceedings will be available, any “covered business method” patent will be susceptible to this proceeding. This includes any patent that was already issued as of the effective date. For newly issued patents, as discussed above, the Section 18 proceeding will not be available for the first nine months after grant.

By far, the biggest question raised by the language of the Act is “what is a ‘covered business method?’” According to the Act, a “covered business method patent” is “a patent that claims a method or corresponding apparatus for performing data processing or other operations used in the practice, administration, or management of a financial product or service, except that the term does not include patents for technological inventions.” This bears repeating: A covered business method patent is for an invention that involves data processing, but which is not considered to be a technological invention.

The AIA itself provides little guidance regarding what would be considered a data processing invention without being considered a technological invention. Perhaps recognizing the difficulties inherent in defining “a technological invention,” Section 18 leaves the definition up to the Director. Specifically, the Director is tasked with issuing regulations for determining whether a patent is for a technological invention. Congress takes the further step of distancing itself from any controversy as to how this definition might affect examination based on §101, remarking that “nothing in this section shall be construed as amending or interpreting categories of patent-eligible subject matter set forth under §101.”

It is unclear how the Director might define a technological invention, and it is likely that any definition will bleed over to applications under initial examination by the PTO, and affect how they are treated under §101. Traditionally in the PTO, a business method patent was considered to be any patent classified in class 705, which is defined by the PTO as “data processing: financial, business practice, management, or cost/price determination.” The specific definition given by the PTO for class 705 is “machines and methods for performing data processing or calculation operations in the: 1) practice, administration or management of an enterprise; 2) processing of financial data; or 3) determination of the charge for goods or services,” so this seems like a logical place to start. The Director could simply define a technological invention as any patent classified outside of class 705. Since a patent applicant likely cannot challenge the classification of a patent, such a solution offers a fairly impartial way of determining which patents will be subject to the Section 18 proceeding. Such a definition could lead to gamesmanship on the part of the patent applicant, though, who may try to draft the claims such that the application would be classified outside of class 705. For example, a patent applicant could focus the claims on a non-financial feature of the invention, causing the application to be classified outside of class 705, yet still claim financial aspects of the invention as secondary features. Further, the PTO has long recognized that some business methods are classified outside of class 705 anyway. These patents are typically not financial patents, but may prove unwise in the long term for the PTO to define something as broad and far-reaching as a “technological invention” without considering the definition’s effect on patents outside Section 18’s limited purview of financial services and products.

In another scenario, the Director may choose a definition of “technological invention” that follows the lines of 35 U.S.C. §101. That is, a technological invention may be defined as any invention whose claims satisfy the requirements of 35 U.S.C. §101. The PTO already has a set of factors in place for examining claims under §101, so both examiners and patentees would be advantageously familiar with such a standard. One difficulty with such a definition, however, is that the law around §101 is in flux and may be changed by the courts. It may be difficult, then, for a patent owner to predict whether its claims will be subject to a Section 18 proceeding or not. Even if the patent may not currently be susceptible to a Section 18 proceeding, a new court case related to §101 could change that susceptibility fairly quickly, if Section 18 availability depended on the interpretation of §101. Similarly, a Section 18 proceeding may begin when a patent is vulnerable under current laws, but there is a question of what would happen when the patent under review no longer presents an issue under §101 due to a change in the law. Additionally, it is questionable as to whether this would go against Congress’s stated intent of trying to limit the impact of Section 18 on 35 U.S.C. §101.

The PTO may also look to the European Patent Office as a model for defining technological inventions. In Europe, the term “invention” is interpreted to imply “a requirement of technical character or technicality to be fulfilled by an invention as claimed in order to be patentable. Thus, an invention may be an invention [under the European patent laws] if, for example, a technical effect is achieved by the invention or if technical considerations are required to carry out the invention.” (Decision of the European Patent Office Board of Appeal Case No. T0931/95, OJ 2001,441 (Sept. 8, 2000)). This definition is somewhat circular, however, in that it defines a technical invention using the word technical, which itself is prone to many interpretations. Additionally, the European Patent Convention has carved out a number of technologies as being non-statutory, including methods for doing business and programs for computers, so the question of whether they would be considered technical is never reached. Following the EPO, then, could be problematic since the EPO’s rules for patent eligibility are, at their core, different than the PTO’s standards.

It is possible that the PTO may consider simply returning to some version of the oft-maligned “technological arts test” for patent-eligibility that fell out of favor several years ago after the Board’s precedential decision in *Lundgren*. The Federal Circuit explicitly rejected the “technological arts test” in its decision in *In re Bilski*, but that decision was overturned by the Supreme Court, which did not explicitly discuss the technological arts test in its decision. Further, the change in the law could provide a springboard for reviving this test.

Of note is that the AIA does not make the Section 18 proceeding available for patents that are considered business methods but which do not involve data processing. Yet, these patents are the kinds that are most vilified by the public, and which give the term “business method” a bad name (e.g., a non-data-specific method of hedging risk).

To recap, if all patents that are traditionally seen as “business method patents” are identified as a set, a smaller set can be identified as “data processing” patents, leaving untouched the business method patents that do not include any type of data processing. A still smaller set of the data processing patents can be identified as relating to financial services or products, leaving untouched any data processing patent that does not have a financial component. Finally, the subset of financial data processing patents can be further split into technological financial data processing patents and non-technological financial



data processing patents. Section 18 is relevant only to that final subset of non-technological financial data processing patents. Although this subset is not insubstantial, the AIA still leaves a large swath of business method patents unaffected by Section 18.

There is the further question of when a business method patent can be categorized as being directed to a financial service or product. There are some patents that would clearly fall within this description, because they involve, for example, capturing and storing images of consumer checks to speed up processing by a bank. But there are a number of patents that may only tangentially claim some financial aspect. For example, would a method for advertising be considered a financial product or service, since advertising is ultimately directed to generating business for a company? Would a novel method of delivering data to a user over the Web be considered a financial product or service, simply because the data could include financial data? And where would patents related to the insurance industry fall? Would those be considered financial products or services for the purposes of Section 18? If a patent included both financial and non-financial claims, would the non-financial claim be excluded from reexamination under the Section 18 proceeding? One thing is clear – any ambiguity in the definition of a “covered business method patent” will likely result in defendants trying to apply the definition to patents outside the intended subject matter to take advantage of the effects Section 18 has on stays in related civil litigation, discussed in further detail below.

### ***B. Grounds for Transitional Proceeding***

Similarly to IPR, a Section 18 proceeding may be based only on the grounds of lack of novelty and obviousness. Despite the focus on business methods in Section 18, the Section 18 proceeding is not intended to address issues under 35 U.S.C. §101, although such issues can likely be raised if the claims are amended during the proceeding. The primary difference between IPR and a section 18 proceeding involves the prior art that serves as the basis for the proceeding.

The art available for IPR under the AIA includes patents and printed publications, much like the current requirements for *ex parte* and *inter partes* reexamination. In contrast, the availability of art in a Section 18 proceeding depends on the pre-AIA version of 35 U.S.C. 102(a). Specifically, Section 18 art includes art that is known or used by others in this country before the invention by the patentee, as well as patents and printed publications that were published in any country before the invention by the patentee. Under the new 35 U.S.C. 102, any printed publication available to the public prior to the filing date of the patent is considered prior art. So, any *printed* document that was available prior to the invention date (and thus the filing date) could be used to support a petition under the regular IPR proceeding. Given that printed publications are able to be handled under the regular IPR proceeding, it appears that Section 18 was included in the AIA to give defendants an opportunity to provide evidence of non-printed knowledge or use of the invention as support for reexamination of an issued patent.

For art that “disclosed the invention more than one year before the application filing date,” Congress opens the door further. Section 18 art can *also* include art that *would have been* described by the pre-AIA version of 35 U.S.C. 102(a) “if the disclosure had been made by another before the invention thereof by the applicant for patent.” There are a number of ways that this clause can be interpreted, because it is unclear which part of the sentence modifies the phrase “if the disclosure had been made.”

If the clause is read with emphasis on “if the disclosure had been made by another,” then the likely meaning of the clause is that the inventor’s own work can be used against him. If the inventor’s own written work was disclosed a year prior to the invention date (and thus the filing date), the art would be 102(b) art, and the regular IPR proceeding would apply. The Section 18 proceeding can therefore be supported by any non-printed disclosure by the inventor, such as an oral disclosure at a conference proceeding or a discussion the inventor may have had with friends regarding his development of the invention.

If the clause is read with emphasis on “if the disclosure had been made...before the invention,” then it is possible that a post-invention disclosure can be used as long as the disclosure was made more than one year before the filing date. Again, since a written disclosure by another would be considered 102(b) art and could be used in a regular IPR proceeding, this provision in Section 18 could be interpreted as allowing for a non-printed disclosure by someone other than the inventor to form the basis of the Section 18 petition, even if the disclosure was made after the date of invention. Section 18 does not provide any exception for derivation. So, if the inventor disclosed the invention to a third party under an NDA, and the third party violates the NDA by speaking openly about the invention, the third party’s actions could form the basis for a Section 18 petition if they took place more than a year before the patent’s filing date.

It is also possible that the primary emphasis could simply be on the phrase “if the disclosure had been made.” The “known or used” language in the pre-AIA version of 35 U.S.C. 102(a) has long been understood to mean “publicly known or used.” This portion of Section 18 clearly is intended to include art that would not traditionally have been considered prior art under 102(a). So, one interpretation of the new language is that secret, non-public use can also serve as a basis for a Section 18 proceeding. Such an interpretation would take the prior user defense a step further, rendering a patent invalid over secret use rather than simply acting as a defense to infringement.

For each of these interpretations there are, of course, questions as to how such prior art would be presented to the PTO. Since the art may not be printed art, some other mechanism must be used to put the art before the examiner in the initial petition. One option may be to include an affidavit or declaration, such as the current practice under 37 CFR 1.132. This raises the further questions of whether the declaration would need to be corroborated, what evidence would be required to support such a declaration, and whether the patentee would have any recourse to question the validity of the declaration, particularly if the declaration references secret knowledge or use that cannot be easily confirmed.

### ***C. Effect on Co-Pending Litigation***

A petitioner requesting a Section 18 proceeding would, of course, have to decide whether the proceeding fits into their overall litigation strategy, but the limitations on litigation imposed by Section 18 are not as stringent as those imposed by regular PGR or IPR.

#### ***1. Effects on ability to file civil actions***

If a claim examined in a Section 18 proceeding is ultimately found to be patentable over the cited art, then the petitioner is prevented from raising in a civil action the same invalidity contentions that were raised in the Section 18 proceeding. Interestingly,

this is less limiting than the typical limitation on petitioners in a standard IPR proceeding. In a standard IPR proceeding, the petitioner is prevented from raising at trial any invalidity contention that *could have been raised* during the IPR proceeding. The Section 18 proceeding is thus less likely to endanger a litigation strategy than the typical IPR proceeding. Because the estoppel resulting from a Section 18 proceeding is less than that resulting from a regular IPR proceeding, a defendant may opt to request a Section 18 proceeding instead of the regular IPR proceeding when the patent is clearly a “covered business method patent.”

## ***2. Effects on ability to stay civil action***

In another departure from the typical IPR proceeding, the Section 18 proceeding changes the standards for how a court decides whether a civil action should be stayed pending review at the PTO. The AIA does not go so far as to actually require that the court stay the civil action pending the outcome of the Section 18 proceeding, but the factors to be considered – whether the trial date is set, whether discovery is complete, whether the stay will reduce the burden of litigation, etc. – could be interpreted as weighing more heavily in favor of a stay.

Section 18 also grants an immediate right of appeal on the issue – if a stay in a civil action related to a Section 18 proceeding is requested in a district court, the losing party can make an immediate interlocutory appeal to the Federal Circuit. The Federal Circuit is required take the appeal, and may review the issue *de novo*. Proponents of this feature argue that Section 18 provides a path to dispense with frivolous infringement suits in a cost-effective manner, because invalidating the patent at the PTO results in significant savings of time and money for both the courts and the parties to a lawsuit. Opponents of the legislation counter that a defendant may now file a frivolous Section 18 proceeding on questionable art that may or may not have been available at the time the patent was filed and examined, and in doing so may tie up a valid infringement suit for years by appealing a motion for stay submitted early in the litigation. Since there is little downside for a defendant who files a motion for stay as a delay tactic, opponents of the legislation worry that Section 18 will present such a serious barrier to patentees trying to enforce their patents that they will be discouraged from pursuing those infringers at all, thus denigrating the value of their legitimately held IP.

## IV. DERIVATION PROCEEDINGS

The AIA replaces interference proceedings with so-called “derivation proceedings.” In a system that awards priority on the basis of filing dates instead of invention dates, inventive activity before to the filing of a patent application has little bearing on priority. Thus, interference proceedings are largely unnecessary. Derivation proceedings address the limited situation in which two applicants file for the same invention but the earlier-filing applicant derived the invention from the later-filing applicant. A strict application of first-to-file principles would award priority to the earlier-filing applicant, but derivation proceedings allow the later-filing applicant to prevail on the issue of priority.

Such priority disputes appear to be the only context in which derivation arises under the AIA. Previously, derivation was a prior art basis for invalidity but it no longer appears to be so. The AIA eliminates 35 USC § 102(f), which precluded anyone from patenting subject matter that “he did not himself invent,” i.e., subject matter derived from someone else. The invalidity defense of 35 USC § 102(f) was available to any accused

infringer, but derivation now becomes a matter strictly between the owners of competing patent applications.

A consequence of this change is that patents based on derived subject matter can be valid and enforceable. This will occur, for example, when “true” inventors either do not file a competing patent application or do not seek to institute a derivation proceeding. In such situations, the owner of a derived patent may block the public from practicing subject matter that he did not invent. Even true inventors may find themselves blocked from practicing their own inventions. This possibility might prompt inventors to file patent applications when they would otherwise forego patent protection.

### ***A. Administrative Proceedings – Institution of Derivation Proceedings Involving a Pending Patent Application***

Administrative derivation proceedings are governed by 35 USC § 135, which allows patent applicants to petition the U.S. Patent and Trademark Office (PTO) to institute a derivation proceeding. The petition must contain substantial evidence of the alleged derivation, including factual bases (1) for finding that an inventor named in an earlier application derived the claimed invention from an inventor named in the petitioner’s application, and (2) for finding that the earlier application was unauthorized. There is a strict time limit for filing such petitions – within one year of the first publication of a patent claim directed to the same invention or an invention that is substantially the same as the invention claimed in the earlier application. Depending on the regulatory implementation, this strict time limit may force later-filing applicants to sacrifice their provisional year of patent term in order to get a non-provisional application into a derivation proceeding. This will depend on whether “applicant for a patent” is interpreted to include the owner of a provisional patent application. If not included, such owners will have to file a non-provisional patent application early, thereby shortening their effective patent term in order to address a derivation issue.

Patent applicants bear the responsibility to identify competing patent claims and to prompt the PTO to institute derivation proceedings. The AIA does not authorize the PTO to institute derivation proceedings *sua sponte* as it currently may institute interference proceedings. Thus, patent applicants must monitor patent publications regularly in order to meet the one-year filing deadline. Otherwise, the opportunity for remedy via a derivation proceeding may be lost entirely. This creates a conundrum for the PTO when an earlier-filed application claiming derived subject matter is alleged prior art to a later-filed application, but it is too late for the later-filing applicant to petition for a derivation proceeding. Presumably, the later-filing applicant can overcome a prior art rejection by showing that the contents of the earlier-filed application was obtained directly or indirectly from an inventor on the later-filed application (see 35 USC 102(b)(2)(a)), but the PTO cannot issue two patents claiming the same subject matter. It is unclear how this possible scenario will be resolved under the AIA.

Upon receiving a petition under 35 USC §135, the PTO determines whether the standards for instituting a derivation proceeding are met. If it determines that the standards are met, the PTO “may” institute a derivation proceeding. The AIA’s use of “may” in lieu of a more definitive word appears to give the PTO discretion as to whether or not it institutes a derivation proceeding. Additionally, the AIA identifies at least two situations in which the PTO might defer taking any action on a petition. First, when two pending patent applications are at issue, the PTO can defer action on a petition until three months

after one of the applications issues with claims directed to subject matter of the petition. Second, when the earlier-filed case is an issued patent that is involved in ex-parte reexamination, inter-partes review or post-grant review, the PTO can defer action on a petition until such other proceeding is terminated. In both of these situations, and perhaps in others, deferrals help the PTO to preserve its resources until a derivation issue is ripe. To accomplish this result, a deferral may mean waiting to institute a derivation proceeding or even suspending a derivation proceeding that is already in process.

The PTO's determination about whether to institute a derivation proceeding is final and non-appealable. Thus, it appears that petitioners who disagree with a PTO determination in that regard have no recourse to the courts.

### ***B. Administrative Proceedings – Conduct of Derivation Proceedings and Remedies Available***

When the PTO initiates a derivation proceeding, the PTAB determines (1) whether an inventor named in the earlier application derived the claimed invention from an inventor named in the petitioner's application, and (2) whether filing of the earlier application was unauthorized. The AIA does not define what it means to "derive" an invention. In an interference proceeding, a party alleging derivation had to prove both a prior conception of the claimed invention and an enabling communication of the invention to the accused party. Whether the same requirements will apply in derivation proceedings is currently unknown.

The AIA also does not set forth detailed procedures for the conduct of derivation proceedings, but charges the PTO to prescribe regulations setting forth standards for conducting derivation proceedings. The standards shall include requiring parties to provide sufficient evidence to prove and rebut a claim of derivation. Presumably, they also will address the types and extent of discovery available for obtaining evidence. The effectiveness of derivation proceedings will heavily depend on the quality of PTO regulations governing them.

If the PTAB determines that derivation occurred, it may correct the inventorship on any application or patent at issue under "appropriate circumstances." Additionally, it may reject or cancel patent claims that cover derived subject matter. A final decision of the PTAB, if adverse to the claims in a pending patent application, will constitute a final refusal of those claims by the PTO. A final decision of the PTAB, if adverse to the claims in an issued patent will constitute cancellation of those claims, unless appeal or other review of the decision is possible. In those cases where the claims in a patent are cancelled, future copies of the patent will contain notice to that effect.

It is interesting to consider what might be "appropriate circumstances" for amending inventorship rather than canceling/rejecting the derived claims. In every derivation proceeding, the prevailing party will have its own patent application. Canceling or rejecting all the derived claims will allow the prevailing party to pursue its own claims in its own patent application. Of course, intervening prior art or some other validity issue may mean that claims to the derived subject matter are not patentable in the prevailing party's later-filed application. That would be one reason for amending inventorship on the earlier-filed application. However, the result might be joint ownership of the amended patent – a result neither party really wants.

### ***C. Administrative Proceedings – Settlements and Arbitration***

With respect to settlements and arbitration, the AIA treats derivation proceedings much the same as interference proceedings previously were treated.

Parties to a derivation proceeding may settle and terminate the proceeding. To do so, they must file a written statement reflecting their agreement as to the correct inventors of the invention in dispute. Unless the PTAB finds the agreement to be inconsistent with evidence of record, it will accept the agreement and take action consistent with it. At the request of either party, the PTO will treat a settlement agreement as confidential information, keep it separate from the file of the involved patents or applications, and make it available only to government agencies or persons showing good cause.

In lieu of a proceeding before the PTO, parties may submit their dispute to arbitration. Arbitration proceedings are governed by Title 9 of the U.S.C. and any specific regulations promulgated by the PTO. Parties involved in arbitration must give notice of any arbitration award to the PTO, and such award shall be dispositive of the relevant issues, as between the parties. However, the PTO still has authority to determine any issues of patentability relating to the claimed inventions.

### ***D. “Appeal” to District Court***

As was the case with interference proceedings, a party dissatisfied with a decision of the PTAB in a derivation proceeding may seek remedy in district court. Thus, 35 U.S.C. § 146 is amended to refer to the PTAB instead of the former Board of Patent Appeals and Interferences and to refer to derivation proceedings instead of interferences. Other than those substitutions, the substance of 35 U.S.C. § 146 is unchanged.

### ***E. Court Proceedings – Derivation Proceedings that Involve Issued Patents Only***

Derivation proceedings that involve only issued patents (i.e., that do not involve a pending application) are handled by the federal courts and are governed by 35 U.S.C. §291. According to that statute, the owner of a patent may seek relief in a civil action against the owner of another patent that claims the same invention and has an earlier effective filing date, if the invention claimed in the other patent was derived from an inventor of the invention claimed in the first patent. Such cases are expected to be rare. The law is designed to preclude multiple patents claiming the same invention, so this will occur only in the event of a PTO error.

As with administrative proceedings, there is a strict time period for bringing an action under 35 U.S.C. §291 – within one year after issuance of the first patent to contain a claim to the allegedly derived invention and to name as an inventor someone who allegedly derived the invention. Thus, patentees need to monitor the patent literature regularly. Otherwise they risk losing the opportunity to seek a remedy via derivation proceeding.

A result of patentees missing their opportunity to invoke a derivation proceeding is that two patents claiming the same invention will exist. Not only will the patent owners be subject to each other, but the public will be subject to two different patent holders. This result is contrary to public policy because it drives up cost and limits access to patented technology.

### ***F. Patent Term Adjustments for Successful Derivation Proceedings***

Delays in the issuance of a patent caused by derivation proceedings will give rise to a patent term adjustment. 35 USC § 154 governs such adjustments and is unchanged except for the substitution of derivation proceedings in place of interference proceedings.

## V. SUPPLEMENTAL EXAMINATION

Supplemental examination permits a patent owner to request that the PTO “consider, reconsider, or correct information believed to be relevant” to a granted patent.<sup>27</sup> If the submitted information does not raise a “substantial new question of patentability,” or the patent is deemed valid over the information at the close of the proceeding, the defense of inequitable conduct cannot be raised in a subsequent litigation unless certain exceptions are met. This new post-grant proceeding provides an opportunity to improve the quality of issued patents and, by doing so, improve and streamline the litigation process.

Following a brief review of the legislative background around Supplemental Examination, this paper will provide an overview of the statutory language and potential practice issues that may emerge following implementation.

### ***A. Legislative Background***

While the AIA follows from several bills introduced in the House and Senate over the last six years, an early public discussion linking patent quality enhancement goals of the legislation with inequitable conduct reform was presented in the Supplemental Comments by Senator Hatch accompanying the Committee Report upon introduction of S.515 during the 111 Congress. These comments recognized that the “inequitable conduct defense is frequently pled, rarely proven, and always drives up the cost of litigation” and that there is “virtually no downside for the infringer to raise this type of defense, even if it lacks a true basis.” The comment further acknowledged the over-disclosure of prior art to the PTO and the counterproductive effect that has on quality patent examination, and that “anything an applicant does to help an examiner focus on the most relevant information during examination becomes the target of an inequitable conduct challenge in court.” The comments conclude that inequitable conduct reform has the “potential to single handedly revolutionize the manner which patent applications are prosecuted” and “will have the most favorable impact on patent quality, and will give the PTO the ability to reduce its pendency, thereby fostering a strong and vibrant environment for all innovation and entrepreneurship.”<sup>28</sup>

On March 4, 2010, a bipartisan group of Senators announced they had agreed to the details of a Manager’s amendment to S.515. These changes included the introduction of the Supplemental Examination provision designed to “permit the patent holder to provide additional, potentially material prior art regarding the patent to the PTO. If the PTO considers the information and determines that it has no effect on patentability, that additional information cannot serve as the basis for an inequitable conduct claim later in court.”<sup>29</sup>

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<sup>27</sup> 35 U.S.C. § 257(a).

<sup>28</sup> Senate Judiciary Committee Report on S.515 (May 12, 2009).

<sup>29</sup> Senate Press Release, Leahy, Sessions, Hatch, Schumer, Kyl, Kaufman Unveil Details of Patent Reform Agreement, March 4, 2010.

On January 25, 2011, the “Patent Reform Act of 2011,” which included the Supplemental Examination provision, was introduced in the Senate and it passed on March 8, 2011. The corresponding House bill, H.R. 1249, was introduced in June 2011. The House Judiciary Report provides further insight into the goal of supplemental examination:

The Act addresses the inequitable conduct doctrine by authorizing supplemental examination of a patent to correct errors or omissions in proceedings before the Office. Under this new procedure, information that was not considered or was inadequately considered or was incorrect can be presented to the Office. If the Office determines that the information does not present a substantial new question of patentability or that the patent is still valid, that information cannot later be used to hold the patent unenforceable or invalid on the basis for an inequitable-conduct attack in civil litigation.<sup>30</sup>

The final House Bill passed on June 23, 2011, and included an amendment to the supplemental examination relating to the PTO’s discovery of fraud during the supplemental examination process.

### ***B The Supplemental Examination Request and Procedure***

35 U.S.C. § 257 (a) provides the basis for requesting supplemental examination.

Request for Supplemental Examination- A patent owner may request supplemental examination of a patent in the Office to consider, reconsider, or correct information believed to be relevant to the patent, in accordance with such requirements as the Director may establish. Within 3 months after the date a request for supplemental examination meeting the requirements of this section is received, the Director shall conduct the supplemental examination and shall conclude such examination by issuing a certificate indicating whether the information presented in the request raises a substantial new question of patentability.

One significant difference between supplemental examination and existing post-grant proceedings is the scope of information that may be considered by the PTO. The statute confirms that information that was not previously submitted may be “considered,” that previously submitted information may be “reconsidered” presumably in a new context or given potentially greater significance, or that information may be “corrected.” The scope of information considered is far broader than the “patent and printed publications” limitation of *ex parte* reexamination, and appears intended to encompass any information believed to be potentially relevant to the patent.

Accordingly, in addition to the traditional submission of prior art publications, patent holders may request supplemental examination of, *e.g.*, positions taken in co-pending or related foreign prosecution that may be considered inconsistent with positions taken in the original examination, statements made in the specification, prosecution or declarations that are unclear, were erroneous at the time of filing, or have been subsequently established to be incorrect based on new data, and/or any other information that could potentially be considered relevant during subsequent litigation. It is difficult to envision

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30 House Judiciary Report on H.R. 1249, Dated June 1, 2011.



information that would not be considered an appropriate basis of a supplemental examination request under this standard.

The scope of information is also broader than allowed via existing reissue proceedings, which require that the patent owner admit that the patent is “deemed wholly or partly inoperative or invalid, by reason of a defective specification or drawing, or by reason of the patentee claiming more or less than he had a right to claim in the patent.”<sup>31</sup> While this requirement has been recently construed in a liberal manner in *In re Tanaka*, 640 F.3d 1246 (Fed. Cir. 2011) with respect to adding additional claims, patent holders are hesitant to admit to a defect, and the scope of review is relatively limited to defects in the specification or claims.

The PTO is required to review the submitted information and complete the supplemental examination within three months of receiving a request. The supplemental examination shares the “substantial new question of patentability” standard with *ex parte* reexamination, and the procedure concludes with the PTO issuing a certificate confirming whether the submitted information meets this standard. 35 U.S.C. § 257 (b) provides the basis for the potential *ex parte* reexamination procedure following supplemental examination.

(b) Reexamination Ordered - If the certificate issued under subsection (a) indicates that a substantial new question of patentability is raised by 1 or more items of information in the request, the Director shall order reexamination of the patent. The reexamination shall be conducted according to procedures established by chapter 30, except that the patent owner shall not have the right to file a statement pursuant to section 304. During the reexamination, the Director shall address each substantial new question of patentability identified during the supplemental examination, notwithstanding the limitations in chapter 30 relating to patents and printed publication or any other provision of such chapter.

If the submitted information meets the substantial new question of patentability standard, there is an ensuing *ex parte* reexamination that differs from current procedure in two ways. First, there is no limitation to patents and printed publications given the broader scope of information that may be submitted to the PTO for consideration, reconsideration, or correction during the supplemental examination. Second, since the patent holder initiates this proceeding, there is no opportunity for a patent owner statement following the determination that there is a substantial new question of patentability but preceding a first office action on the merits during the reexamination.

According to the USPTO statistic as of June 30, 2011, the PTO grants 92% of *ex parte* reexamination requests. It remains to be seen whether this trend will continue when considering this broader category of information in supplemental examination requests, or whether a significant number of patents will emerge from the supplemental examination within three months of the request without a full reexamination procedure.

### ***C. The Effect of Supplemental Examination On A Subsequent Inequitable Conduct Defense***

35 U.S.C. § 257(c)(1) confirms the effect of the supplemental examination process on subsequent litigation.

IN GENERAL- A patent shall not be held unenforceable on the basis of conduct relating to information that had not been considered, was inadequately considered, or was incorrect in a prior examination of the patent if the information was considered, reconsidered, or corrected during a supplemental examination of the patent. The making of a request under subsection (a), or the absence thereof, shall not be relevant to enforceability of the patent under section 282.

Thus, the same information considered during supplemental examination cannot be used a basis for an inequitable conduct defense. This potential bar on the inequitable conduct defense following supplemental examination is a further distinction from existing post-grant procedures. The Federal Circuit has held that the submission of information during reexamination or reissue does not bar a subsequent inequitable conduct defense based on that information.<sup>32</sup> When a patent owner submits information for consideration by the PTO during reexamination or reissue, there is an effective admission of the materiality of this information. Even if a patent is maintained as valid by the PTO, this admission could be used in subsequent litigation as part of an inequitable conduct defense designed to render an otherwise valid patent unenforceable. This possibility discouraged patent owners from submitting information and addressing issues in the PTO, and instead incentivized patent owners to “take their chances” in court. The supplemental examination process appears designed to encourage patent owners to seek PTO review by removing concerns surrounding the potential admission and providing an incentive through this inequitable conduct bar.

### ***D. The Exceptions to the Inequitable Conduct Bar***

There are two exceptions to the inequitable conduct bar triggered by supplemental examination. The first exception is set forth in § 257(c)(2)(A):

(A) PRIOR ALLEGATIONS- Paragraph (1) shall not apply to an allegation pled with particularity in a civil action, or set forth with particularity in a notice received by the patent owner under section 505(j)(2)(B)(iv)(II) of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. § 355(j)(2)(B)(iv)(II)), before the date of a supplemental examination request under subsection (a) to consider, reconsider, or correct information forming the basis for the allegation.

Accordingly, the inequitable conduct bar will not apply to information pled with particularity in a civil action, or set forth with particularity in a “Paragraph IV certification letter” submitted pursuant to the Hatch-Waxman Act, before the date of the supplemental examination request.

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<sup>32</sup> See, e.g., *Bristol-Myers Squibb Company v. Rhone-Poulenc Rorer, Inc.*, 326 F.3d 1226 (Fed. Cir. 2003).

35 U.S.C. § 257(c)(2)(A) encourages a patent holder to initiate supplemental examination significantly prior to a time when it can receive information from potential infringers as to their substantive defenses in either a civil action or during the Hatch Waxman process. At a minimum, a patent holder could initiate supplemental examination three months prior to litigation, and hope the PTO finds no substantial question of patentability, prior to receiving any substantive allegations in a pleading or Paragraph IV certification. More likely, patent holders will initiate supplemental examinations several years prior to initiating litigation to take into account the potential *ex parte* reexamination process should a substantial question of patentability be found.

However, since subsection (A) applies to information pled with particularity in a civil action, it is possible that declaratory judgment action could trigger this exception and thus provide a certain degree of uncertainty as to when a supplemental examination should be filed. The situation is different for Paragraph IV certifications. Declaratory judgment actions cannot be filed during the Hatch-Waxman process. Moreover, the timing of these certifications is generally predictable, *e.g.* four years following FDA approval of a new chemical entity, with litigation following within forty five days after, so a pharmaceutical patent holder would have more clarity as to the timing for initiating supplemental examination.

In both instances, the “information” would have to be “pled with particularity,” which suggests the standard for pleading fraud under Fed.R.Civ.P. 9(b). The Federal Circuit recently clarified the standard for pleading inequitable conduct with particularity in *Exergen Corp. v. Wal-Mart Stores, Inc.*,<sup>33</sup> and one possibility is that courts will adopt aspects of this standard in analyzing whether the “information” was pled with particularity in a sufficient way to trigger the 35 U.S.C. § 257(c)(2)(A) exception.

The second exception to receiving the inequitable conduct bar is set forth in § 257(c)(2)(B):

(B) PATENT ENFORCEMENT ACTIONS- In an action brought under section 337(a) of the Tariff Act of 1930 (19 U.S.C. § 1337(a)), or section 281 of this title, paragraph (1) shall not apply to any defense raised in the action that is based upon information that was considered, reconsidered, or corrected pursuant to a supplemental examination request under subsection (a), unless the supplemental examination, and any reexamination ordered pursuant to the request, are concluded before the date on which the action is brought.

Accordingly, the bar will also not apply as a defense raised in a patent infringement or ITC action brought before the conclusion of the supplemental examination/reexamination proceeding. This provision appears designed to discourage patent holders from initiating supplemental examination shortly before or during litigation, regardless of whether the relevant information was provided by the defendant. Based on the reference to 35 U.S.C. § 281 and Section 337, this exception is limited to actions brought by the patent holder, rather than declaratory judgment actions, and therefore the patent holder has some control on its impact. Given that the current average pendency for an *ex parte* reexamination is about two years, however, it is likely that supplemental examinations will be brought significantly in advance of likely infringement if possible.

While these statutory exceptions are designed not to prejudice defendants during patent litigation, or from sharing their defenses, there are no other exceptions to the inequitable conduct bar following supplemental examination. Accordingly, information provided by third parties in other post-grant proceedings in the PTO will not trigger this exception, nor would information provided in the context of licensing negotiations, or ex-US litigation/administrative proceedings. It remains to be seen whether the potential for such information to be used in a supplemental examination will reduce the pre-litigation sharing of information between parties.

### ***E. PTO Regulations, Transition & Disciplinary Power***

The PTO shall issue regulations establishing fees relating to supplemental examination, and governing the “form, content, and other requirements” of the supplemental examination request, and procedures for reviewing the information submitted in such requests.<sup>34</sup> This section takes effect upon expiration of the one year period beginning on the date of the enactment of this Act, and shall apply to any patent issued before, on or after that effective date.<sup>35</sup> Presumably, the PTO will issue regulations during that interim period.

If the PTO becomes aware that a material fraud may be committed on the Office in connection with the patent that is the subject of the supplemental examination, then in addition to the other actions that the PTO is authorized to take, included cancellation of claims found invalid under section 307, the PTO shall also refer the matter to the Attorney General. Such a referral would remain confidential unless a person is charged with a criminal offense in connection with the referral.<sup>36</sup> Moreover, the statute confirms that sanctions under the criminal or antitrust laws remain available, as well the ability of the PTO to investigate, regulate, and impose sanctions for misconduct before the PTO.<sup>37</sup>

### ***F. Conclusion***

The *Therasense* decision should reduce the overuse of the inequitable conduct defense, and thus raises the question of whether the supplemental examination process will be broadly used to address this concern. However, in addition to the benefit of eliminating potential inequitable conduct allegations, patent holders also may find supplemental examination a helpful tool for enhancing patent quality, as it broadens the scope of information considered, and the ability of the PTO to consider, reconsider, or correct information, over previously existing procedures.

For example, a patent owner may become aware of information during product development, or during a pre-litigation review that was not apparent during the original examination process. Relevant prior art may have been cited in related prosecution, or statements in the specification, declarations, or prosecution history may now be considered incorrect or inadvertently misleading. Supplemental examination now provides a platform for patent holder to obtain PTO consideration of these potential concerns and emerge with a stronger patent prior to litigation. Moreover, patents owners are now incentivized to review their commercially important patents and seek supplemental examination where issues are identified during this review due to the inequitable conduct bar.

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<sup>34</sup> 35 U.S.C. § 257(d).

<sup>35</sup> 35 U.S.C. § 257(c).

<sup>36</sup> 35 U.S.C. § 257(e).

<sup>37</sup> 35 U.S.C. § 257(f).

Another area where this tool may be particularly useful is in the context of patent licensing and acquisition. Small companies and academic institutions often rely on licensing or selling their technology to other companies for continued development and commercialization. Potential partners will perform extensive due diligence on the relevant intellectual property to ensure that sufficient exclusivity is provided to warrant the investment. It is not uncommon for these reviews to uncover potential defects in the relevant patent, which may in part be due to the limited resources and experience of the patent holder. Supplemental examination gives the patent holder and partners an option to consider where concerns are identified. Potential partners now have an alternative to simply refusing the opportunity when they become aware of a possible defect in a patent.

By encouraging patent owners to obtain stronger patents, the patent litigation process should be more narrowly focused on key validity and non-infringement issues, and provide more predictable results.

## VI. CONCLUSION

This article shows the enormous complexity that the AIA brings to U.S. patent law. There are many unanswered questions, concerns and dilemmas both for patent owners and requesters. The PTO is faced with a daunting task of creating the new rules and regulations and staffing the new laws. The stakeholders in the patent community will need to master the strategy and tactics of this new regime as will the courts. But this is the new world and all will need to come to grips with how to live in it.



# THE COMPLICATED RELATIONSHIP BETWEEN MULTIPLE PARTY PATENT INFRINGEMENT LIABILITY AND COMMON LAW PRINCIPLES

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This year, the tests regarding how and when multiple parties can be liable for the same act of infringement will have undergone more scrutiny than perhaps in any other year. In May, the Supreme Court declared that to be liable for inducement, the defendant must have knowledge that the acts induced constitute patent infringement.<sup>2</sup> But in so doing it also relied on the common law doctrine of “willful blindness” to conclude that those who intentionally avoid knowledge of a patent cannot escape liability. This fall, the Federal Circuit will review *en banc* two cases, *Akamai Technologies Inc. v. Limelight Networks Inc.*<sup>3</sup> and *McKesson Technologies Inc. v. Epic Systems Corp.*<sup>4</sup> to decide whether, and if so, under what circumstances, a party who does not perform all steps of a method claim can be held liable. Here, a prominent argument by the plaintiffs is that the common-law rule of joint tort-feasors should govern, allowing for liability without any single entity performing all claimed steps. The debates surrounding these two evolving doctrines illustrate the difficulties sometimes faced when applying common law doctrines to the statutory patent regime.

Patent infringement is often described as a strict liability tort, and it is well-settled that liability for direct infringement exists without regard to intent or negligence. It is hardly surprising that attorneys and jurists rationalizing an outcome of a case will cloak their analysis with time-honored doctrines of the common law. And when courts face questions of first impression, which call out for shaping or adopting a standard, the common law provides a wealth of possibilities. But while common law principles are often mentioned in patent cases,<sup>5</sup> seldom, if ever, do opinions consider *whether* a principle developed for, *e.g.*, common law conversion or negligence, is suitable for application to a *sui generis* statutory scheme such as the patent law. Often the analysis consists of little more than the statement that “direct infringement is a strict liability tort.”<sup>6</sup> Seldom have courts

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2 *Global-Tech Appliances, Inc. v. SEB S.A.*, 131 S.Ct. 2060, 2068 (2011).

3 629 F.3d 1311 (Fed.Cir. 2010).

4 2011 WL 2173401 (Fed. Cir. 2011).

5 See *Akamai Tech. Inc. v. Limelight Networks Inc.*, 629 F.3d 1311, 1319-20 (Fed. Cir. 2010).

6 *BMC Resources v. Paymantech, L.P.*, 498 F.3d 1373, 1381 (Fed. Cir. 2007); see also *Carbice Corp. of Am. v. Am. Patents Dev. Corp.*, 283 U.S. 27, 33 (1931) (“Infringement, whether direct or contributory, is essentially a tort, and implies invasion of some right of the patentee.”). But see R. Blair & T. Cotter, *Strict Liability and its Alternatives in Patent Law*, 17 Berkeley Technology Law Journal 799 (2002) (observing that even direct infringement is not a pure strict liability tort, since the scope and duration of liability is dependant upon notice, either actual or constructive).

evaluated whether patent infringement and common law torts are similar *enough* in ways that pertain to potential vicarious patent liability to share principles that are not spelled out in the statute.

In this paper we explore some potential complications associated with importing common law principals into the patent system. In *Part I*, we discuss the development of the law of indirect infringement and the Supreme Court's recent decision in *Global-Tech*. In *Part II*, we describe the current state of the law of infringement by multiple actors, including the major arguments on either side of the *Akamai* and *McKesson* cases. In *Part III*, we examine three areas of debate in the area of multiple-party liability that touch upon common-law principles.

## I. THE ORIGINS OF INDIRECT INFRINGEMENT AND THE “WILLFUL BLINDNESS” TEST OF *GLOBAL-TECH*.

For at least 150 years courts have struggled with the question of whether patent liability should attach for conduct that falls short of practicing each and every claimed step or element. Courts sitting in “equity” in the 1800s exercised wide discretion to achieve a “fair” result in these cases. Then, as now, they resorted to common law principles to fill in where the patent statute is silent or ambiguous.

In 1871, the Circuit Court of Appeals sitting in the District of Connecticut decided *Wallace v. Holmes*,<sup>7</sup> a case commonly cited as the first to hold that an entity could be held liable for patent infringement even if it did not practice each and every element of the patent's claim. In that case, the patent covered a lamp including an improved burner and a glass chimney. The defendant only sold the burner apparatus – never the chimney – even though the burner had no use without the chimney, and vice versa.<sup>8</sup> The court held that both the burner manufacturer and the chimney maker were liable as joint tort-feasors.<sup>9</sup>

Other early cases similarly focused on conduct now thought of as contributory infringement, in which an entity was accused of encouraging infringement by selling a component of a patented device.<sup>10</sup> Where a component had no use other than in a patented combination or product, courts consistently found that the seller of the component could be held liable as a joint tort-feasor.<sup>11</sup> Where, however, a component had both infringing and non-infringing uses, courts looked for additional evidence indicating that the defendant intended that the component be used in an infringing fashion.<sup>12</sup>

In *Saxe v. Hammond*, for example, the plaintiff had patented a method for creating certain types of notes on musical instruments.<sup>13</sup> The defendants manufactured components

7 29 F. Cas. 74 (C.C. D. Conn. 1871).

8 *Id.* at 79-80.

9 *Id.* at 80.

10 See *Global-Tech*, 131 S.Ct. at 2065-66; 5 Donald S. Chisum, *Chisum on Patents* § 17.02 (2011); Mark A. Lemley, *Inducing Patent Infringement*, 39 U.C. Davis L. Rev. 225, 227 (Nov. 2005).

11 See, e.g., *New York Scaffolding Co. v. Whitney*, 224 F. 452, 459 (8th Cir. 1915); *Canda v. Michigan Malleable Iron Co.*, 124 F. 486, 489 (6th Cir. 1903); *Imperial Chem. Mfg. Co. v. Stein*, 69 F. 616 (C.C. S.D. N.Y. 1895); *Alabastine v. Payne*, 27 F. 559, 560 (C.C. N.D. N.Y. 1886); *Travers v. Beyer*, 26 F. 450 (C.C. N.D. N.Y. 1886); *Schneider v. Pountney*, 21 F. 399 (C.C. S.D. N.Y. 1884); *New York Bung & Bushing Co. v. Hoffman*, 9 F. 199 (C.C. S.D. N.Y. 1881); *Rumford Chem. Works v. Hecker*, 20 F. Cas. 1342, 1346 (No. 12,133) (C.C. D. N.J. 1876); *Renwick v. Pond*, 20 F. Cas. 536, 541 (No. 11,702) (C.C. S.D. N.Y. 1872).

12 See, e.g., *Celluloid Mfg. Co. v. American Zylonite Co.*, 30 F. 437 (C.C. S.D. N.Y. 1887); *Willis v. McCullen*, 29 F. 641 (C.C. E.D. Pa. 1886); *Holly v. Vergennes Machine Co.*, 4 F. 74, 82 (C.C.D. Vt. 1880); *Richardson v. Noyes*, 20 F. Cas. 723, 724 (No. 11,792) (C.C.D. Mass. 1876).

13 21 F. Cas. 593 (No. 12,411) (C.C.D. Mass. 1875).



for organs which, if used in a specific configuration, allegedly infringed.<sup>14</sup> Distinguishing *Wallace*, the court found that the defendants were not liable as “the mere manufacture of a separate element of a patented combination, unless such manufacture be proved to have been conducted for the purpose, and with the intent of aiding infringement, is not, in and of itself, infringement.”<sup>15</sup>

While *Saxe* established that the sale of a staple item of commerce could not, in itself, lead to liability for contributory infringement, courts remained sympathetic to claims of infringement in which the defendant sold an important part, but less than the whole, of the claimed invention.<sup>16</sup> Most cases concluded that a defendant could be held liable for selling a component with infringing and non-infringing uses if he took additional affirmative steps to “induce” infringement, for example, by helping a customer implement the component in an infringing system.<sup>17</sup>

In 1952, Congress codified the law of indirect infringement in § 271 of the Patent Act. Section 271(b), provides patentees with a remedy against those who “actively induce” infringement by engaging in acts that direct, facilitate, or abet infringement. Contributory infringement, governed by § 271(c), provides patentees with a remedy against those who supply a material component of a patented invention which is not a staple article of commerce.

While the Patent Act resolved many, though not all, of the controversies regarding the scope of contributory infringement, considerable confusion continued to exist regarding the type of conduct that can lead to liability for inducement under § 271(b).<sup>18</sup> In particular, courts remained sharply divided about the requisite level of knowledge and intent.<sup>19</sup> Even within the Federal Circuit, different cases articulated different standards, with some cases holding that inducement required actual knowledge of the patent and other cases holding that it merely required knowledge of the acts constituting infringement.<sup>20</sup>

The Supreme Court’s recent decision in *Global-Tech* clarifies § 271(b)’s knowledge requirement. The Court held that liability for induced infringement – like liability for contributory infringement – requires knowledge of the existence of the patent that is infringed.<sup>21</sup> The Court went on to hold, however, that a showing of “willful blindness” is sufficient to satisfy this knowledge requirement.<sup>22</sup> While willful blindness has a long lineage in criminal law, its application to patent law is novel and its prospective application uncertain.

The willful blindness test articulated in *Global-Tech* has two components: (1) “the defendant must subjectively believe that there is a high probability that a fact exists;” and

14 *Id.* at 594.

15 *Id.*

16 *See, e.g., American Cotton-Tie Co. v. Simmons*, 106 U.S. 89 (1882) (sale of a cotton tie for baling cotton was infringement even though the defendant did not use the tie with cotton as claimed).

17 *See, e.g., Holly v. Vergennes Machine Co.*, 4 F. 74, 82 (C.C.D. Vt. 1880).

18 *See R. Carl Moy, Moy’s Walker on Patents*, §§ 15:20-21 (2010).

19 *See e.g., Hewlett-Packard Co. v. Bausch & Lomb, Inc.*, 909 F.2d 1464, 1469 (Fed. Cir. 1990) (“Proof of actual intent to cause the acts which constitute infringement is a necessary prerequisite to finding active infringement.”); *Manville Sales Corp. v. Paramount Systems, Inc.*, 917 F.2d 544, 553 (Fed. Cir. 1990) (“The plaintiff has the burden of showing that the alleged infringer’s actions induced infringing acts and that he knew or should have known his actions would induce actual infringements.”); *DSU Medical Corp. v. JMS Co., Ltd.*, 471 F.3d 1293, 1304 (Fed. Cir. 2006) (“The requirement that the alleged infringer knew or should have known his actions would induce actual infringement necessarily includes the requirement that he or she knew of the patent.”).

20 *Compare DSU Medical Corp.*, 471 F.3d at 1304 to *Hewlett-Packard Co.*, 909 F.2d at 1469.

21 *Global-Tech*, 131 S.Ct. at 2068.

22 *Id.* at 2069.

(2) “the defendant must take deliberate actions to avoid learning of that fact.”<sup>23</sup> Determining the existence of either of these factors in the patent context is far from straightforward, as the facts at issue in *Global-Tech* illustrate.

With respect to the first factor, *Global-Tech* asserts that a defendant can subjectively believe that there is a high probability that an article or process is patented without actual knowledge of the patent.<sup>24</sup> But how is this type of subjective belief established? The *Global-Tech* Court relied primarily on evidence that the alleged infringer knew that it was copying a commercially successful product.<sup>25</sup> A product’s commercial success is not, however, a particularly reliable indicator that all of its features are claimed in a valid, enforceable patent. And the mere fact of copying, absent knowledge that the copied features were novel and patented, is not inherently nefarious.<sup>26</sup>

The Court’s analysis of the second willful blindness factor – “deliberate actions to avoid learning” – also leaves many unanswered questions. Two “deliberate actions” are identified by the Court. First, the defendant based its design on an overseas model of a competitor’s device which did not bear U.S. patent markings.<sup>27</sup> The defendant, however, was a Hong Kong company and it purchased the competitor’s product in Hong Kong.<sup>28</sup> Without more, this hardly seems like a deliberate effort to avoid knowledge.

Second, the defendant retained an attorney to conduct a right-to-use study but failed to inform him that it had copied the design from a competitor’s device.<sup>29</sup> The Court found this to be particularly compelling evidence of the defendant’s willful blindness, stating: “We cannot fathom what motive [the defendant’s CEO and president] could have had for withholding this information other than to manufacture a claim of plausible deniability in the event that his company was later accused of patent infringement.”<sup>30</sup> But if the defendant’s failure to provide an attorney with information about a competitor’s product is the only “deliberate action” taken to avoid guilty knowledge, it is a strange one. As an initial matter, the failure to disclose information isn’t an action at all, but a failure to act. To anchor liability in such a failure implies that there is an affirmative duty to provide opinion counsel with a certain quantum of information. But how would one square such a duty with *In re Seagate Technology, LLC*, which held that there is no affirmative obligation to obtain an opinion of counsel,<sup>31</sup> or with the recently enacted Patent Reform Act, which precludes any consideration whatsoever as to a company’s failure to obtain an opinion of counsel.<sup>32</sup>

Is it really now the rule that *Global-Tech* could have escaped liability entirely had it simply decided to forego the right-to-use study? Or is it the case that, by obtaining the opinion, *Global-Tech* evidenced its awareness of the United States patent risk, thus making its failure to disclose all relevant facts to opinion counsel particularly incriminating? Either way, it is difficult to decipher the lesson from the decision.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.* at 2070-71.

<sup>25</sup> *Id.* at 2071.

<sup>26</sup> To the contrary, the Supreme Court has noted that the free exploitation of unpatented designs is essential to continued innovation and a competitive economy. See *Bonito Boats, Inc. v. Thunder Craft Boats, Inc.*, 489 U.S. 141, 151 (1989) (“[F]ree exploitation of ideas will be the rule, to which the protection of a federal patent is the exception.”).

<sup>27</sup> *Global-Tech*, 131 S.Ct. at 2071.

<sup>28</sup> *Id.* at 2064.

<sup>29</sup> *Id.* at 2071.

<sup>30</sup> *Id.*

<sup>31</sup> *In re Seagate Technology, LLC*, 497 F.3d 1360 (Fed. Cir. 2007).

<sup>32</sup> H.R. 1249, 112th Cong. (2011) (enacted) (to be codified at 35 U.S.C. § 298).

Ultimately, *Global-Tech* provides lower courts with little guidance as to how to go about assessing the two prongs of the willful blindness test. The case demonstrates, however, that determining whether an alleged indirect infringer acted with “willful blindness” is not a straightforward inquiry and will evolve as the lower courts and the Federal Circuit consider its application in particular cases.

## II. THE ORIGINS AND CURRENT STATE OF THE “DIVIDED INFRINGEMENT” DEFENSE.

Like indirect infringement, the divided infringement defense has its origins in case law that attempts to define the circumstances in which a defendant can be held liable for conduct that falls short of practicing the full invention. As early as 1842, the Supreme Court held that a combination claim is not infringed unless all elements are practiced.<sup>33</sup> Nonetheless, historically, many lower courts concluded that a defendant can be liable for infringement of a method claim even if it does not practice each step, so long as there is “some connection” between the defendants who complete the practice of all steps.<sup>34</sup>

A relatively recent example is *Marley Mouldings v. Mikron Industries, Inc.*, where the defendant contracted out to an independent company the first two steps of the claimed process for manufacturing composite wood.<sup>35</sup> The court allowed the case to proceed to trial despite the admitted divided infringement. “It is undisputed that there is some type of connection between *Mikron* and North Wood. The pellets are ‘made to order’ by North Wood based on certain directives from *Mikron*.”<sup>36</sup>

Other courts have held that when some claim elements are practiced by the defendant supplier, and other elements are practiced by its customer, there is no direct infringement.<sup>37</sup> Likewise, where the link was remote between actors who carried out all the steps of the claim – and the conduct was as much as a decade removed – a court soundly rejected the argument for direct infringement. In *Faroudja Labs. v. Dwin Elecs., Inc.*, the court found there was no concerted action, and therefore could be no infringement.<sup>38</sup> The court reasoned

In drafting its patent application, Faroudja was free to include only those steps or means that actually improved the quality of images resulting from previously transferred signals. It did not do so, however, and for the Court to now find infringement by a process or device that does not include a transfer step or means would impermissibly extend coverage of the patent and improperly broaden its claims.<sup>39</sup>

33 *Prouty v. Draper, Ruggles & Co.*, 41 U.S. 336 (1842). Interestingly, the conclusion was reached without any citation — based entirely upon the logic that if a patentee chooses to claim his invention as a combination, he must show use of the combination, not merely the constituent parts, to prove infringement. *Id.* at 341.

34 See *Marley Mouldings Ltd. v. Mikron Industries, Inc.*, 2003 WL 1989640 at \* 2, 3 (N.D. Ill. April 30, 2003) (collecting cases); see also D. Chisum, *Chisum on Patents* §16.02[g][a][i], n. 11.

35 *Marley Mouldings* at \*2.

36 *Id.* at \*4.

37 *E.I. DuPont de Nemours & Co. v. Monsanto Co.*, 903 F.Supp. 680, 6734-5 (D. Del. 1995), *aff'd* 92 F.3d 1208 (Fed. Cir. 1996) (finding no direct infringement by manufacturer who performed the first step of a process claim even where its customer performed the other steps of the claim). In the context of apparatus claims, the finding of no direct infringement appears not to be particularly controversial. See also *Cross Med. Prods. v. Medtronic Sofamor Danek*, 424 F.3d 1293, 1311 (Fed. Cir. 2005) (rejecting argument that device supplier could be held liable for infringing an apparatus claim when the device only satisfied all claim elements when it was implanted by a surgeon).

38 1999 WL 111788 (N.D.Cal. Feb. 24, 1999).

39 *Id.* at \*7.

Through many of these cases, courts struggle with the unseemly prospect of conscious schemes to avoid infringement, balanced against the equally unseemly prospect of subjecting persons to liability for conduct that is clearly unpatented. As long ago as 1898, one judge observed a number of difficulties with multiple-party patent liability taken to its extreme, many of which today remain unresolved.<sup>40</sup> That judge posed questions that may still vex the Federal Circuit in *McKesson* and *Akamai*, such as:

If there rests upon the seller of materials a duty of careful investigation into the objects of his vendee . . . the former may, at least, reasonably ask precisely what he is bound to investigate.<sup>41</sup>

Only in 2007 did the Federal Circuit finally directly address the question of whether there can be direct infringement when multiple actors are required to satisfy the claim elements.<sup>42</sup> In *BMC Resources*, the patent claimed

a method for PIN-less debit bill payment (PDBP) featuring the combined action of several participants, including the payee's agent (for example, *BMC*), a remote payment network (for example, an ATM network), and the card-issuing financial institutions.<sup>43</sup>

The court endorsed a standard of “direction and control” that had been adopted by the lower court, and held that the defendant did not direct or control either the debit networks or the financial institutions, and therefore could not infringe.<sup>44</sup> This standard, the court noted, would not allow entities simply to contract out claim elements to avoid infringement; the controlling entity would still be liable. And if, under traditional notions of vicarious liability, one entity would be responsible for the actions of another, that connection would be sufficient for a finding of direct liability also.<sup>45</sup> But arms-length transactions – presumably where neither party directs or controls the other – that result in the parties independently performing all the steps of a method claim would not be sufficient for direct infringement.<sup>46</sup>

As of this writing, however, all potential solutions are on the table as we await the outcome of the pending *en banc* decision in the *Akamai* and *McKesson* cases. Although the *en banc* hearing presents pure questions of law, the facts of these cases are worth considering. *Akamai Tech. v. Limelight Networks* involves Content Delivery Networks or “CDNs” – systems of computers designed to speed the delivery of web content by hosting a webpage’s “embedded objects” separate from the base web page.<sup>47</sup> It is undisputed that the defendant Limelight does not perform all of the claimed steps: specifically, it does not perform the “tagging” step, which involves modifying the web pages that would benefit from the CDN so that user requests for embedded objects from those pages are directed to the Limelight CDN server rather than to the content provider server.<sup>48</sup> The court granted

<sup>40</sup> See, e.g., *Tubular Rivet & Stud Co. v. O'Brien*, 93 F. 200, 202-03 (Cir. C. D. Mass 1989) (“a trespass is aided if the trespasser is fed during the trespass. Yet it can hardly be contended that an infringer’s cook is liable as a contributory infringer.”).

<sup>41</sup> *Id.* at 204.

<sup>42</sup> *BMC Resources, Inc. v. Paymentech, L.P.*, 498 F.3d 1373 (Fed. Cir. 2007). A year earlier, in *On Demand Machine Corp. v. Ingram Industries, Inc.*, 442, F.3d 1331, 1345 (Fed. Cir. 2006), the court approved without analysis a jury instruction that allowed for the finding of infringement that “results from the participation and combined action(s) of more than one person or entity. . . .” This result was discounted as *dicta* in *BMC Resources*. 498 F.3d at 1380.

<sup>43</sup> *Id.* at 1375.

<sup>44</sup> *Id.* at 1381-2.

<sup>45</sup> *Id.* at 1379.

<sup>46</sup> *BMC Resources*, 498 F. 3d at 1381. See also *Muniauction, Inc. v. Thomson Corp.*, 532 F. 3d 1318 (Fed. Cir. 2008), *cert. denied* 129 S.Ct. 1585 (2009) (finding no infringement where one step was performed by bond auction bidders, and other steps performed by bond auctioneers).

<sup>47</sup> 629 F.3d 1311, 1315-16 (Fed. Cir. 2011) reh’g *en banc* granted, vacated by *Akamai Technologies*, 419 Fed. Appx. 981 (2011).

<sup>48</sup> *Id.* at 1317.

JMOL of non-infringement, relying heavily upon the limits of vicarious liability discussed in *BMC Resources*.<sup>49</sup> The panel opinion held that controlling the computer system on which the claimed steps are performed, even combined with providing instructions as to how to perform the steps, is insufficient for a finding of direct infringement: “there can only be joint infringement when there is an agency relationship between the parties who perform the method steps or when one party is contractually obligated to the other to perform the steps.”<sup>50</sup>

*McKesson Tech. Inc. v. Epic Systems Corp.* also involves internet technology but is specific to the medical services field.<sup>51</sup> The patent claims a method for facilitating doctor-patient communications by allowing patients and doctors to post questions, requests and responses on a personalized web page.<sup>52</sup> As in the *Akamai* case, in light of *Muniauction*, the district court had concluded there could be no direct infringement because certain claimed steps were performed by patients and others by doctors who did not direct or control one another.<sup>53</sup> The Federal Circuit affirmed, following the test set out in *Akamai*. The panel decision went on to reject *McKesson*’s argument that common law joint tort-feasor principles should apply to direct infringement.<sup>54</sup>

Granting *en banc* review of both the *Akamai* and the *McKesson* decisions, the Federal Circuit seeks answers to the following questions:

1. If separate entities each perform separate steps of a method claim, under what circumstances would that claim be directly infringed and to what extent would each of the parties be liable?<sup>55</sup>
2. If separate entities each perform separate steps of a method claim, under what circumstances, if any, would either entity or any third party be liable for inducing infringement or for contributory infringement?
3. Does the nature of the relationship between the relevant actors – e.g., service provider/user; doctor/patient – affect the question of direct or indirect infringement liability?<sup>56</sup>

The order granting *en banc* review has led to full-throated party and *amici* responses. *Akamai*, *McKesson* and those in favor of overturning the narrow “agency” rule of the *Akamai* panel opinion primarily make the following arguments:

- the statute itself imposes no “single entity infringer” rule<sup>57</sup>

49 *Id.* at 1318. Indicative of the uncertainty in the law, the lower court initially applied the *BMC Resources* “direction and control” test and upheld a \$40 million verdict in favor of *Akamai*. Then, after *Muniauction* came down (without ostensibly changing the law), the district court reconsidered the question and granted JMOL of non-infringement.

50 *Id.* at 1320.

51 2011 U.S. App. LEXIS 7531 (Fed. Cir. April 12, 2011)

52 *Id.* at \*2.

53 *Id.* at \*11.

54 *Id.* at \*14.

55 *McKesson Tech., Inc. v. Limelight Networks, Inc.*, Nos. 2009-1372, 2009-1380, 2009-1416, 2009-1417, 2011 WL 1518909 (Fed. Cir. April 20, 2011)

56 *McKesson Tech. Inc. v. Epic Systems Corp.*, No. 2010-1291, 2011 WL 2173401 (Fed. Cir. May 26, 2011)

57 See Principal Br. of Plaintiff-Appellant *Akamai Tech.*, 2011 WL 2822716 at \*15 (Fed. Cir. June 20, 2011).

- anyone who “directs or controls” the performance of a claimed step, or acts in concert to perform the steps, should be liable as an direct infringer<sup>58</sup>
- parties acting in concert, even if not controlled or directed by one another, can be liable under common law joint tort-feasor principles<sup>59</sup>
- a party who performs some steps and knows of the performance of the remaining steps should be liable as a direct infringer, even if not acting in concert<sup>60</sup>
- a party who induces or contributes to the performance of every step of a patented method should be liable as an indirect infringer, even if no single entity directly performs all steps<sup>61</sup>
- patent protection in bio-tech and pharmaceuticals fields would be particularly threatened by a strict “single entity” rule.<sup>62</sup>

Those in favor of affirming the *Akamai* and *McKesson* decisions primarily make the following arguments:

- the rules of agency, whereby the agent’s conduct is imputed to the principle, is the only doctrine of vicarious liability that should apply to direct infringement<sup>63</sup>
- the distinct statutory rules of indirect infringement indicate that Congress did not mean for courts to expand direct infringement by borrowing concepts from the indirect infringement statutes<sup>64</sup>
- the public notice function of patents would be undermined if liability attached to the conduct of multiple parties who do not control one another<sup>65</sup>
- common law joint tort-feasor rules have no place in a statutory scheme such as the patent law.<sup>66</sup>

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58 *Id.* at \*21-22.

59 *Id.* at \*23-27.

60 *Id.* at 2011 WL 2822716 at \*29.

61 Opening *En Banc* Br. of Plaintiff-Appellant *McKesson Techs. Inc., McKesson Techs. Inc. v. Epic Sys. Corp.*, No. 2010-1291 (Fed. Cir.), 2011 WL 2173401, \*39-44.

62 Br. of Pharmaceutical Research and Manufacturers of America, as *Amicus Curiae*, *Akamai Tech. v. Limelight Networks*, 2011 WL 3101831; Br. of Biotechnology Industry Organization, as *Amicus Curiae*, 2011 WL 3101890; Br. of Myriad Genetics, Inc., as *Amicus Curiae*, 2011 WL 3281836.

63 Br. of *Altera Corp., HTC Corp. et al.*, as *Amici Curiae* in Support of *Limelight Networks*, 2011 WL 3796790 at \*223-25, *Akamai*, 2011 WL 2822716.

64 Defendant-Appellee Epic’s Response to Plaintiff Appellant’s Opening *En Banc* Br., 2011 WL 3796789 at \*25, *McKesson*, 2011 WL 2173401.

65 Br. of *Altera Corp., HTC Corp. et al.* as *Amici Curiae* in Support of *Limelight Networks*, 2011 WL 3796790 at \*223-25, *Akamai*, 2011 WL 2822716.

66 Defendant-Appellee’s Epic’s Response to Plaintiff Appellant’s Opening *En Banc* Br., 2011 WL 3796789 at \*25, *McKesson*, 2011 WL 2173401; Br. of *Altera Corp., HTC Corp. et al.* as *Amici Curiae* in Support of *Limelight Networks*, 2011 WL 3796790 at \*223-25, *Akamai*, 2011 WL 2822716.

### III. THE AWKWARD INVOCATION OF COMMON-LAW PRINCIPLES IN PATENT LAW.

Patent law and certain common law torts readily lend themselves to comparison, although often only at a superficial level. A patent is, of course, a property right.<sup>67</sup> Courts often analogize a patent claim to the metes and bounds of real property,<sup>68</sup> and infringement of a claim has traditionally been deemed a “trespass.”<sup>69</sup> Indeed, trespass to land is surely the most analogous tort to patent infringement. As with patent infringement, it is no defense to a trespass claim that the defendant did not realize that someone else possessed the land in question. And like a patent claim, the remedy for trespass could be actual damages or, in the related tort of wrongful occupancy, a payment of rent for the period of occupation.<sup>70</sup>

But at least among scholars, if not the courts, analogizing patent rights to real property rights has met with significant criticism.<sup>71</sup> Primarily this is due to the relative uncertainty of the patent right as compared to a right to real property. These uncertainties arise in several dimensions, and affect both the patent owner and the potential infringer.

First, there is the chance of the patent being invalid in light of unknown (or known, but undisclosed) prior art. While there are instances in which title to land is held invalid or subordinate to another title, those are rare. Imagine how real estate markets would differ if, like patents, there were only a 60% likelihood that the recorded title to land was valid.<sup>72</sup>

Second, there are uncertainties as to both the existence and the duration of the patent right. Unlike the relative certainty one has about whether one is on another’s property, there is no obvious reason to believe that any given conduct people may engage in is the subject of a patent claim. Even for apparatus claims, since there is no obligation to sell a commercial embodiment of each patent claim, much less mark such an embodiment with the patent number,<sup>73</sup> one cannot assess the patent landscape merely by surveying the competition. And in many fields of art, a patent search is likely only to skim the surface of all patents that may be asserted. Further, a patent is a time-limited monopoly, whose life may be shortened by a terminal disclaimer, or lengthened by a patent term extension. None of these variables exist with respect to a deed to land.

Finally, even when the putative infringer is able to locate patents in the relevant field, the uncertainty about the scope of the rights granted by those patents remains. In the vast majority of cases, words are an inadequate vehicle to plot out the boundaries of a patentee’s monopoly right, but they are the only vehicle we have. And because a patentee is entitled to claim more broadly than the specific embodiments disclosed, per the canons of claim construction the words of a claim are rarely limited by the description in the specification. Sixteen years after *Markman v. Westview*, claim construction remains the single most important pre-trial event. And despite the effort invested by trial courts and parties, the Federal Circuit frequently comes to a different conclusion about the meaning of

67 *Dowagiac Mfg. Co. v. Minnesota Moline Plow Co.*, 235 U.S. 641, 648 (1915) (“[T]he exclusive right conferred by the patent was property, and the infringement was a tortious taking of a part of that property.”)

68 See *Kara Tech., Inc. v. Stamps.com*, 582 F.3d 1341, 1347 (Fed. Cir. 2009).

69 See *Markman v. Westview Instruments, Inc.*, 52 F.3d 967, 997, 1014 (Fed. Cir. 1995), *aff’d* 517 U.S. 370 (1996).

70 Cal. Civ. Code § 3334(a); see generally 6 Witkin, Summary 10th (2005) Torts §1726.

71 See M. Lemley, *Ignoring Patents*, 2008 Mich. St. L. R. 19, 23, n. 22 (gathering articles addressing patents and other intellectual property as analogous, or not, to conventional property).

72 See *id.* at 27-28, n. 33.

73 While failure to mark may limit damages, that is little consolation to the defendant if it has sunk a substantial investment into its business venture before receiving any notice of the patent.

claims.<sup>74</sup> Again, the analogy to a deed to land breaks down: if the law of patent claim construction applied to deeds, it would be as if the map of the property and measures of its boundaries were only rough guides to the scope of the property right.

From the perspective of the potential infringer, venturing into a new field may raise risks of patent infringement, but it is virtually impossible to assess those risks (or even determine what are at issue) with any reliability. By contrast, no one who treads on a property on which sits a well-maintained house with a car in the driveway could seriously claim he had no idea he was trespassing. In an analogous hypothetical world of imprecise deeds and questionable title, would trespass be a tort without fault?

Analogizing patent infringement with torts other than trespass requires even more significant leaps. The traditional common law strict liability torts are for “ultrahazardous activity” and keeping animals, because in these activities the defendant has voluntarily put his or her neighbors at greater risk.<sup>75</sup> By contrast, the act of the patent infringer can be as varied as commerce itself: indeed, practically any act of any person or private entity, commercial or otherwise, is a potential act of infringement. The other strict liability tort – defective product liability – is closer to patent infringement in that the law of product liability reflects a policy decision that the putative defendant is best positioned to ensure that its products are safe. Direct patent infringement reflects a similar policy decision that accused infringers must bear the risk that their commercial endeavors may infringe. Whether that is a risk that, with diligence, one could ever avoid is another question.<sup>76</sup>

In this section we consider three areas of recent or current debate in the area of multiple-party liability that have touched upon common-law principles: the argument that joint tort-feasor rules should apply to hold multiple parties liable for a single act of patent infringement; the argument that indirect infringement should not require an act of direct infringement by a single entity; and the borrowing of the willful blindness standard from criminal law to establish inducement.

### A. Applying common-law vicarious liability to questions of divided infringement.

The briefs in the *Akamai/McKesson en banc* review are replete with calls to follow common law principles.<sup>77</sup> That call is never stated more clearly than in the Opening Brief of McKesson Technologies:

Over the course of centuries, common-law courts developed a series of distinct but overlapping bases for joint and vicarious liability. . . .  
Because common law principles reflect our legal system’s considered and

<sup>74</sup> See Christian A. Chu, *Empirical Analysis of the Federal Circuit’s Claim Construction Trends*, 16 Berkeley Tech. L.J. 1075, 1150, tbl. A-2 (2001) (finding that the Federal Circuit changed at least one claim construction in 44% of the cases it considered between January 1998 and April 2000, and that a claim construction change was outcome dispositive in 30% of the cases considered during the same period).

<sup>75</sup> For a comparison of these torts to patent infringement, see Br. of *Electronic Frontier Foundation as Amicus Curiae in Akamai Tech., Inc. v. Limelight Networks, Inc.*, 2011 WL 3796789, at 20-22 (Aug. 9, 2011).

<sup>76</sup> Other torts provide no closer analogy. For one, no other tort permits the victim to define the scope and nature of his rights, which the rest of the world is expected to know. See *McKesson Tech.*, 2011 U.S. App. LEXIS 7531 at \*14.

<sup>77</sup> See, e.g., in *Akamai Tech. v. Limelight Networks*, Nos. 2009-1372, 2009-1300, 2009-1416, 2009-1417, Br. of Boston Patent Law Association as *Amici Curiae* in Support of Appellant, 2011 WL 2822706 at \*7 (June 27, 2011) (“Basic concepts of proximate cause and joint tort-feasor liability . . .”); Br. of Aristocrat Tech., Inc., as *Amici Curiae* in Support of Appellant, 2011 WL 3101833 at \*13 (June 29, 2011) (“At least proximate cause and joint tort-feasor liability are appropriate tools . . .”); Br. of American Intellectual Property Law Ass’n as *Amici Curiae* in Support of Reversal, but in Support of Neither Party, 2011 WL 3580500 at 15 (July 1, 2011) (“Joint tort-feasor law, not agency law, is the correct basis for determining infringement . . .”).



nuanced determination of when one party should be held responsible for the acts of another, they are entitled to considerable respect.<sup>78</sup>

How do the similarities and differences between patent law and common law torts affect the debate over which common law doctrine – e.g., agency or joint tort-feasor liability – should control the extent of multiple-party liability for direct infringement?

On one hand, and as noted, the strict liability nature of patent infringement reflects a policy decision that everyone who participates in commerce bears the risk that its conduct is already patented.<sup>79</sup> It makes no difference whether or not you search for patents in the field, or search but do not find the patent that is ultimately asserted against you. You are equally culpable if found to have infringed. Like the squatter who sits on another's property—whether or not it is reasonable to believe the land was vacant is no defense, the squatter is still a trespasser and will owe damages or a fair rent to the owner.

On the other hand, as noted in the *en banc* brief filed by Epic, traditionally, principles of joint tort-feasor apply only where each tort-feasor is guilty of some culpable conduct.<sup>80</sup> And in such cases, most people would readily deem the conduct of each of the joint tort-feasors to be unjust or wrong. For example, most would readily accept without controversy that an individual is entitled to be secure in their real property and anyone who enters onto another's land has wronged the landowner. Given the uncertainties of patent scope and validity discussed above, and the near impossibility of detecting all possible patent risk, could one also conclude that a “partial infringer,” who has not contracted to complete the infringement with another “partial infringer,” is “culpable” of anything akin to trespass?

## **B. Can indirect infringement exist without a direct infringer?**

Another example of the uneasy fit of common law doctrines in the patent scheme can be seen in a specific argument raised in *McKesson*. Some argue that parties acting in concert to infringe a patent should be liable for indirect infringement even if no one could be held liable for direct infringement.<sup>81</sup> While indirect infringement may require a predicate act of direct infringement, they argue it does not require the existence of a direct *infringer*.<sup>82</sup> Rather, appellants assert that a patent is directly infringed whenever each and every claim limitation is met, regardless of whether any single actor can be held directly liable for the infringement.<sup>83</sup> Those who contribute or induce infringement should be held liable under §§ 271(b) and (c), even if no one can be held liable under § 271(a).<sup>84</sup>

While there may be policy reasons for this outcome in certain cases, it is difficult to envision any analog to this argument in the tort context. Torts, quite simply, do not exist independent of a tort-feasor. Whereas infringement is defined by the metes and bounds of the patent right, most torts are characterized by wrongful acts directed to a specific person or person's property. One who commits a battery intentionally causes a harmful contact to another person without consent; one who commits libel publishes a

78 Opening *En Banc* Br. of McKesson Tech., 2011 WL 2822667, *McKesson v. Epic*, No. 2010-1291 (Fed. Cir.), *McKesson* Opening Br., 2011 WL 2822667 at \*18 (June 20, 2011).

79 *Id.* at 23-24.

80 *Epic* Resp. Br., 2011 WL 3796789 at 46-47.

81 *McKesson Techs. Br.*, 2011 WL 2173401 at \*39-44; Corrected Br. of *Amici Curiae* Aristocrat Techs. Austral. Pty. Ltd., 2011 WL 3101833 at \*4-10.

82 *Id.*

83 *Id.*

84 *Id.*

defamatory statement regarding another.<sup>85</sup> Liability for aiding and abetting a tort is tied to the existence of the underlying tort and, implicitly, to the existence of an underlying tort-feasor.<sup>86</sup> Put another way, one cannot be vicariously liable for conduct that is not, itself, tortious. The argument that indirect infringement can exist without a direct infringer necessarily implies that direct infringement for purposes of §§ 271(b) and (c) encompasses a broader swath of conduct than that captured by § 271(a). But in tort law, there is no known rule that says the elements of a tort are different when considered as a predicate for vicarious liability as compared to elements for proving direct tort liability.

### **C. Does the common law doctrine of “willful blindness” fit naturally into the indirect infringement regime?**

A final illustration of the strange interplay between common-law doctrines and patent law can be seen in the Supreme Court’s decision to apply the willful blindness test to inducement liability in *Global-Tech*. The willful blindness doctrine is premised on the idea that a defendant can purposefully avoid guilt by taking affirmative steps to stay ignorant of some readily identifiable fact. For example, a “mule” who is paid a substantial sum of money to bring a wrapped package into the country may have good reason to believe that the package contains illicit material. The guilty suspicion in this scenario can be readily confirmed – the defendant need only open the package to see if it contains drugs. That the defendant chooses not to do so cannot be a defense, but rather is evidence of his culpable intent.

But knowledge about the existence and scope of a patent right is rarely so clear. As discussed above, identifying potentially relevant patents is no easy matter given the volume of issued patents in many fields. Even after a potentially relevant patent has been identified, its scope is often unclear and its validity remains uncertain unless and until it has been fully litigated. In short, reasonable minds can and do often differ about the risk of a finding of infringement.

The uncertainties inherent in patent rights thus substantially complicate the application of the common law willful blindness doctrine. Using the drug “mule” hypothetical above, would one be criminally liable for carrying a package under circumstances in which one could reasonably believe the job was legal and innocent? And could one be “willfully blind” if one could only detect the illicit nature of the package by sophisticated laboratory analysis because upon opening the package, there is nothing to indicate it contains drugs? Although not considered by the Supreme Court, these are the more apt analogies to most patent cases. These questions suggest that courts will have a challenging task ahead when the issue of “willful blindness” arises in future cases. How this common law principle will be shaped in patent cases may well depend upon how courts compare patent liability to common law tort liability.

## **IV. CONCLUSION**

Applying common law principles to patent law questions is tempting: take principles that virtually all judges and lawyers are familiar with and apply them to try to make sense of an arcane statutory regime. Others might defend the practice as imperfect but the best available option. As Winston Churchill might say, “the common law is the

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<sup>85</sup> California Jury Instructions Civil (BAJI), Nos. 7.00, 7.50 (2003).

<sup>86</sup> See Restatement (Second) of Torts § 876 (1979).

worst source of principles for patent law, except all those other sources that have been tried from time to time.” The temptation is dangerous, however. Patent law is nothing like any of the common law torts around which its principles of vicarious liability developed. It is a *sui generis* system in which property rights and tort-like liability are created on a daily basis by the US Patent Office in order to promote inventions and the advance of science. At a minimum, before common law principles are incorporated into patent law, courts and Congress should carefully consider the differences in the underlying substantive law and policy of patent liability and common law doctrines.



# CASE MANAGEMENT ISSUES IN PATENT INFRINGEMENT LITIGATION

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## I. INTRODUCTION

In 2011, The Sedona Conference® on Patent Litigation included a panel discussion on “case management issues” in recognition of the fact that the fairness of the outcome in any litigation, not to mention how efficiently and economically the matter is resolved, is often affected by the manner in which the district court manages the case before trial. This paper, prepared for the Conference and updated in May 2012, focuses on aspects of several topics: the level of detail required in pleadings in the post-*Twombly/Iqbal* world; joinder/severance issues in multi-defendant cases; timing of, and restrictions on, claim construction; and procedures being practiced for streamlining cases.

### **Pleading in Patent Infringement Cases After *Twombly* and *Iqbal***

The sufficiency of information provided in the initial pleading of an infringement claim or an invalidity counterclaim is often disputed. This is especially so when an infringement complaint does not provide sufficiently detailed averments so that a defendant can understand the basis of the claim against it.

Under Rule 8 of the Federal Rules of Civil Procedure, a complaint must contain a “short and plain statement of the claim showing that the pleader is entitled to relief.” Decades ago, Rule 8 was interpreted by the Supreme Court as requiring a plaintiff to merely give a defendant “fair notice of what the . . . claim is and the grounds upon which it rests.” *Conley v. Gibson*, 355 U.S. 41, 47 (1957). Under *Conley*, a complaint was not to be dismissed unless it appeared beyond a doubt that the “plaintiff can prove no set of facts in support of his claim which would entitle him to relief.” *Id.* at 45-46.

Federal Rule of Civil Procedure 84 states that the pleadings in the Appendix “suffice under these rules and illustrate the simplicity and brevity that these rules contemplate.” In the Appendix to the Rules is Form 18, which provides a sample complaint for patent infringement. Form 18 consists of only four paragraphs which set forth: (1) a statement of jurisdiction; (2) an identification of the patent at issue and an assertion of ownership; (3) an assertion and description of how the defendant is infringing the patent; and (4) an assertion that the plaintiff has complied with the statutory notice requirements and has given the defendant written notice of the infringement.

But Form 18's continued viability has been called into question by more recent Supreme Court decisions in *Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007) and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009). In *Twombly* and *Iqbal*, the Court held that, to adequately state a claim, allegations must establish a plausible claim to relief, above the speculation level. *Twombly*, 550 U.S. at 555; *Iqbal*, 556 U.S. at 678-679. A plaintiff's obligation to provide the grounds of his entitlement to relief now requires "more than labels and conclusions," and a "formulaic recitation of the elements of a cause of action will not do." *Twombly*, 550 U.S. at 555; *Iqbal*, 556 U.S. at 678. What, then, is required in a patent infringement complaint in this post *Twombly/Iqbal* world?

*To What Extent Does Form 18 Control Standards for Pleading Patent Infringement?*

Following the *Twombly* decision but before *Iqbal*, the Federal Circuit ruled that "a bare allegation in accordance with Form 16 (now Form 18) would be sufficient under Rule 8 to state a claim." *McZeal v. Sprint Nextel Corp.*, 501 F.3d 1354, 1360 (Fed. Cir. 2007) (parenthetical added). Since *Twombly*, *Iqbal*, and *McZeal*, the lower courts have been in disagreement over the application of Form 18 and heightened pleading standards not only with respect to direct infringement, but to indirect infringement as well.

Relying on the Federal Circuit's decision in *McZeal*, many district courts have determined that the Supreme Court's decisions in *Twombly* and *Iqbal* have not affected the adequacy of a patent infringement pleading that complies with Form 18 because, to hold otherwise, would render Rule 84 and Form 18 invalid, which cannot be done by judicial action. For example, in *Automated Transactions, LLC v. First Niagara Fin. Grp., Inc.*, the court noted that reconciling the dictates of *Twombly* and *Iqbal* with the Appendix Forms "is not merely difficult, it is impossible." No. 10-CV-00407, 2010 U.S. Dist. LEXIS 141275, at \*8 (W.D.N.Y. Aug. 31, 2010). However, it also determined that courts are not free to amend a rule outside the process Congress ordered and that, "unless or until Rule 84 is amended,...the sufficiency of... [the plaintiff's]... direct infringement allegations is governed by Appendix Form 18." *Id.* at \*12. See also *Cascades Branding Innovation, LLC v. Walgreen Co.*, No. 11 C 2519, 2012 WL 1570774, at \*2 (N.D. Ill. May 03, 2012); *Realtime Data, LLC v. Stanley*, 721 F. Supp. 2d 538, 542 (E.D. Tex. 2009); *W.L. Gore & Assocs. v. Medtronic, Inc.*, 778 F. Supp. 2d 667, 675 (E.D. Va. 2011); *Mark IV Indus. Corp. v. Transcore, L.P.*, No. 09-418 GMS, 2009 U.S. Dist. LEXIS 112069, at \*6-10 (D. Del. Dec. 2, 2009).

Some courts have found that an infringement complaint that fails to make reference to an infringing product or method is deficient, even under Form 18. See, e.g., *Fifth Mkt., Inc. v. CME Grp., Inc.*, No. 08-520, 2009 U.S. Dist. LEXIS 108776, at \*3-4 (D. Del. May 14, 2009) (dismissing complaint alleging that defendants have infringed asserted patents by "making, using, selling and/or offering for sale products and methods covered by the claims of the asserted patents."); *Realtime Data*, 721 F. Supp. 2d at 543 (plaintiff's allegations referring to "data compression products and/or services" are vague in light of the number of claims asserted and therefore "fail to adhere to Form 18 in that they do not specifically identify any accused products or services."). Other courts have found that an infringement complaint is sufficient to meet the "bare-bones" Form 18 requirements when it identifies a general category of accused products or methods. See *Cascades Branding*, 2012 WL 1570774, at \*2 (complaint averring that defendant infringed its patent by "making, using (for example testing), offering to sell and/or selling" a mobile device application "equates with Form 18."); *Tech. Innovations, LLC v. Amazon.com, Inc.*, No. 11-690, 2012 WL 1441300, at \*2 (D. Del. Apr. 25, 2012) (denying motion to dismiss

where plaintiff's reference to defendant's "books" was sufficient to identify the accused products, including e-readers); *Motivation Innovations, LLC v. Express, Inc.*, No. 11-615, 2012 WL 1415412, at \*3-4 (D. Del. Apr. 24, 2012) (denying defendant's motion to dismiss because reference to "home delivered coupon programs and systems" was sufficient to identify defendant's products under Form 18 and while "[t]rade names can assist in specifying a general class of allegedly infringing products or methods, ...[they]... are not required."); *Lodsys, LLC v. Brother Int'l Corp.*, No. 2:11-cv-90-JRG, 2012 WL 760729, at \*3-4 (E.D. Tex. Mar. 8, 2012) (plaintiff's complaint that defendant "makes, sells, offers to sell, and/or uses infringing computer server(s)" was sufficient under Form 18).

And some courts have simply applied the *Twombly/Iqbal* plausibility standard to patent infringement complaints, without regard to Form 18. See *Gradient Enter., Inc. v. Skype Tech. S.A.*, No. 10-cv-6712L, 2012 WL 864804, at \*1-3 (W.D.N.Y. Mar. 13, 2012) (recognizing that while some courts accept a patent infringement complaint that conforms to Form 18, other courts hold that Form 18 no longer suffices in view of *Iqbal*). Because *McZeal* was decided pre-*Iqbal*, these courts take the position that it is not clear now "whether the Federal Circuit would, post-*Iqbal*, hold that a complaint for patent infringement that tracks Form 18 is necessarily sufficient to withstand a motion to dismiss." *Id.* at \*2. For example, in *MedSquire LLC v. Spring Med. Sys. Inc.*, Judge Nguyen ruled that the *Iqbal/Twombly* "plausibility" standard applies to direct patent infringement actions, and that pleading merely in conformance with Form 18 is insufficient. No. 2:11-cv-04504, at 2-3 (C.D. Cal. Aug. 31, 2011) (order granting motion to dismiss); see also *Avocet Sports Tech., Inc. v. Garmin Int'l, Inc.*, No. C 11-04049, 2012 WL 1030031, at \*2-3 (N.D. Cal. Mar. 22, 2012) ("Form 18 does not provide adequate notice under the heightened pleading standards articulated in" *Twombly* and *Iqbal*); *PageMelding, Inc. v. ESPN, Inc.*, No. C 11-06263, 2012 WL 851574, at \*1-2 (N.D. Cal. Mar. 13, 2012) ("Form 18 provides for nothing more than the type of 'defendant-unlawfully-harmed-me accusation' expressly rejected in *Iqbal*"). In *MedSquire*, Judge Nguyen dismissed a complaint that averred:

Defendant Quest has directly infringed and continues to directly infringe the '526 patent by making, using, selling, and/or offering for sale its Care360 system, which embodies and/or otherwise practices one or more of the claims of the '526 patent. As a direct and proximate result of Quest's infringement of the '526 patent, Plaintiff has been and continues to be damaged in an amount yet to be determined.

*MedSquire*, No. 2:11-cv-04504, at 4. Judge Nguyen found that this allegation contained nothing more than a "threadbare recital" of the elements of direct patent infringement, which the court need not accept as true. *Id.* at 5. She stated that, once these "conclusory recitals" were removed from consideration, the complaint was devoid of any factual allegation to support a plausible claim for relief. *Id.* For example, the plaintiff had failed to "include any facts identifying what aspect of the 'Care 360' system infringes its patents." *Id.* Finally, she stated, "Merely naming a product and providing a conclusory statement that it infringes a patent is insufficient to meet the 'plausibility' standard set forth in *Twombly* and *Iqbal*." *Id.*; see also *Avocet Sports*, 2012 WL 10300331, at \*2-3 (plaintiff's averment to defendant's sale of "altimeter devices" was insufficient because plaintiff does not identify a particular product or component alleged to infringe...) (emphasis added); *PageMelding*, 2012 WL 851574, at \*1-2 ("stating in the most general terms what that product does without identifying how the product accomplishes any of its functions, and...without explanation as to the how or why these products infringe, does not lead to any inference that plaintiff may be entitled to relief.").

There is no form complaint analogous to Form 18 for pleading indirect infringement. Because of this, district courts have diverged on whether a higher standard applies for pleading such. Compare *PA Advisors, LLC v. Google, Inc.*, No. 2:07-cv-480, 2008 U.S. Dist. LEXIS 71285, at \*20-23 (E.D. Tex. Aug. 7, 2008) (Folsom, J.) (granting in part a motion for more definite statement requiring the plaintiff to at least generically identify the end users), with *FotoMedia Techs., LLC v. AOL, LLC*, No. 2:07-cv-255, 2008 U.S. Dist. LEXIS 109403, at \*8-10 (E.D. Tex. Aug. 29, 2008) (Everingham, Mag.) (denying motion to dismiss indirect infringement because neither the sample complaint form nor the Federal Circuit require pleading every element of a claim for indirect infringement), and *Bluestone Innovations Tex., L.L.C v. Formosa Epitaxy Inc.*, No. 2:10-cv-171, 2011 WL 4591906, at \*3 (E.D. Tex. Sept. 12, 2011) (denying defendant's motion to dismiss because plaintiff's indirect infringement claims, drafted in conformance with Form 18, were sufficient). In *Elan Microelectronics Corp. v. Apple, Inc.*, the court dismissed a counterclaim averring that Elan "has been and is currently, directly and/or indirectly infringing, in violation of 35 U.S.C. § 271" the specified patents "through its design, marketing, manufacture and/or sale of touch sensitive input devices or touchpads, including but not limited to the Smart-Pad." No. 09-01531, 2009 U.S. Dist. LEXIS 83715, at \*4 (N.D. Cal. Sept. 14, 2009). Following a discussion of *Twombly* and *Iqbal*, the court acknowledged that it is not easy to reconcile those decisions with Form 18 but concluded that, "[u]nder Rule 84 of the Federal Rules of Civil Procedure, however, a court must accept as sufficient any pleading made in conformance with the forms." *Id.* at \*6-7. However, the court still dismissed Apple's counterclaims that Elan was "directly and/or indirectly" infringing the patents because, while Form 18 provides an example of how *direct* infringement may be alleged, it does not address a pleading of indirect infringement. *Id.* at \*7-8.

Other courts have taken an even narrower approach than the *Elan* court, holding that Form 18 is not relevant at all when evaluating the sufficiency of an indirect infringement complaint. See *Cascades Branding*, 2012 WL 1570774, at \*2-3 ("Form 18 does not apply to indirect infringement") (citing *Elan Microelectronics*, 2009 U.S. Dist. LEXIS 83715, at \*2); *BIAX Corp. v. Motorola Solutions, Inc.*, No. 10-cv-03013, 2012 WL 502727, at \*2 (D. Colo. Feb. 15, 2012) ("Indirect infringement claims...contain additional elements left entirely unaddressed by Form 18."). For example, in *Nielsen Co. (US), LLC v. comScore, Inc.*, the court recognized that Form 18 does not reference the elements of induced or contributory infringement and is therefore irrelevant to indirect infringement claims. 819 F. Supp. 2d 589, 599-600 (E.D.Va. 2011). Instead, claims of indirect infringement must be evaluated under the standard set forth in *Twombly* and *Iqbal*, without reference to the language of Form 18...." *Id.* at 600; see also *DR Sys., Inc. v. Avreo, Inc.*, No. 11-cv-0932, 2012 WL 1068995, at \*1 (S.D. Cal. Mar. 29, 2012) ("because Form 18 does not address induced infringement or contributory infringement, the heightened pleading standard of *Twombly* and *Iqbal* apply to allegations of induced infringement and contributory infringement.").

### *Pleading Affirmative Defenses and Counterclaims*

There is a split of decisions on whether the heightened pleading standards of *Twombly/Iqbal* apply to pleading affirmative defenses and invalidity counterclaims.

In one corner are courts such as the Eastern District of Pennsylvania, as illustrated in *Tyco Fire Prods., LP v. Victaulic Co.*, 777 F. Supp. 2d 893 (E.D. Pa. 2011). In *Tyco*, the defendant charged with infringement pleaded the affirmative defense that plaintiff's patents are "invalid and/or unenforceable for failure to comply with the conditions of patentability



specified in Title 35 of the United States Code, including, without limitation, at least §§ 101, 102, 103 and 112.” *Id.* at 896. The defendant also pleaded a counterclaim averring that the patents are “invalid and/or unenforceable for failure to comply with the conditions of patentability specified in Title 35 of the United States Code, including, without limitation, at least §§ 101, 102, 103 and 112.” *Id.* The court declined to strike the affirmative validity defense as insufficient, but struck the invalidity counterclaim.

The *Tyco* court found that, in the wake of *Twombly* and *Iqbal*, it is clear that an invalidity counterclaim must set forth sufficient facts to give rise to a plausible claim for relief. *Id.* at 898. Several other courts have taken a similar position. For example, in *Memory Control Enter., LLC v. Edmunds.com*, the defendant’s counterclaim averred “[t]he claims of the ’791 Patent are invalid for failure to comply with one or more provisions of Title 35 of the United States Code related to patentability.” No. cv 11-7658-PA, 2012 WL 681765, at \*3 (C.D. Cal. Feb. 8, 2012). The court found that this and other conclusory statements, with no supporting facts, were insufficient to provide fair notice to the plaintiff. *Id.* The court did “not find it incongruous to require heightened pleading for a counterclaim for declaratory judgment of invalidity when the pleading standard for infringement only needs to meet Form 18’s level of particularity... [and]...[u]ntil such a form is included, defendants must meet the pleading standard the Supreme Court announced in *Twombly* and *Iqbal*.” *Id.*; see also *Gemcor II, LLC v. Electroimpact Inc.*, No. 11-cv-2520-CM, 2012 WL 628199, at \*2 (D. Kan. Feb. 27, 2012); *PPS Data, LLC v. Availability, LLC*, 3:11-cv-747-J-37TEM, 2012 WL 252830, at \*2 (M.D. Fla. Jan. 26, 2012); *Armstrong Pump, Inc. v. Hartman*, 10-cv-446-S, 2011 WL 7628517, at \*7 (W.D.N.Y. Dec. 29, 2011); *Cleversafe, Inc. v. Amplidata, Inc.*, 11 C 4890, 2011 WL 6379300, at \*2 (N.D. Ill. Dec. 20, 2011).

The *Tyco* court also noted that whether *Twombly*’s “plausibility” standard applies to affirmative defenses is far from settled. *Tyco*, 777 F. Supp. 2d at 898. It held that, in light of the differences between FRCP 8(a) and (c) in text and purpose, *Twombly* and *Iqbal* do not apply to affirmative defenses. *Id.* at 900; see also *Ferring B.V. v. Watson Labs., Inc.*, No. 3:11-cv-00481, 2012 WL 607539, at \*3 (D. Nev. Feb. 24, 2012) (holding that while fairness and efficiency suggest that *Twombly* and *Iqbal* should apply to affirmative defenses in patent cases, those Supreme Court decisions apply to Rule 8(a), not Rule 8(c)); *Memory Control*, 2012 WL 681765, at \*4 (unlike Rule 8(a), “Rule 8(c) contain[s] no language that pleaders must ‘show’ that they are entitled to relief.”). An affirmative defense does not have to be plausible to survive; it merely has to provide fair notice of the issue involved. *Tyco*, 777 F. Supp. 2d at 900. “[T]he requisite notice is provided where the affirmative defense in question alerts the adversary to the existence of the issue for trial.” *Id.* at 901.

The *Tyco* court noted that requiring more in an affirmative defense pleading than awareness of the issue’s existence imposes an unreasonable burden on defendants who risk the prospect of waiving a defense at trial by failing to plead it and have a short amount of time to develop the facts necessary to do so. *Id.*; see also *Memory Control*, 2012 WL 681765, at \*5 (the *Twombly* and *Iqbal* requirements are more fairly imposed on plaintiffs who have years to develop a case than on defendants who have 21 days to answer a complaint). It determined that the apparent incongruity in treatment of affirmative defenses and counterclaims is warranted by the different forms of relief accorded by affirmative defenses and counterclaims. *Tyco*, 777 F. Supp. 2d at 901. If a defendant prevails on its counterclaim, it would be entitled to an order declaring plaintiff’s patent invalid. *Id.* On the other hand, a victory on an affirmative defense would not have this effect. *Id.* Many other courts are in agreement with the *Tyco* court’s position on affirmative

defense pleading. See *Whitserve, LLC v. GoDaddy.com, Inc.*, No. 3:11-cv-948, 2011 WL 5825712, at \*2 (D. Conn. Nov. 17, 2011); *J & J Sports Prods., Inc. v. Scace*, No. 10-cv-2496-WQH-CAB, 2011 WL 2132723, at \*1 (S.D. Cal. May 27, 2011).

In another example, in *Bayer Cropscience AG v. Dow Agrosciences LLC*, the District of Delaware provided an exhaustive list of reasons why *Twombly* and *Iqbal* do not apply to affirmative defenses. No. 10-1045 RMB/JS, 2011 WL 6934557, at \*1-2 (D. Del. Dec. 30, 2011). The court recognized that there is disagreement among district courts as to how to treat affirmative defenses in light of *Twombly* and *Iqbal*. *Id.*; see also *Paducah River Painting, Inc. v. McNational Inc.*, No. 5:11-cv-00135, 2011 WL 5525938, at \*2 (W.D. Ky. Nov. 14, 2011) (“*Twombly* and *Iqbal* have provoked a frenzy of district court opinions reexamining...[whether the]...heightened pleading standard or the ‘fair notice’ standard” applies to affirmative defenses.). Nevertheless, the court held that *Twombly* and *Iqbal* do not apply to affirmative defenses because of the following: (1) textual differences between Rules 8(a) and 8(c); (2) plaintiffs have time to obtain more information while defendant have little time to respond; (3) no concern that defense is opening the doors to discovery; (4) limited discovery costs as compared to costs imposed on defendant; (5) low likelihood that motions to strike would be granted; (6) risk of waiver by the defendant; (7) lack of detail in Form 30, which demonstrates affirmative defense pleading; and (8) heightened pleading would produce more motions to strike. *Bayer Cropscience*, 2011 WL 6934557, at \*1-2; see also *Paducah*, 2011 WL 5525938, at \*2 (detailing the various reasons why courts have refused to apply *Twombly* and *Iqbal* to affirmative defenses).

The court in *Teirstein v. AGA Med. Corp.* took an even more liberal approach, declining to apply heightened pleading standards to a defendant’s counterclaim for “declaratory judgment of invalidity.” No. 6:08-cv-14, 2009 U.S. Dist. LEXIS 125002, at \*7-17 (E.D. Tex. Feb. 13, 2009). The counterclaim stated that “[t]he claims of the ’995 patent are invalid for failing to satisfy one or more of the statutory requirements for patentability set forth in 35 U.S.C. §§ 101, 102, 103, and/or 112.” *Id.* at \*11. The court concluded that these allegations comprised “more than mere labels, conclusions, or a formulaic recitation of the elements of a cause of action” and were “more than sufficient to give Plaintiff fair notice of what Defendant is claiming.” *Id.* at \*13-14. It also noted that to require anything more of the defendant at the pleading stage would be to impose a higher burden on the defendant’s claim for invalidity than the plaintiff’s claim for infringement, when these pleading standards are identical under Rule 8. *Id.* at \*14. Moreover, according to this court, requiring the defendant to state facts as to why the patent is invalid or to list prior art would undermine the purpose of the court’s Local Patent Rules, which require a defendant, early in a litigation, to serve invalidity contentions detailing prior art, disclose grounds for indefiniteness, and include a claim chart regarding invalidity. *Id.* at \*14-15; see also *Microsoft Corp. v. Phoenix Solutions, Inc.*, 741 F. Supp. 2d 1156, 1159 (C.D. Cal. 2010) (agreeing with other district courts that “it would be incongruous to require heightened pleading for invalidity counterclaims when the pleading standard for infringement does not require facts such as ‘why the accused products allegedly infringe’ or ‘to specifically list the accused products.’”). Many other courts are in agreement with the *Teirstein* court’s approach. See *Bayer Cropscience*, 2011 WL 6934557, at \*2-3 (similar to invalidity counterclaims, patent unenforceability counterclaims are “not subject to heightened pleading under *Twombly/Iqbal*” for the reasons announced in *Teirstein*); *InvestmentSignals, LLC v. Irrisoft, Inc.*, No. 10-cv-600-SM, 2011 WL 3320525, at \*2 (D. N.H. Aug. 1, 2011) (“as long as patent claims and counterclaims meet the minimal pleading standards modeled in Form 18, they adequately state viable causes of action.”). For example, in *Graphic Packaging Int’l, Inc. v. C.W. Zumbiel Co.*, the court recognized that

no federal court of appeals has considered how the *Twombly/Iqbal* decisions apply to counterclaims or affirmative defenses, and that district courts deciding the issue are in conflict. No. 1:10-cv-3008-AT, 2011 WL 5829674, at \*2 (N.D. Ga. Aug. 1, 2011). Nevertheless, the court held that “invalidity counterclaims and affirmative defenses that allege only their statutory bases are adequate to survive a Rule 12 motion challenging the sufficiency of the pleadings.” *Id.* at \*3.

Although it appears that many courts have determined that heightened pleading standards *do not* apply to invalidity defenses and counterclaims, there are courts in the other camp. For example, the court in *Semco, LLC v. Huntair, Inc.* found that the *Iqbal* and *Twombly* standards *do* apply to the pleading of affirmative defenses. No. 11-4026, 2011 U.S. Dist. LEXIS 82795, at \*3 (W.D. Mo. July 28, 2011); Notably, although the pleading was not stricken by the court, it was also somewhat more detailed than that in the *Tyco* case, including, for example, the following averment reciting an example of prior art:

15. Prior art to the '388 patent exists such that the differences between the prior art and the alleged invention of the '388 patent would have been obvious at the time of the alleged invention to a person of ordinary skill in the art. An example of such prior art is U.S. Patent No. 5,758,511 to Yoho et al., “Desiccant Multi-Duel Hot Air/Water Air Conditioning System.”

*Id.* at \*4-5. Similarly, in *Barnes & Noble, Inc. v. LSI Corp.*, the court determined that *Twombly* and *Iqbal* apply to affirmative defenses. No. C-11-2709, 2012 WL 359713, at \*14 (N.D. Cal. Feb. 2, 2012). The court struck the plaintiff’s laches defense to a counterclaim of infringement on the basis that, while the pleading put the defendant on notice, it failed to allege any facts specific to laches. *Id.* at \*14. The court reasoned that *Twombly*’s rationale of “fair notice” should equally apply to affirmative defenses, and that “applying the same standard will also serve to weed out the boilerplate listing of affirmative defenses which is commonplace in most defendants’ pleadings where many of the defenses alleged are irrelevant to the claims asserted.” *Id.* at \*2 (quoting *Barnes v. AT & T Pension Benefit Plan-NonBargained Program*, 718 F. Supp. 2d 1167, 1171-72 (N.D. Cal. 2010)).

In sum, based on decisions to date, it appears that there is no uniform view among the district courts with respect to the level of detail required to plead patent infringement or invalidity, and that there may never be such uniformity until legislative action is taken to amend Form 18. That leads to the following question: if Form 18 is amended or deleted, just how much detail *should* be required in a pleading? Beyond identifying with specificity the accused products or methods, must a patentee identify the asserted claims? Identify accused products or methods by trade names? Provide a claim chart? Must the defendant/counterclaimant likewise identify all prior art, and apply it to the claims in the same level of detail? How reasonable and fair would it be to require this level of detail in opening pleadings, and would such rigorous requirements bog the courts down in motion practice as parties seek to amend pleadings based on information learned in discovery? Are requirements to provide infringement/invalidity contentions at an early stage in the litigation preferable, over rigorous pleading requirements, as a means for getting meaningful information to the litigants? There are many aspects to consider when addressing the question of pleading requirements, and the debate going forward will be followed with great interest by stakeholders on both sides of the issue.

## Multi-Defendant Cases

Another issue that comes up in the pleading phase of many cases is the appropriateness of joinder of multiple defendants in a single patent infringement suit. Federal Rule of Civil Procedure 20(a) provides that joinder of defendants is appropriate where “any right to relief is asserted against them jointly, severally, or in the alternative with respect to or arising out of the same transaction, occurrence, or series of transactions or occurrences; and [] any question of law or fact common to all defendants will arise in the action.” Fed. R. Civ. P. 20(a)(2). Where misjoinder is apparent, a court is within its discretion to dismiss or sever the claims against the misjoined parties. Fed. R. Civ. P. 21.

Prior to the Federal Circuit’s very recent decision in *In re EMC Corp.*, district courts around the country were divided on their approach to severance in patent infringement cases. For example, many courts around the country found that patent infringement claims against unrelated defendants independently selling distinct products did not satisfy the transactional relatedness requirement of Rule 20(a)(2) merely because the distinct products are all alleged to infringe the same patent. See, e.g., *Pergo, Inc. v. Alloc, Inc.*, 262 F. Supp. 2d 122, 128 (S.D.N.Y. 2003); *Philips Elec. N. Am. Corp. v. Contec Corp.*, 220 F.R.D. 415, 417 (D. Del. 2004); *Androphy v. Smith & Nephew, Inc.*, 31 F. Supp. 2d 620, 623 (N.D. Ill. 1998); *WiAV Networks, LLC v. 3Com Corp.*, No. 10-03448, 2010 U.S. Dist. LEXIS 110957, at \*19 (N.D. Cal. Oct. 1, 2010); *Tierravision, Inc. v. Research in Motion Ltd.*, No. 11-cv-0639, 2011 WL 4862961, at \*1 (S.D. Cal. Sept. 16, 2011); *Brandywine Commc’ns Tech., LLC v. Apple Inc.*, No. 6:11-cv-1512, 2012 WL 527180, at \*1 (M.D. Fla. Feb. 17, 2012).

On the other hand, in a minority of other courts, and particularly in the Eastern District of Texas where many multi-defendant cases are filed, the courts have held that claims of infringement of the same patent made against multiple defendants, selling different products, can be properly joined in a single lawsuit. These decisions frequently point to judicial economy and some overall similarity between defendants’ accused products as the basis for declining to sever actions.

For example, in *Eolas Techs., Inc. v. Adobe Sys., Inc.*, Eolas accused twenty-three defendants – located all around the country, including several in California – of infringing a patent. No. 6:09-cv-446, 2010 U.S. Dist. LEXIS 104125, at \*13 (E.D. Tex. Sept. 28, 2010). The court denied a request to sever any of the defendants on the grounds that severance would not promote judicial economy. *Id.* at \*15-16. It noted that determining the defendants’ liability would involve substantially overlapping questions of law and fact, such as construing the claims and evaluating the patents’ innovation over the prior art. *Id.* at \*15. Further, it found,

For multiple courts to simultaneously address these identical issues would be a waste of the courts’ and parties’ resources and could potentially lead to inconsistent results. Moreover, the record before the Court does not show that the products or methods at issue are so different that determining infringement in one case is less proper or efficient than determining infringement in multiple cases. Nor does the record show that any defendant will be so prejudiced by joinder that severance is necessary to prevent an inequitable process or result. See Fed. R. Civ. P. 42(b).

*Id.* at \*15-16. On defendants' writ of mandamus, the Federal Circuit ruled that the court had not abused its discretion in refusing to sever certain of the petitioner's claims for transfer to the Northern District of California. *In re Google Inc.*, 412 Fed. Appx. 295, 296 (Fed. Cir. 2011). It stated, "Courts have consistently held that judicial economy plays a paramount role in trying to maintain an orderly, effective, administration of justice and having one trial court decide all of these claims clearly furthers that objective." *Id.* at 296; *see also Imperium (IP) Holdings, Inc. v. Apple Inc.*, No. 4:11-cv-163, 2012 WL 461775, at \*2-3 (E.D. Tex. 2012) (refusing to sever claims merely based on infringement of the same patent because the Federal Circuit recognized in *In re Google* that such joinder is appropriate).

In the wake of the Leahy-Smith America Invents Act (H.R. 1249), the Federal Circuit reversed its position on joinder and severance in the landmark decision *In re EMC Corp.*, No. 100, 2012 WL 1563920, at \*1 (Fed. Cir. May 4, 2012). A provision of the Leahy-Smith America Invents Act (H.R. 1249) signed into law on September 16, 2011 appears to strip courts of their power to join multiple defendants in a single lawsuit simply based solely upon the fact that the defendants are all alleged to infringe the same patent. *See Genetic Tech. Ltd. v. Agilent Tech., Inc.*, No. 11-cv-01389, 2012 WL 1060040, at \*3 fn. 2 (D. Colo. Mar. 28, 2012) (finding that, while the AIA did not apply to plaintiffs claims filed prior to September 16, 2011, it is still persuasive authority that severing the claims, which are based solely on the fact that defendants infringe the same patent, is appropriate); *see also Brandywine*, 2012 WL 527180, at \*1.

Section 299 of the Act, which applies to all cases filed on or after September 16, 2011, provides:

§299. Joinder of Parties

(a) JOINDER OF ACCUSED INFRINGERS. – With respect to any civil action arising under any Act of Congress relating to patents, other than an action or trial in which an act of infringement under section 271(e)(2) has been pled, parties that are accused infringers may be joined in one action as defendants or counterclaim defendants, or have their actions consolidated for trial, or counterclaim defendants only if –

(1) any right to relief is asserted against the parties jointly, severally, or in the alternative with respect to or arising out of the same transaction, occurrence, or series of transactions or occurrences relating to the making, using importing into the United States, offering for sale, or selling of the same accused product or process; and

(2) questions of fact common to all defendants or counterclaim defendants will arise in the action.

(b) ALLEGATIONS INSUFFICIENT FOR JOINDER. – For purposes of this subsection, accused infringers may not be joined in one action as defendants or counterclaim defendants, or have their actions consolidated for trial, based solely on allegations that they each have infringed the patent or patents in suit.

(c) WAIVER. – A party that is an accused infringer may waive the limitations set forth in this section with respect to that party.

Unsurprisingly, in the days before the America Invents Act was signed by the President, scores of new patent cases were filed in jurisdictions around the country, accusing hundreds of corporate entities of patent infringement. However, to the dismay of those plaintiffs and perhaps unsurprisingly, on May 4, 2012, the Federal Circuit reversed its position in *In re Google* and applied the stricter standards of the AIA teachings to pre-AIA filings, even though the AIA does not retroactively apply to those cases. *In re EMC*, 2012 WL 1563920, at \*1.

In *In re EMC Corp.*, the Federal Circuit, on a writ of mandamus, overturned an Eastern District of Texas decision denying a severance and transfer of numerous defendants' claims to the District of Utah. *In re EMC*, 2012 WL 1563920, at \*1. The lower court denied the motion to sever the claims on grounds that the defendants offered similar products, and there were common questions of claim scope and validity. *Id.* The defendants argued on mandamus that the Eastern District of Texas had applied the wrong test for joinder. *Id.* The Federal Circuit agreed. While the court recognized that the recently enacted AIA did not apply to the plaintiff's pre-AIA claims, it nevertheless held consistently with the AIA that "the existence of a single common question of law or fact alone is insufficient to satisfy the transaction-or-occurrence requirement" of Rule 20. *Id.* at \*4-5. Importantly, in patent infringement cases, "the mere fact that infringement of the same claims of the same patent is alleged does not support joinder, even though the claims would raise common questions of claim construction and patent invalidity." *Id.* The transaction-or-occurrence test is satisfied when there is a logical relationship between the separate causes of action, i.e., defendant's infringing acts "must *share* an aggregate of operative facts." *Id.* at \*6 (emphasis in original). Because the lower court applied an incorrect test, the Federal Circuit vacated the denial of severance and transfer, and remanded. *Id.*

It seems that the Federal Circuit has finally put to rest the disagreement among courts with respect to joinder and severance. But it still remains to be seen what the real effect of Section 299 will be. One might expect that it will now be easier for an individual defendant to transfer a lawsuit to a more convenient venue, without the need to consider and address the ties of other joint defendants to a forum. But one might also expect that a court before which multiple cases on the same patent remain will consolidate the cases for purposes of pre-trial discovery and claim construction, leaving defendants in much the same position as they were before Section 299. See also the discussion below of the *Parallel Networks* case.

### **Claim Construction Proceedings**

The timing of claim construction proceedings varies from court to court – and sometimes from judge to judge within a district – and can affect the likelihood of resolving a lawsuit before trial, either by settlement or summary judgment.

Two general approaches to claim construction have evolved in the district courts since issuance of the *Markman* decision in 1996. The first approach, generally driven by special local patent rules, prescribes disclosure of contentions by each party that purportedly serve to narrow and define claim construction disputes, leading to independent consideration of disputed claim terms through briefing and, usually, a separate claim

construction hearing. Under this approach, claim construction issues are generally resolved before infringement or validity issues are considered.

Under a second and broader approach, claim construction disputes are considered at the time of dispositive motions – usually a summary judgment motion or a request for injunctive relief. For example, Judge Robinson, sitting on the District Court for the District of Delaware, a jurisdiction that does not have special local patent rules, has a standard scheduling order for patent cases. The order provides that, unless the court determines that an earlier claim construction would be helpful in resolving a case, the parties must exchange lists of terms to be construed, and proposed constructions, on an agreed upon date. Furthermore, they must be provided on a date on which the hearing on *both* claim construction and summary judgment motions will be heard. Chambers of the Honorable Sue L. Robinson, <http://www.ded.uscourts.gov/SLRmain.htm>.<sup>1</sup>

Recently, Judge Crabb in the Western District of Wisconsin has announced a new procedure that appears to limit claim construction solely to claim terms raised in summary judgment motions. This new procedure was announced via a magistrate judge's order in a pending patent case, *Dashwire, Inc. v. Synchronoss Techs., Inc.*, No. 11-cv-257 (W.D. Wis. July 28, 2011) (order changing procedures for construing claims). This Order indicated that, under Judge Crabb's new procedure, parties must still exchange claim terms according to deadlines set in the preliminary pretrial conference order, but shall not file motions or briefs requesting claim construction. *Id.* at 1. The Order stated “[t]he court will not hold a stand-alone claims construction hearing and shall not issue an order construing claims. Instead, if any party wants the court to construe a claim, it must make that request and offer its proposed construction in its motion for summary judgment and supporting documents.” *Id.* What remains to be seen, however, is how, under this procedure, infringement or invalidity issues that depend on claim construction will be presented to a jury where claim construction disputes exist but did not arise in the context of a proper dispositive motion.

A survey of federal district court patent litigation-experienced judges undertaken by the Federal Judicial Center and reported in a 2008 publication indicated that 79% of judges undertook claim construction unconnected to other motions or proceedings, while 26% undertook claim construction in the context of summary judgment motions. Patent Claim Construction: A Survey of Federal District Court Judges, Federal Judicial Center, February 2008 at 14.

Last year, a Working Group of The Sedona Conference® published a report setting forth a set of “best practices” for claim construction in patent litigation. The Sedona Conference® Report on the *Markman* Process (A Project of The Sedona Conference® Working Group on Markman Hearings & Claim Construction (WG5) November 2010 Version), *available at* <http://www.thosedonaconference.org>. These best practices included early exchange of infringement and invalidity contentions and provided that the *Markman* hearing should take place toward the middle of the case. *Id.* at 6. The Report suggests that this timing is ideal because, if the claim construction hearing is done too early, the parties

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<sup>1</sup> Judge Robinson's approach appears to be unique in the District of Delaware. For example, in his standard Scheduling Order, Chief Judge Sleet sets a date for a Markman hearing and allows summary judgment motions only if permission is granted after letter briefing explaining why any such motion is warranted. Chambers of the Honorable Gregory M. Sleet, <http://www.ded.uscourts.gov/GMSmain.htm>. Judge Stark's standard Scheduling Order leaves open the possibility for a “limited earlier claim construction” where it would be helpful in resolving the case, but otherwise sets a date certain for a claim construction briefing separate from summary judgment briefing. Chambers of the Honorable Leonard P. Stark, <http://www.ded.uscourts.gov/LPSmain.htm>.

may not have sufficient time to conduct discovery that might be relevant to the claim construction issues, such as how one skilled in the art uses the term. *Id.* Further, the Report suggests, even if the parties have exchanged contentions, they still may not fully know what terms are in dispute if there has been little or no discovery on infringement and invalidity. *Id.* On the other hand, if the hearing is held too late in the case, the parties may not have sufficient time to conduct additional fact discovery or expert discovery based on the claim construction. *Id.* The Report also suggests that where an issue of infringement or invalidity can be determined solely on the basis of claim construction, then some efficiency could be achieved by coupling summary judgment motions with a *Markman* hearing. *Id.* It also notes, however, that “if the parties dispute the characteristics of the accused product or the disclosure of the prior art, coupling a summary judgment motion with a *Markman* hearing is not likely to achieve judicial economy since a determination of the genuineness of the dispute will be needed and, if it is found, summary judgment would be precluded.” *Id.*

### Streamlining the Case

Faced with many cases involving multiple patents, multiple accused devices, and/or multiple prior art defenses, judges in the Eastern District of Texas have been trying different case management procedures to streamline cases and bring them to resolution as quickly and efficiently as possible.

#### *Streamlining by early and limited claim construction*

For example, in a case in which Parallel Networks LLC originally asserted a web communications patent against 124 defendants, Judge Leonard Davis agreed to an early claim construction – to be held only three months after the initial scheduling conference – of three terms that the defendants believed to be case dispositive, and stayed discovery other than that relating to the early claim construction. *Parallel Networks LLC v. Abercrombie & Fitch*, No. 6:10-cv-111 (E.D. Tex. Mar. 15, 2011) (order denying motion to bifurcate and motion to sever and transfer). He wrote,

Plaintiff’s strategy presents defendants with a *Hobson’s* choice: spend more than the settlement range on discovery, or settle for what amounts to cost of defense, regardless of whether a defendant believes it has a legitimate defense. Because the patent rules and the court’s standard docket control order do not achieve their intended result in this particular case, it is necessary to depart from them in an effort to accomplish both parties’ objectives in the most cost effective manner.

*Id.* at 6. Judge Davis’ order provided that, if the early claim construction and related summary judgment process did not resolve the case, then the court would hold the parties to an originally scheduled *Markman* date set according to a “normal” trial schedule. *Id.* at 9.

The *Markman* ruling did indeed result in summary judgment of non-infringement for ninety-nine of the defendants. *Parallel Networks LLC v. Abercrombie & Fitch*, No. 6:10-cv-111 (E.D. Tex. Aug. 12, 2011) (order construing claim terms and granting summary judgment in part). Judge Davis’ Order stated:



As of the filing of Defendants' claim construction brief and summary judgment motion, 112 Defendants remained in the case. The summary judgment motion on the "dynamically generated" issue has resolved this case as to 99 of the 112 Defendants. The Court notes that in many patent cases before it involving multiple defendants, it is frequently faced with motions for severance and transfer to many different districts. Had the Court taken that approach in this case, Parallel and Defendants would be litigating this patent all over the country in many districts at great additional expense to all parties and the judiciary.

The Court commends the parties in this case for working together to identify issues common to nearly all Defendants and moving the case to resolution of these important issues in a timely and economic manner. By doing so, this case was resolved in a manner of months – as opposed to years – for the vast majority of Defendants. By all Defendants remaining in one case in one District, the Court was able to resolve the controversy in the most judicially economic manner sparing many other courts from repetitive work, and at the same time saving the parties very significant sums of money in attorneys fees.

*Id.* at 16-17.

Other judges in the Eastern District of Texas are also trying to streamline cases with limited, early *Markman* rulings. Judge Love granted a request for an early *Markman* in *Whetstone Elec., LLC v. Xerox Corp.*, No. 6:10-cv-278 (E.D. Tex. Apr. 7, 2011) (order granting early *Markman* request). Judge Love directed the defendants to submit the three claim terms they had represented to be "case dispositive," and he set a *Markman* hearing on the terms only three months later. *Id.* at 1. Pending a claim construction ruling on the three identified terms, discovery was limited to production of user and service manuals of the accused products as well as the deposition of one representative of each defendant regarding the accused products and related manuals. *Id.* at 1-2.

In an effort to improve efficiency and decrease litigation costs, on January 9, 2012, Judge Love turned his *Whetstone* decision into a unique standing order regarding briefing procedures for an "early *Markman* hearing" and summary judgment of noninfringement. According to the Order, 145 days before a scheduled *Markman* hearing, a defendant may submit a letter brief requesting construction of no more than three dispositive claim terms. If accepted, the defendant may then file a summary judgment motion and combined claim construction brief 95 days before trial. After responses are filed, the court will hold an "early *Markman* hearing" to adjudicate the dispositive claim terms and summary judgment. If the case is not resolved at that time, the originally scheduled *Markman* hearing will proceed as scheduled. Chamber of the Honorable John D. Love, <http://www.txed.uscourts.gov/page1.shtml?location=info;judge&judge=1>. As of today, no other judges in the Eastern District of Texas, including Judge Davis, have issued a similar standing order.

*Streamlining by Limiting Number of Asserted Claims or Claim Terms*

In *LML Patent Corp. v. JP Morgan Chase & Co.*, No. 2:08-cv-448 (E.D. Tex. Oct. 12, 2010) (order granting modified motion to sever and stay), Judge Folsom ordered the plaintiff to elect a limited number of claims. He then granted plaintiff's motion to sever

and stay the non-elected claims and rejected the defendants' argument that plaintiff had waived any right to seek severance because it had not challenged the court's requirement to elect a limited number of claims. *Id.* at 2. Judge Folsom ruled that the limitations on the number of asserted claims were necessary for effective and efficient management of the case:

If the patentee wins, infringement of a single claim can support an award of damages, so the patentee generally need not then pursue nonelected claims. If the patentee loses, then the likelihood of any subsequent litigation is low because the patentee presumably elected the claims that "they believe are most likely to be infringed." If Defendants' estoppel arguments were accepted, however, enforcement of the Court's claim election requirement would foreclose Plaintiff's rights as to all non-elected claims without ever reaching the merits of those claims.

Finding no clear support from the Court of Appeals for either the Fifth Circuit or the Federal Circuit for Defendants' position, this Court rejects it. This conclusion is necessary to avoid what would appear on its face to be a significant due process violation.

*Id.* at 2-3 (internal citations omitted); *see also Round Rock Research, LLC v. Oracle Corp.*, No. 4-11-cv-00332 (E.D. Tex. Mar. 26, 2012) (holding that "limiting the amount of claims asserted by Plaintiff is appropriate at this time to aid in efficiency and narrowing the claims prior to claim construction.").

Similarly, Judge Everingham granted a motion to stay certain patent claims, pending resolution of fifteen claims that the plaintiff was required to elect. *Personalized Media Commc'ns, LLC v. Motorola, Inc.*, No. 2:08-CV-70 (E.D. Tex. Aug. 15, 2011) (order granting motion to stay non-elected claims). The order provided that the non-elected claims would not be severed into a new cause of action; instead, the non-elected claims could be addressed, "if need be," after the merits of the elected claims are resolved. *Id.*

Numerous other courts across the country have imposed limitations on the number of asserted claims. *See, e.g., XPRT Ventures LLC v. eBay Inc.*, No. 1-10-cv-00595 (D. Del. September 9, 2011) (order limiting asserted claims) (finding that the duty falls upon the judge to "select a number which respects [plaintiff's] proprietary interests and due process rights on the one hand, while protecting the Defendants from suffering undue burden, and more importantly, ensuring that this case proceeds in an orderly manner."); *Gen-Probe Inc. v. Becton Dickinson & Co.*, No. 3-09-cv-02319 (S.D. Cal. Feb. 22, 2012) (order granting motion to limit asserted claims); *Havco Wood Prods., LLC v. Indus. Hardwood Prods., Inc.*, No. 3-10-cv-00566 (W.D. Wis. Nov. 10, 2011) (order granting motion to limit asserted claims).

Other courts have imposed limitations on the number of asserted claims *terms*, regardless of the number of claims. For example, Judge Guilford of the Central District of California just recently struck down a Joint Claim Construction and Prehearing Statement, requesting the court to construe 45 claim terms. *Vizio, Inc. v. LSI Corp., Inc.*, No. SACV 10-1602 AG (C.D. Cal. May 8, 2012) (order striking joint claim construction statement). In a scheduling order, the court limited the number of claim terms to just 12, finding that "placing a ceiling on claim construction furthers the interests of justice by 'requir[ing] counsel to think about coalescing, joining, and I think simplifying, which I think ultimately produces a good – a better product to be presented to the jury.'" *Id.* at 1. Because the

plaintiff and defendant did not comply with the court by filing a motion requesting construction of additional terms, the joint construction statement was struck, and the parties were ordered to resubmit their claim construction statements identifying no more than 12 claim terms for construction. *Id.* at 2.

Interestingly, at least one court has limited both the number of asserted claims, and the number of claim terms, not just to improve efficiency, but also in the interests of fairness to the parties. In *DCG Sys., Inc. v. Checkpoint Tech., LLC*, the Northern District of California limited the number of terms for construction to 10, notwithstanding the defendant's plea to the court to construe 23 terms. No. 11-cv-03792-PSG (N.D. Cal.) (order limiting asserted claims and claim terms). "Without such a limit, the court faces a glut of terms that threatens the efficiency of the claim construction." *Id.* at 2. On the other hand, to mitigate the defendant's burden, and to improve efficiency, the court ordered the plaintiff to identify 25 of the originally 57 asserted claims on which to proceed. *Id.* "This itself may not be the final cut, but it is a reasonable start down that road." *Id.*

### *Streamlining by limiting discovery*

A different approach was used in *Adjustacam LLC v. Amazon.com, Inc.*, No. 6:10-cv-329 (E.D. Tex. April 27, 2011) (order denying motion to stay and sever claims and granting request for leave to file early summary judgment motion). In this case, the parties agreed that infringement issues were not complex, that much of the discovery would relate to damages, and that a limited, initial damages disclosure would help streamline the case. *Id.* at 2. Judge Davis approved of the parties' requests to: (1) streamline and limit discovery; (2) address certain issues on summary judgment (pre-suit damages and laches); and (3) attend an early mediation. *Id.* His opinion provided comments on the results of the status conference in the case:

While the Patent Rules efficiently govern and manage most cases, the parties in this case have identified and agreed on specific modifications to the Court's standard schedule that would streamline and potentially lead to an early resolution of the dispute. In this case, the issues of laches and recoverable damages are amenable to an early determination. Therefore, the Court will consider an early summary judgment motion on these issues. As set forth at the hearing, the parties shall exchange limited damages disclosures relating to these issues (e.g., Adjustacam's compliance with the marking statute and the quantity of accused devices sold by Defendants in the United States and revenue from those sales). Although the parties may file an early summary judgment motion, the Court strongly encourages the parties to meaningfully meet and confer to potentially resolve or narrow these issues before expending significant resources and incurring unnecessary litigation costs. Although the parties have agreed to this specific course of action, they remain obligated to comply with the disclosure requirements provided in the Local Rules.

*Id.*

Another approach to streamlining discovery is to place limitations on over-burdensome document productions. For example, the Federal Circuit Advisory Council recently promulgated an E-Discovery Model Order in an effort to "to promote economic and judicial efficiency by streamlining ediscovery, particularly email production, and

requiring litigants to focus on the proper purpose of discovery – the gathering of material information – rather than permitting unlimited fishing expeditions.” Introduction to [Model] Order Regarding E-Discovery in Patent Cases, Federal Circuit Advisory Council, at 2 (2011). Among other things, the Model Order greatly limits the scope of email production, which “carry staggering time and production costs that have a debilitating effect.” *Id.* at 2. While the Model Order proposals would seemingly reduce the expenses and burdens of discovery on patent infringement litigants, it is too early to tell whether these proposals will actually improve efficiencies in patent litigation.

### *Streamlining by limiting trial time*

Eastern District of Texas judges have also routinely limited trial time. In *SynQor, Inc. v. Artesyn Techs., Inc.*, following a trial against eleven defendants, a jury entered a verdict finding infringement of the patent by seven of the defendants and awarding \$95 million in damages. No. 2:07-cv-497, 2011 U.S. Dist. LEXIS 91693, at \*6 (E.D. Tex. Aug. 17, 2011). The defendants moved for a new trial on several grounds, including that they had had an inadequate amount of time to present evidence. *Id.* at \*51. The defendants (represented by four law firms) were given twenty hours of trial time, while SynQor was given seventeen hours. *Id.* In denying the motion, the court ruled that its decision to limit the parties’ available trial time was reasonable and not unduly prejudicial. *Id.* at \*52. It noted that courts have broad authority to impose reasonable time limits to prevent undue delay, waste of time, or needless presentation of cumulative evidence. *Id.* The court also noted that the defendants had submitted a joint letter estimating that they would need 25 hours of trial time, and that the court had given them only 20% less than what had been requested, while the court reduced plaintiff’s requested time by 32%. *Id.* at \*53. Furthermore, at the time the estimate was provided, there were more issues in the case than wound up being tried. *Id.* at \*53-54. Thus, the court concluded that it was within its discretion to take into account the defendants’ estimates and the narrowing issues. *Id.* It also noted that the defendants failed to use their time wisely. *Id.* at \*55.

The court also denied defendants’ motion seeking a new trial on the ground that they had allegedly been unfairly limited to 40 prior art references. *Id.* at \*56. The court noted that it had only limited the number of asserted prior art references as a reciprocal measure after a group of the defendants had successfully moved to limit the number of claims SynQor would be permitted to assert. *Id.* Further, it noted that the defendants had not pointed to a single reference that they would have otherwise offered and that would have changed the jury’s verdict. *Id.* Without a specific identification of prejudice that allegedly resulted from the court’s ruling, the defendants had identified no basis for granting a new trial. *Id.* at \*56-57.

### *Streamlining by discouraging assertion of questionable patents*

Judge Davis has also expressed concern about plaintiffs who may assert questionable patents in order to extract “nuisance value” settlements. He summarized his views in an order denying sanctions in *Raylon LLC v. Complux Data Innovations*:

[T]his Court has some concerns about plaintiffs who file cases with extremely weak infringement positions in order to settle for less than the cost of defense and have no intention of taking the case to trial. Such a practice is an abuse of the judicial system and threatens the integrity of and respect for the courts. Often in such cases, a plaintiff asserts an

overly inflated damages model, seeking hundreds of millions of dollars, and settles for pennies on the dollar, which is far less than the cost of defense. Where it is clear that a case lacks any credible infringement theory and has been brought only to coerce a nuisance value settlement, Rule 11 sanctions are warranted.

No. 6:09-cv-355, at 5 (E.D. Tex. Mar. 9, 2011) (order denying Rule 11 sanctions). Judge Davis found that Raylon's claim constructions "stretch[ed] the bounds of reasonableness" but concluded that sanctions were not warranted because Raylon's positions were not "objectively frivolous." *Id.* at 4. In another case, Judge Davis indicated that he may now require the submission of settlement agreements *in camera* as part of the initial Scheduling Conference and will probe a plaintiff's litigation and settlement strategy at the conference. See *PaclD Grp., LLC v. Cisco Sys., Inc.*, No. 6:09-cv-324 (E.D. Tex. Mar. 16, 2011) (order consolidating cases).

Notably, the Federal Circuit affirmed an "exceptional case" finding an award of Rule 11 sanctions against a plaintiff-patent holding company for litigation misconduct and for filing a baseless infringement action in bad faith for an improper purpose. *Eon-Net LP v. Flagstar Bancorp.*, 653 F.3d 1314 (Fed. Cir. 2011). Writing for the Court, Judge Lourie found that the lawsuit "was part of Eon-Net's history of filing nearly identical patent infringement complaints against a plethora of diverse defendants, where Eon-Net followed each filing with a demand for a quick settlement at a price far lower than the cost to defend the litigation." *Id.* at 1326. The Court also noted that Eon-Net had the ability to impose disproportionate discovery costs on Flagstar, at least in part because accused infringers often possess enormous amounts of potentially relevant documents that are ultimately collected and produced. *Id.* at 1327. At the same time, Eon-Net placed little at risk when filing suit. *Id.* As a non-practicing entity, it was generally immune to counterclaims for patent infringement, antitrust, or unfair competition and did not face any business risk resulting from the loss of patent protection over a product or process. *Id.* These circumstances, coupled with the court's supported findings of litigation misconduct, led the Court to conclude that the district court did not clearly err in its exceptional case finding. *Id.* at 1328; see also *MarcTec, LLC v. Johnson & Johnson*, 664 F.3d 907, 918-21 (Fed. Cir. 2012) (upholding lower courts imposition of sanctions where plaintiff's "proposed claim construction was so lacking in any evidentiary support that assertion of this construction was unreasonable and reflects a lack of good faith."); *IA Labs CA, LLC v. Nintendo Co., Ltd.*, No. PJM 10-833, 2012 WL 1565296, at \*2-3 (D. Md. May 1, 2012); *Pfizer Inc. v. Teva Pharm. USA, Inc.*, 820 F. Supp. 2d 751, 760-62 (E.D. Va. 2011).



# PATENT LAW AND ANTITRUST LAW: NEITHER FRIEND NOR FOE, BUT BUSINESS PARTNERS

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*Remarks of J. Thomas Rosch\**  
*Commissioner, Federal Trade Commission*  
*Washington, DC*

## INTRODUCTION

I will take up the question whether patent law and antitrust law are friends or foes in encouraging and rewarding innovation. Let me suggest to you that the answer is neither. Instead, each has its own role to play in respect to the larger enterprise that we call innovation, and what we should strive to do as regulators and enforcers—at least in the United States—is to ensure that they work cooperatively and complementarily as “business partners” in that enterprise.

In suggesting this answer, I speak, of course, from the perspective of the Federal Trade Commission. I therefore don’t purport to have particular insight into how any other agency (for example, the U.S. Patent and Trademark Office), or the United States Congress, is thinking about the interplay between patent law and antitrust law.

The Commission’s principal enforcement statute is Section 5 of the Federal Trade Commission Act.<sup>1</sup> For the purposes of my remarks, Section 5 has two relevant parts, one substantive and one procedural.<sup>2</sup> First, Section 5(a) is substantive in that it declares as unlawful “unfair methods of competition.”<sup>3</sup> Violations of the Sherman and Clayton Acts are considered “unfair methods of competition” under this statute.<sup>4</sup> But as the Supreme Court confirmed in the famous *S&H* case,<sup>5</sup> “unfair competitive practices” proscribed by Section 5 are “not limited to those likely to have anticompetitive consequences after the manner of the antitrust laws[.]”<sup>6</sup>

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\* The views stated here are my own and do not necessarily reflect the views of the Commission or other Commissioners. I am grateful to my attorney advisor, Henry Su, for his invaluable assistance in preparing these remarks.

1 15 U.S.C. § 5 (2010). The Commission enforces the Sherman Act through Section 5, but it does have separate and independent enforcement authority under the Clayton Act, *see* 15 U.S.C. § 21 (2010).

2 There are a number of other subsections in Section 5 that are not pertinent to the discussion here.

3 15 U.S.C. § 5(a) (2010).

4 *See, e.g., FTC v. Ind. Fed’n of Dentists*, 476 U.S. 447, 465-66 (1986) (“The factual findings of the Commission regarding the effect of the Federation’s policy of withholding x rays are supported by substantial evidence, and those findings are sufficient as a matter of law to establish a violation of § 1 of the Sherman Act, and, hence, § 5 of the Federal Trade Commission Act.”); *Fashion Originators’ Guild, Inc. v. FTC*, 312 U.S. 457, 464 (1941) (“And the Federal Trade Commission concluded in the language of the Clayton Act that these understandings substantially lessened competition and tended to create a monopoly. We hold that the Commission, upon adequate and unchallenged findings, correctly concluded that this practice constituted an unfair method of competition.”).

5 *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233 (1972).

6 *Id.* at 244 (reviewing *FTC v. R.F. Keppel & Bros., Co.*, 291 U.S. 304 (1934)).

Second, Section 5(b) sets out the Commission's procedure for bringing an enforcement action under the statute. Specifically, it requires that the Commission determine that it has "reason to believe" there has been a violation of one or more of the antitrust (or consumer protection) laws that the Commission enforces, and that bringing an enforcement action would be in the public interest.<sup>7</sup> As I have observed on other occasions, the reason-to-believe standard is akin to a prosecutor's probable cause standard.<sup>8</sup>

Why is Section 5 of the FTC Act important to my remarks today about the interplay between patent law and antitrust law? Because, to my way of thinking, the statute reminds us that while innovation certainly can be a key ingredient of competition on the merits, and a key driver of a dynamic and robust economy, the Commission can be said to "promote" innovation only indirectly – through its principal role as a law enforcement agency. In other words, our prime directive is not simply to make competition "better" or consumers "better off" by encouraging more innovation or fostering certain activities deemed to be innovative over other activities that appear not to be.

In saying this, I don't mean to denigrate the important advocacy and policy work of the Commission in the patent – antitrust arena.<sup>9</sup> But the Commission is – first and foremost – a law enforcement agency, and I therefore will focus on what considerations should come into play when we are deciding whether to bring an antitrust case challenging an acquisition, assertion, or licensing of patents. In my view, we as a Commission should recognize: *one*, that as an antitrust institution, we don't have sole guardianship of innovation, and other federal agencies, including notably the U.S. Patent and Trademark Office (PTO), have equally important roles to play; *two*, that even if we are enforcing the antitrust laws in order to promote innovation, we generally still have to anchor our enforcement cases to relevant markets for goods or services in which competition has occurred or is occurring; and *three*, that the public interest underlying our mission means our guardianship of innovation generally needs to benefit competition, and not solely competitors or other purely private interests.

## I.

As I have said, the Commission is a law enforcement agency. Namely, we invoke the judicial power of the federal courts as well as our own administrative powers to enjoin and remedy proven violations of antitrust law.<sup>10</sup> In the 2004 *Trinko* decision,<sup>11</sup> however, the

7 15 U.S.C. § 5(b) (2010).

8 J. Thomas Rosch, Comm'r, Fed. Trade Comm'n, So I Serve as Both a Prosecutor and a Judge – What's the Big Deal? Remarks before the ABA Annual Meeting 4 (Aug. 5, 2010), <http://www.ftc.gov/speeches/rosch/100805abaspeech.pdf>.

9 For recent examples of the Commission's patent-related advocacy work, see Brief of the Federal Trade Commission as Amicus Curiae Supporting Appellants and Urging Reversal, *In re K-Dur Antitrust Litig.*, Nos. 10-2077, -2078 & -2079 (3d Cir. argued Dec. 12, 2011), available at <http://www.ftc.gov/os/2011/05/110518amicusbrief.pdf>; Brief of Amicus Curiae Federal Trade Commission on Rehearing En Banc Supporting Neither Party, *Tivo Inc. v. EchoStar Corp.*, 646 F.3d 869 (Fed. Cir. 2011) (No. 2009-1374), available at <http://www.ftc.gov/os/2010/08/100802tivoechostarbrief.pdf>; Brief of Amicus Curiae Federal Trade Commission on Rehearing En Banc Supporting Neither Party, *Princo Corp. v. ITC*, 616 F.3d 1318 (Fed. Cir. 2010) (No. 2007-1386), available at <http://www.ftc.gov/os/2010/02/100219amicusbrief.pdf>. The Commission's policy work includes, notably, the several reports prepared by staff on the interplay between patent law and antitrust law. FED. TRADE COMM'N, THE EVOLVING IP MARKETPLACE: ALIGNING PATENT NOTICE AND REMEDIES WITH COMPETITION (2011), available at <http://www.ftc.gov/os/2011/03/110307patentreport.pdf> [hereinafter PATENT REPORT]; U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, ANTITRUST ENFORCEMENT AND INTELLECTUAL PROPERTY RIGHTS: PROMOTING INNOVATION AND COMPETITION (2007), available at <http://www.ftc.gov/reports/innovation/P040101PromotingInnovationandCompetitionrpt0704.pdf> [hereinafter ENFORCEMENT REPORT]; FED. TRADE COMM'N, TO PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW AND POLICY (2003), available at <http://www.ftc.gov/os/2003/10/innovationrpt.pdf> [hereinafter INNOVATION REPORT].

10 See 15 U.S.C. §§ 21(b), 45, 53(b) (2010).

11 *Verizon Comm'ns Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398 (2004).



Supreme Court cautioned that we, as antitrust enforcers, “must always be attuned to the particular structure and circumstances of the industry at issue.”<sup>12</sup> Specifically, the Court stressed that “[o]ne factor of particular importance is the existence of a regulatory structure designed to deter and remedy anticompetitive harm. Where such a structure exists, the additional benefit to competition provided by antitrust enforcement will tend to be small, and it will be less plausible that the antitrust laws contemplate such additional scrutiny.”<sup>13</sup>

In my view, *Trinko’s* cautionary note squarely applies to our enforcement approach in the patent-antitrust arena. That is to say, as antitrust enforcers we need to be cognizant of the regulatory structure that already exists in respect to patents. Significantly, last September, President Obama signed into law the Leahy-Smith America Invents Act (AIA),<sup>14</sup> the first major overhaul of the U.S. patent system since 1952.<sup>15</sup> In passing the AIA, the U.S. Congress inserted in the statute its expressed “sense . . . that the patent system should promote industries to continue to develop new technologies that spur growth and create jobs across the country which includes protecting the rights of small businesses and inventors from predatory behavior that could result in the cutting off of innovation.”<sup>16</sup>

To ensure that the patent system properly promotes innovation, Congress therefore enacted a number of reform measures in the AIA. Let me mention two particular measures that arguably inform our antitrust enforcement agenda in this arena.<sup>17</sup>

First, the AIA created new procedures for interested third parties to seek post-grant and inter partes review of the validity of issued patents, to be heard by a newly created, administrative Patent Trial and Appeal Board.<sup>18</sup> These procedures appear to be designed to encourage and favor an administrative resolution of questions of patent validity by the PTO, in the first instance, over a judicial resolution by the courts, which can be more costly and time-consuming.<sup>19</sup>

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12 *Id.* at 411.

13 *Id.* at 412. It bears noting that *Trinko* was unanimously decided, and Justice Scalia’s opinion of the Court had bipartisan support from Chief Justice Rehnquist and Justices O’Connor and Kennedy, on the one hand, and Justices Ginsburg and Breyer, on the other.

14 Leahy-Smith America Invents Act, Pub. L. No. 112-29, 125 Stat. 284 (2011).

15 Press Release, U.S. Dept. of Commerce, President Obama Signs America Invents Act and Announces New Steps to Help Entrepreneurs Create Jobs (Sept. 16, 2011), <http://www.commerce.gov/news/press-releases/2011/09/16/president-obama-signs-america-invents-act-and-announces-new-steps-hel>.

16 Leahy-Smith America Invents Act § 30, 125 Stat. at 339.

17 Another reform measure of interest – given the Commission’s recent policy work in this arena – is the AIA’s direction to the Comptroller General, through his Government Accountability Office (GAO), to study the consequences of patent litigation brought by the so-called “non-practicing entities” (NPEs) or “patent assertion entities” (PAEs). *Id.* § 34(a), 125 Stat. at 340. The Commission had discussed the potentially adverse impact of PAEs on innovation at length in its 2011 patent report. *See* Patent Report, *supra* note 9, at 8-9 & n.5, 27, 29, 30, 50-51 & n.2, 58-72. Now the GAO will study the problem, by looking at the volume of cases brought by NPEs and PAEs over a twenty-year period; the number of cases found to be without merit by the courts; the time required to resolve the claims through litigation and the costs of litigation for all stakeholders; the economic impact of such litigation on the U.S. economy, including inventors and consumers; and any benefits to commerce supplied by NPEs and PAEs. Leahy-Smith America Invents Act § 34(b), 125 Stat. at 340. A report to the Judiciary Committees of the Senate and the House is due no later than one-year anniversary of the AIA’s enactment, and it is supposed to recommend changes that might be made to the laws and regulations to minimize any negative impact flowing from NPE- or PAE-instituted litigation. *Id.* § 34(c), 125 Stat. at 340.

18 Leahy-Smith America Invents Act § 6, 125 Stat. at 299-313 (provisions relating to inter partes and post-grant review; codified at 35 U.S.C. §§ 311-19, 321-29 (2011)); *id.* § 7, 125 Stat. at 313-15 (provisions relating to the Patent Trial and Appeal Board; codified as amended at 35 U.S.C. §§ 6, 141 (2011)). The inter partes and post-grant reviews are similar procedures in that both are designed to permit a third party to challenge the validity of an issued patent in the PTO. But in terms of timing and scope, they are different. Post-grant review may be sought only within the first nine months after issuance whereas inter partes review may be sought nine months after issuance, or after termination of post-grant review, whichever is later. *Id.* § 6, 125 Stat. at 299, 306 (codified at 35 U.S.C. §§ 311(c), 321(c) (2011)). Moreover, the invalidity grounds that may be raised in post-grant review are broader than those that may be raised in inter partes review, the former procedure encompassing any ground of invalidity (except an alleged failure to disclose best mode), and the latter procedure being limited to lack of novelty and obviousness based on prior art patents and printed publications. *Id.* (codified at 35 U.S.C. §§ 311(b), 321(b) (2011)).

19 *See id.* § 6, 125 Stat. at 300-02, 307-08 (codified at 35 U.S.C. §§ 315, 325 (2011)); detailing the relationship of these procedures to other proceedings, including stays of civil actions filed subsequently by a party that has already petitioned the PTO for inter partes or post-grant review).

Second, the AIA also creates a supplemental examination procedure for patent owners to ask the PTO “to consider, reconsider, or correct information believed to be relevant to the patent.”<sup>20</sup> If the PTO determines that the submitted information raises “a substantial new question of patentability,” it can order a reexamination of the patent.<sup>21</sup> Importantly, the new statute provides that, with two stated exceptions, a patent cannot be held unenforceable based on conduct “relating to information that had not been considered, was inadequately considered, or was incorrect in a prior examination of the patent if the information was considered, reconsidered, or corrected during a supplemental examination of the patent.”<sup>22</sup> Clearly, a purpose of this new procedure is to encourage full consideration of all information that is relevant to patentability, and to discourage charges of inequitable conduct based on the mere fact that some relevant information might not have been fully or correctly considered during the original examination.

At the same time, however, the AIA directs the PTO Director, during the course of the supplemental examination and reexamination proceeding, to refer any discovered instances of “material fraud on the Office that may have been committed in connection with the patent” to the Attorney General for possible criminal prosecution or other action as appropriate.<sup>23</sup> Furthermore, the statute makes clear that it is not to be construed, *inter alia*, “to preclude the imposition of sanctions based upon criminal or antitrust laws (including section 1001(a) of title 18, the first section of the Clayton Act, and section 5 of the Federal Trade Commission Act to the extent that section relates to unfair methods of competition).”<sup>24</sup> The new statute thus also evinces an intent to punish instances of actual misconduct before the PTO.

Why might these reform measures that I have described be significant to antitrust enforcement? First of all, U.S. antitrust law has long recognized that the enforcement of a patent procured by fraud on the PTO, or asserted in bad faith by the patent owner (for example, with knowledge of its invalidity), can potentially give rise to a violation of Section 2 of the Sherman Act for monopolization or attempted monopolization. We even have popular names for those types of Section 2 claims – the former is known as a *Walker Process* claim<sup>25</sup> and the latter is known as a *Handgards* claim.<sup>26</sup> But the same cases that have recognized and lent their names to those types of Section 2 claims also make clear that the bar for proving fraudulent procurement or bad faith enforcement has been purposely set high, in order to prevent private, treble-damages, antitrust litigation from burdening or

20 *Id.* § 12, 125 Stat. at 325 (codified at 35 U.S.C. § 257(a) (2011)).

21 *Id.*, 125 Stat. at 325-26 (codified at 35 U.S.C. § 257(b) (2011)).

22 *Id.*, 125 Stat. at 326 (codified at 35 U.S.C. § 257(c) (2011)). The two exceptions are (1) allegations of inequitable conduct that have already been pled or described with particularity in a pending civil action or in a Paragraph IV notice before the date of the supplemental examination request relating to the same information at issue; and (2) defenses of inequitable conduct raised in an infringement action or an ITC Section 337 unfair import investigation based on information that was the subject of a supplemental examination request if the supplemental examination and reexamination have not concluded before the date the action or investigation is brought. *Id.*

23 *Id.*, 125 Stat. at 326-27 (codified at 35 U.S.C. § 257(e) (2011)). For example, declarations submitted to the PTO come with the warning that willful false statements are subject to criminal prosecution under 18 U.S.C. § 1001 (2011).

24 *Id.*, 125 Stat. at 327 (codified at 35 U.S.C. § 257(f) (2011)).

25 *Walker Process Equip., Inc. v. Food Mach. & Chem. Corp.*, 382 U.S. 172, 174 (1965) (“We have concluded that the enforcement of a patent procured by fraud on the Patent Office may be violative of § 2 of the Sherman Act provided the other elements necessary to a § 2 case are present.”).

26 *Handgards, Inc. v. Ethicon, Inc.*, 601 F.2d 986, 993 (9th Cir. 1979) (holding that “infringement actions initiated and conducted in bad faith contribute nothing to the furtherance of the policies of either the patent law or the antitrust law” and that the district court was therefore correct in holding that “such actions may constitute an attempt to monopolize violative of Section 2 of the antitrust law”), *cert. denied*, 444 U.S. 1025 (1980). *Accord* *Loctite Corp. v. Ultraseal Ltd.*, 781 F.2d 861, 876-77 (Fed. Cir. 1985), *overruled on other grounds by* *Nobelpharma AB v. Implant Innovations, Inc.*, 141 F.3d 1059, 1068 (Fed. Cir. 1998) (*en banc* in relevant part).

chilling the legitimate exercise of patent rights.<sup>27</sup> As a result of these standards, successful *Walker Process* and *Handgards* claims have been few and far between.<sup>28</sup>

At the same time, however, antitrust legal scholars and economists (including two economists who respectively have led the Commission's Bureau of Economics and the Economic Analysis Group of the Department of Justice's Antitrust Division) have mused about the adverse impact of "weak" or potentially invalid patents on innovation and social welfare.<sup>29</sup> Although we all may generally agree that "weak" or potentially invalid patents are not good for the health of an innovative and competitive economy, the question on the table is whether *antitrust law* is the right instrument to attack those patents.<sup>30</sup> To my way of thinking, the answer is – in most cases – no, and the AIA-instituted reforms correctly put the general problem of invalid patents squarely back in the lap of the agency best situated to remedy it – the PTO.

Why do I say that? Here are three reasons. First, we have to recognize that patents – whether strong or weak, valid or invalid – are the product of a regulatory process administered by the PTO. The law presumes that the PTO, as an administrative agency, acts properly and according to law when it examines patent applications and issues patents.<sup>31</sup> That presumption of administrative correctness in turn gave rise to a common-law presumption of patent

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- 27 *Walker Process*, 382 U.S. at 176 (expressing a lack of concern with the prospect of "innumerable vexatious suits," or the punitive consequences of private, treble-damages claims brought under Section 2 of the Sherman Act and Section 4 of the Clayton Act, because "[i]t must be remembered that we deal only with a special class of patents, i.e., those procured by intentional fraud") & 180 (Harlan, J., concurring) (emphasizing that the Court is *not* holding that private antitrust suits can reach patent monopolies "that for one reason or another may turn out to be voidable under one or more of the numerous technicalities attending the issuance of a patent"); *Handgards*, 601 F.2d at 993 (recognizing the dilemma that "bad faith" "is a subjective state of mind the existence of which, while not susceptible to certain proof, easily can spring from suggestive and weakly corroborative circumstances," and therefore an antitrust court must have "the means whereby the bad faith infringement action can be identified post hoc with a sufficiently high degree of certainty to make it highly improbable that the action in fact was brought in good faith") & 996 (concluding that the solution "is to erect such barriers to antitrust suits as are necessary to provide reasonable protection for the honest patentee who brings an infringement action to protect his legal monopoly").
- 28 See, e.g., *C.R. Bard, Inc. v. M3 Sys., Inc.*, 157 F.3d 1340 (Fed. Cir. 1998) (affirming the jury verdict on M3's antitrust counterclaim); *Handgards, Inc. v. Ethicon, Inc.*, 743 F.2d 1282 (9th Cir. 1984) (affirming the jury's antitrust verdict against Ethicon), *cert. denied*, 469 U.S. 1190 (1985).
- 29 See, e.g., Josh Lerner, *The Litigation of Financial Innovations*, 53 J.L. & ECON. 807, 827 (2010) (concluding that observed patterns in litigation over patents on "financial inventions" are consistent with models of strategic exploitation of weak patents, which "can have socially detrimental effects beyond the deadweight losses associated with the licensing payments [. . . ranging] from distortions in the incentives to innovate to spending on socially unproductive litigation"); Joseph Farrell & Carl Shapiro, *How Strong Are Weak Patents?*, 98 AM. ECON. REV. 1347, 1347 (2008) ("The bigger issue, we suggest, concerns patents that are not clearly invalid, but are weak – they may well be invalid, but nobody knows for sure without conclusive litigation."); Christopher R. Leslie, *The Anticompetitive Effects of Unenforced Invalid Patents*, 91 MINN. L. REV. 101, 104 (2006) ("But antitrust law's current treatment of invalid patents remains inadequate. While antitrust law recognizes that enforcing invalid patents can constitute illegal monopolization or attempted monopolization, courts have refused to consider the anticompetitive effects of simply having an invalid patent."); Mark A. Lemley & Carl Shapiro, *Probabilistic Patents*, J. ECON. PERSPECTIVES, Spring 2005, at 75, 88 ("What is driving this striking result that even a weak patent can command royalties approaching those of an ironclad patent covering the same claims? The key insight is that invalidating a patent generates significant positive externalities, and activities that generate positive externalities are undersupplied.").
- 30 For example, Professor Christopher Leslie has argued that antitrust law should do more to rid society of invalid patents. See Christopher R. Leslie, *Invention, Creation, & Public Policy Symposium: Innovation & Competition Policy: Antitrust and Patent Law as Component Parts of Innovation Policy*, 34 IOWA J. CORR. L. 1259, 1289 (2009) ("Too many judges appear to assume that patent problems should be addressed solely through patent law. This is a mistake. Analyzing these problems through an antitrust lens provides a more effective response to patent misconduct that stifles innovation."); Leslie, *supra* note 29, at 183 (advocating for the elimination of the "enforcement" requirement in *Walker Process* claims so that the mere possession of "knowingly invalid" patents would violate the antitrust laws).
- 31 *Am. Hoist & Derrick Co. v. Sowa & Sons, Inc.*, 725 F.2d 1350, 1359 (Fed. Cir.) ("When no prior art other than that which was considered by the PTO examiner is relied on by the attacker, he has the added burden of overcoming the deference that is due to a qualified government agency presumed to have properly done its job, which includes one or more examiners who are assumed to have some expertise in interpreting the references and to be familiar from their work with the level of skill in the art and whose duty it is to issue only valid patents. In some cases a PTO board of appeals may have approved the issuance of the patent."), *cert. denied*, 469 U.S. 821 (1984). See also *FCC v. Schreiber*, 381 U.S. 279, 296 (1965) (observing that an administrative agency (e.g., the FCC) is entitled to the presumption that it will act properly and according to law).

validity, now codified in our Patent Act.<sup>32</sup> Viewed against this regulatory backdrop, the incremental benefits of bringing antitrust enforcement against weak or potentially invalid patents are not particularly compelling – absent strong evidence that the patent in question was obtained by intentional fraud on the PTO,<sup>33</sup> or is manifestly defective such that its enforcement would be regarded as objectively baseless and subjectively in bad faith.<sup>34</sup> Those latter two circumstances describe instances of regulatory failure where it would be appropriate for antitrust enforcers to discard the presumption that the PTO has done its job properly and according to law.<sup>35</sup>

That brings to me to the second reason, which is that we would expect instances of regulatory failure, that is, intentional fraud on the PTO or a manifestly defective patent, to be rare. The mine run of cases will be those numerous instances that the *Walker Process* Court termed “technical fraud,”<sup>36</sup> that is, errors and omissions that invariably arise because the patenting process has been, and still remains, an exercise of human judgment (whether on the part of the applicant or the examiner) within a complex set of rules and procedures. Antitrust law is ill-suited to address the mine run of cases because such challenges would produce the very scenario that the *Walker Process* Court sought to avoid – the risk that a patent owner will be subjected to “innumerable vexatious suits” that may chill innovation.<sup>37</sup> Indeed, we have seen this very scenario play out in the courts in respect to the oft-asserted and “overplayed” defense of inequitable conduct – the kissing cousin of fraudulent procurement, which the Federal Circuit (the court of appeals that has exclusive jurisdiction over patent cases) has repeatedly characterized as “an absolute plague” on the courts and the patent system.<sup>38</sup> Consequently, last year, in the *Therasense* case, that court sat *en banc* to fix the problem by tightening the standard for proving inequitable conduct,<sup>39</sup> thereby bringing the doctrine virtually congruent with intentional fraud under *Walker Process*.<sup>40</sup>

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- 32 35 U.S.C. § 282 (2011) (“A patent shall be presumed valid. . . . The burden of establishing invalidity of a patent or any claim thereof shall rest on the party asserting such invalidity.”). See *American Hoist*, 725 F.2d at 1359 (observing that section 282 merely codified what had already been recognized and accepted in the common law – that a government agency like the PTO is presumed to do its job (citing *Radio Corp. of Am. v. Radio Eng'g Labs., Inc.*, 293 U.S. 1, 7 (1934)); accord *Microsoft Corp. v. i4i Ltd. P'ship*, 131 S. Ct. 2238, 2243, 2251-52 (2011) (reaffirming the clear-and-convincing-evidence standard for overcoming the presumption of validity as a choice made by Congress when it enacted the 1952 Patent Act, and declining “to judge the comparative force of [the] policy arguments” for and against a heightened standard of proof, including Microsoft’s argument that the prevailing standard “dampens innovation by unduly insulating ‘bad’ patents from invalidity challenges”).
- 33 In this discussion, I am lumping inequitable conduct before the PTO together with intentional fraud. As observed later, there may not be much of a difference, if any, between the two types of conduct after the Federal Circuit tightened the requirements of intent and materiality for inequitable conduct in *Therasense, Inc. v. Becton, Dickinson & Co.*, 649 F.3d 1276 (Fed. Cir. 2011) (*en banc*). See *infra* notes 38-40 and accompanying text.
- 34 In *Professional Real Estate Investors, Inc. v. Columbia Pictures Industries, Inc.*, the Supreme Court outlined a two-part definition of “sham” litigation, which applies to bad faith enforcement of patents: “First, the lawsuit must be objectively baseless in the sense that no reasonable litigant could realistically expect success on the merits. . . . [Second], the court should focus on whether the baseless lawsuit conceals ‘an attempt to interfere directly with the business relationships of a competitor,’ . . . through the ‘use [of] the governmental process – as opposed to the outcome of that process – as an anticompetitive weapon[.]’” 508 U.S. 49, 60-61 (1993) (citations omitted).
- 35 In *Precision Instrument Manufacturing Co. v. Automotive Maintenance Machinery Co.*, the Supreme Court, in articulating a duty of candor to the PTO regarding information relevant to the prosecution of a patent application, recognized the PTO’s responsibility “to safeguard the public in the first instance against fraudulent patent monopolies.” 324 U.S. 806, 818 (1945). The point here is that antitrust enforcement can and should intervene if it is shown that the PTO has failed to perform, or been prevented from performing, its gatekeeping role to protect the public from invalid or fraudulent patent monopolies.
- 36 *Walker Process Equip., Inc. v. Food Mach. & Chem. Corp.*, 382 U.S. 172, 177 (1965). See also *id.* at 179, 180 (Harlan, J., concurring).
- 37 *Id.* at 176; see also *id.* at 180 (Harlan, J., concurring).
- 38 *Therasense, Inc. v. Becton, Dickinson & Co.*, 649 F.3d 1276, 1289 (Fed. Cir. 2011) (*en banc*) (citing prior decisions of that court).
- 39 *Id.* at 1290 (“This court now tightens the standards for finding both intent and materiality in order to redirect a doctrine that has been overused to the detriment of the public.”). The Federal Circuit reaffirmed that inequitable conduct requires proof of specific intent to deceive the PTO, which means clear and convincing evidence “that the applicant knew of the reference, knew that it was material, and made a deliberate decision to withhold it.” *Id.* Constructive knowledge is not sufficient, nor is inference based on the materiality of the undisclosed prior art reference. *Id.* Moreover, intent and materiality are separate requirements to be independently analyzed, and a sliding scale whereby a strong showing of one element may compensate for a weak showing of the other element is inappropriate. *Id.* Concluding that a higher intent standard alone did not reduce the number of inequitable conduct cases, the Federal Circuit also raised the bar for proving materiality by introducing a “but-for” test, i.e., whether the PTO would have allowed the claim or patent if it had been aware of the undisclosed reference. *Id.* at 1291-92.
- 40 Cf. *Dippin’ Dots, Inc. v. Mosey*, 476 F.3d 1337, 1346-47 (Fed. Cir.) (observing that the then-prevailing inequitable conduct standard was broader and more inclusive than *Walker Process* fraud because the latter required a greater showing of both intent and materiality than the former), *cert. denied*, 552 U.S. 948 (2007). *Therasense* has more or less closed that gap. See generally George G. Gordon & Stephen A. Stack, *Aligning Antitrust and Patent Law: Side Effects from the Federal Circuit’s Cure for the Inequitable Conduct “Plague” in Therasense*, ANTITRUST, Fall 2011, at 88.

A third reason is that antitrust enforcement, like most federal court litigation, can be very expensive and time-consuming. Litigants sometimes blithely ignore or forget the fact that *Walker Process* and *Handgards* claims require proof as well of the other elements of a Section 2 violation, which includes defining a relevant antitrust market and demonstrating the existence of monopoly or market power in that market.<sup>41</sup> That exercise in most cases requires some econometric analysis provided by a testifying economist, which consumes time and resources, not only of the litigants but also of the courts.

Recognizing that litigation is generally a less-than-desirable vehicle for resolving garden-variety issues involving weak or potentially invalid patents, the AIA-instituted reform measures redirect the general problem back to the PTO through the administrative channels of post-grant review, inter partes review, and supplemental examination. This approach makes sense because it will allow the PTO to bring its regulatory expertise to bear on issues of validity, and thereby free up the courts – and the antitrust enforcement agencies – to focus on the egregious cases that may well warrant the imposition of treble-damages liability under the antitrust laws.

There is potentially an added benefit to the AIA-instituted reform measures from the standpoint of antitrust enforcement. Specifically, as mentioned earlier, the new supplemental examination procedure directs the PTO Director to report any “material fraud on the Office” that may have been committed in connection with a patent being reexamined to the Attorney General for possible enforcement action.<sup>42</sup> Although we as a Commission do not have criminal jurisdiction, we wield enforcement powers under Section 5 to combat cases involving intentional fraud and inequitable conduct before the PTO as “unfair methods of competition,” which the AIA has explicitly recognized.<sup>43</sup>

Perhaps the best known example of our enforcement in this arena is the tetracycline case we brought against Pfizer, American Cyanamid, and others in the 1960s.<sup>44</sup> In that case, the Commission charged and found that Pfizer had violated Section 5, *inter alia*, by making “deliberately false and misleading statements to, and with[holding] material information from, the Patent Office in securing its tetracycline patent,” and by using that tetracycline patent to restrain competition, and to create a monopoly, in the manufacture and sale of the drug.<sup>45</sup> The Commission’s decision was twice reviewed by the Sixth Circuit and affirmed the second time.

In the first review, however, the court of appeals overturned the Commission’s findings with respect to the inequitable conduct charge for lack of substantial evidence because the Commission – without calling the PTO employee who had examined Pfizer’s

41 *Walker Process*, 382 U.S. at 177 (“To establish monopolization or attempt to monopolize a part of trade or commerce under § 2 of the Sherman Act, it would then be necessary to appraise the exclusionary power of the illegal patent claim in terms of the relevant market for the product involved. Without a definition of that market there is no way to measure Food Machinery’s ability to lessen or destroy competition.”). See, e.g., *Delano Farms Co. v. Cal. Table Grapes Comm’n*, 655 F.3d 1337, 1350-52 (Fed. Cir. 2011) (affirming the district court’s dismissal of the plaintiff’s *Walker Process* claim for failure to allege a plausible basis for finding that a variety of grapes constitutes its own relevant submarket); *Unitherm Food Sys., Inc. v. Swift-Eckrich, Inc.*, 375 F.3d 1341, 1363-65 (Fed. Cir. 2004) (concluding that the district court had erred in letting the verdict of *Walker Process* liability stand because the plaintiff had failed to provide any evidence of economic substitutability critical to market definition), *rev’d on other grounds*, 546 U.S. 394 (2006); *Neumann v. Reinforced Earth Co.*, 786 F.2d 424, 429-30 (D.C. Cir.) (Bork, J.) (affirming the district court’s judgment notwithstanding the verdict in a sham litigation case because the plaintiff failed to meet his burden of defining a relevant market), *cert. denied*, 479 U.S. 851 (1986).

42 Leahy-Smith America Invents Act, Pub. L. No. 112-29, 125 Stat. 284, 326-27 (2011) (codified at 35 U.S.C. § 257(e) (2011)).

43 *Id.*, 125 Stat. at 327 (codified at 35 U.S.C. § 257(f) (2011)).

44 See *Charles Pfizer & Co., Inc. v. FTC*, 401 F.2d 574 (6th Cir. 1968); *Am. Cyanamid Co. v. FTC*, 363 F.2d 757 (6th Cir. 1966). Notably, the Supreme Court had decided *Walker Process* during the same period, in 1965.

45 *Cyanamid*, 363 F.2d at 762. The Commission also found that American Cyanamid aided and abetted Pfizer’s inequitable conduct on the PTO by making erroneous representations to the PTO about the patentability of tetracycline, and failing to correct those representations or disclosing that they were inaccurate until after the PTO had granted the patent. *Id.*

tetracycline patent application to testify – had “[drawn] opposite inferences and reached opposite conclusions” from its hearing examiner as to what that PTO employee supposedly knew, intended, and required in connection with the processing of patent applications.<sup>46</sup> The Sixth Circuit held that the PTO employee’s testimony would have conclusively resolved the issue of inequitable conduct, and that there was no reason why he should not have been subpoenaed to testify in the public interest.<sup>47</sup>

The problem with the Sixth Circuit’s first ruling in *American Cyanamid* is that there was – and still is – a general PTO policy against patent examiners being called as witnesses, especially if the questions being asked will delve into their mental processes, analyses, or conclusions in acting on a patent application.<sup>48</sup> If that policy were strictly enforced, it would arguably make the “but-for” materiality required for intentional fraud or inequitable conduct<sup>49</sup> more difficult to prove – at least from the standpoint of having direct evidence bearing on this issue.

But the AIA-instituted supplemental examination procedure may get around that problem because it places an obligation on the PTO Director to identify and report instances of “material fraud.” Implicit in that obligation – it would seem – is an expectation of cooperation from the PTO in providing whatever testimony and other evidence needed to prove the putative fraud, whether as a criminal violation or an antitrust violation. Moreover, because the PTO Director would be the one reporting instances of “material fraud” perpetrated on his agency, that will arguably minimize the risk of false positives for antitrust enforcement and conserve resources to combat only meritorious and provable claims of intentional fraud or inequitable conduct.

Let me say a brief word about appellate jurisdiction over patent-antitrust claims. As the Eleventh Circuit recently reminded us in *FTC v. Watson Pharmaceuticals, Inc.*,<sup>50</sup> even prior to the enactment of the AIA, Congress had given the Federal Circuit exclusive jurisdiction over appeals in cases “arising under” the patent laws.<sup>51</sup> Obviously, an antitrust claim does not “arise under” patent law from the standpoint of federal patent law creating that cause of action.<sup>52</sup>

Federal Circuit jurisdiction can still exist, however, if the “right to relief necessarily depends on resolution of a substantial question of federal patent law, in that patent law is a

46 *Id.* at 779.

47 *Id.* at 778, 779.

48 *Id.* at 778-79; see 37 C.F.R. § 104.23(a) (2011) (limiting testimony for private litigants, if authorized in advance, to facts within the examiner’s personal knowledge, and permitting expert or opinion testimony only upon a showing that exceptional circumstances so warrant and that the anticipated testimony will not be adverse to the interests of the PTO or the United States); U.S. PAT. & TRADEMARK OFFICE, MANUAL OF PAT. EXAMINING PROC. § 1701 (8th ed. 2001 & rev. 2010) (“Members of the patent examining corps are cautioned to be especially wary of any inquiry from any person outside the USPTO, including an employee of another U.S. Government agency, the answer to which might indicate that a particular patent should not have issued.”); U.S. PAT. & TRADEMARK OFFICE, MANUAL OF PAT. EXAMINING PROC. § 1701.01 (8th ed. 2001 & rev. 2010) (taking the position that it is impermissible “[t]o inquire into the bases, reasons, mental processes, analyses, or conclusions of [a PTO] employee in performing the quasi-judicial function”). See also Note, *Legal Basis for Precluding a Patent Examiner from Testifying*, 42 IND. L.J. 255 (1967) (commenting on the Sixth Circuit’s decision in *American Cyanamid*).

49 *Thenasense, Inc. v. Becton, Dickinson & Co.*, 649 F.3d 1276, 1291 (Fed. Cir. 2011) (*en banc*); *Dippin’ Dots, Inc. v. Mosey*, 476 F.3d 1337, 1347 (Fed. Cir.), *cert. denied*, 552 U.S. 948 (2007).

50 No. 10-12729, 2012 U.S. App. LEXIS 8377, at \*45 (11th Cir. Apr. 25, 2012).

51 28 U.S.C. § 1295(a) (2011) (vesting the Federal Circuit with exclusive jurisdiction over appeals of final district court decisions “in any civil action arising under, or in any civil action in which a party has asserted a compulsory counterclaim arising under, any Act of Congress relating to patents or plant variety protection”). The AIA amended section 1295(a) to include exclusive jurisdiction over actions involving compulsory counterclaims for patent infringement, thereby overruling the specific holding in *Holmes Group, Inc. v. Vornado Air Circulation Systems, Inc.*, 535 U.S. 826, 830-32 (2002). See Leahy-Smith America Invents Act, Pub. L. No. 112-29 § 19(b), 125 Stat. 284, 331-32 (2011) (codified as amended at 28 U.S.C. § 1295(a)(1) (2011)).

52 *Christianson v. Colt Indus. Operating Corp.*, 486 U.S. 800, 809 (1988); *In re DDAVP Direct Purchaser Antitrust Litig.*, 585 F.3d 677, 685 (2d Cir. 2009).

necessary element of one of the well-pleaded claims.<sup>53</sup> Applying that jurisdictional test, *Walker Process* claims have been held to “arise under” federal patent law because a necessary element of the claim – fraudulent procurement of the patent – turns on a substantial question of patent law,<sup>54</sup> which requires an application of Federal Circuit precedent.<sup>55</sup> It is by no means clear, however, whether the Federal Circuit would have exclusive jurisdiction over patent–antitrust claims, including *Walker Process* claims, decided by the Commission under its Part 3 administrative process, as opposed to the district courts, because a different appellate statute governs.<sup>56</sup>

## II.

Let me now turn to a second consideration that we as a Commission should keep in mind when we are deciding whether to bring an antitrust case challenging the acquisition, assertion, or licensing of patents. As a law enforcement agency, the Commission promotes or protects innovation principally by bringing cases that charge some conduct or transaction as violations of the antitrust laws that we enforce. Accordingly, even if we are concerned about the adverse impact of some conduct or transaction on innovation, we still must translate that concern into an antitrust law violation that we can allege and prove, either in federal court or in our own adjudicative process.<sup>57</sup> That generally means we still should anchor our enforcement cases to markets for goods or services in which competition has occurred or is occurring, even though patents may be the main source of concern, because those commercial markets are what the antitrust laws were enacted to protect.<sup>58</sup>

The principal statute that the Commission enforces is Section 5 of the FTC Act, which outlaws, *inter alia*, “unfair methods of competition in or affecting commerce.”<sup>59</sup> To be sure, Section 5’s proscription is not limited to practices that violate the letter or the spirit of the antitrust laws.<sup>60</sup> If the Commission is enforcing the statute as an antitrust law, however, then its jurisdiction would be based on the existence of present or potential competition, and the harm or injury to such competition caused by, or likely to be caused by, the employment of practices that are deemed “unfair.”<sup>61</sup> When used as an antitrust

53 *Id.*

54 *DDAVP*, 585 F.3d at 685; *In re Ciprofloxacin Hydrochloride Antitrust Litig.*, 544 F.3d 1323, 1330 n.8 (Fed. Cir. 2008). Although *Ciprofloxacin* was principally an antitrust case challenging the legality of a “pay-for-delay” settlement under Sections 1 and 2 of the Sherman Act and related state antitrust and consumer protection laws, the plaintiffs amended their complaint to add a “state law *Walker Process* type antitrust claim.” That may have provided the “hook” needed to give the Federal Circuit exclusive jurisdiction over the ensuing appeal. *Id.* at 1329-30. In *Watson Pharmaceuticals*, however, apparently the Eleventh Circuit intimated that a “pay-for-delay” settlement case, which raises a question regarding the strength, validity, or exclusionary power of the patent, is a case “arising under” patent law and thus subject to the Federal Circuit’s exclusive jurisdiction. 2012 U.S. App. LEXIS 8377, at \*46 (“We are ill-equipped to make a judgment about the merits of a patent infringement claim, which is what we would have to do in order to decide how likely the claim was to prevail if it had been pursued to the end. The FTC’s approach is in tension with Congress’ decision to have appeals involving patent issues decided by the Federal Circuit.”).

55 *Nobelpharma AB v. Implant Innovations, Inc.*, 141 F.3d 1059, 1068 (Fed. Cir. 1998) (*en banc* in relevant part).

56 *Compare* 28 U.S.C. § 1295(a)(1) (2011) (conferring exclusive jurisdiction to the Federal Circuit over *final decisions of the district courts* in patent cases), *with* 15 U.S.C. § 45(c) (2010) (conferring jurisdiction to the regional Circuits over *Commission decisions* based on “where the method of competition or the act or practice in question was used or where such person, partnership, or corporation resides or carries on business”).

57 *See generally* 16 C.F.R. pt. 3 (2012).

58 This does not mean that when anticompetitive effects have occurred, we are barred from “backing into” the relevant market, i.e., defining the relevant market after the effects have been identified. *See* Concurring Opinion of J. Thomas Rosch, Comm’r, Fed. Trade Comm’n, at 1–2, *Polypore Int’l, Inc.*, No. 9327, 2010 FTC LEXIS 96, at \*2-6 (F.T.C. Dec. 13, 2010), *available at* <http://www.ftc.gov/os/adjpro/d9327/101213polyporeconcurringopinion.pdf>. Notably, in *FTC v. Indiana Federation of Dentists*, the Supreme Court upheld the Commission’s “finding of actual, sustained adverse effects on competition in those areas where [Indiana Federation] dentists predominated, viewed in light of the reality that markets for dental services tend to be relatively localized,” as legally sufficient for a rule-of-reason analysis. 476 U.S. 447, 461 (1986). As the Court explained, because the only purpose of the inquiries into market definition and market power is to assess the potential of a challenged restraint to cause adverse effects of competition, “proof of actual detrimental effects, such as a reduction of output,” can obviate the need to make those inquiries. *Id.* at 460-61 (quoting 7 PHILLIP AREEDA, ANTITRUST LAW ¶ 1511, at 429 (1986)). In other words, market definition is but a means to an end, not an end unto itself.

59 15 U.S.C. § 45(a)(1) (2010).

60 *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233, 239 (1972); *Atl. Ref. Co. v. FTC*, 381 U.S. 357, 369 (1965).

61 *FTC v. Raladam Co.*, 283 U.S. 643, 649, 654 (1931).

statute, Section 5 protects “the public from the evils likely to result from the destruction of competition or the restriction of it in a substantial degree, and this presupposes the existence of some substantial competition to be affected, since the public is not concerned in the maintenance of competition which itself is without real substance.”<sup>62</sup> This is in line with the objectives of the Sherman Act<sup>63</sup> and the Clayton Act,<sup>64</sup> which the Commission also enforces.

In the patent-antitrust arena, the fact that an antitrust law violation is typically premised on a showing of actual or likely substantial harm to competition in some market for goods or services means that we should not just focus on the patents themselves, even though they may be the main source of the concern. A case that illustrates this very point is the Pfizer tetracycline patent litigation that I have already mentioned.

In *American Cyanamid*, one of the issues before the Sixth Circuit was whether the Commission had jurisdiction – assuming Pfizer’s tetracycline patent had been obtained by misrepresentation and improper conduct before the PTO – to hold that Pfizer’s use of that patent for the purpose of excluding competition was an unfair method of competition proscribed by Section 5, and to order as a remedy the compulsory licensing of that patent on a reasonable royalty basis.<sup>65</sup> Pfizer argued that the Commission was overstepping its jurisdiction under Section 5 by essentially “second-guessing” the actions of the PTO as to the validity of Pfizer’s patent.<sup>66</sup> The court of appeals disagreed, however, with Pfizer’s characterization that the Commission was passing judgment on the validity of the patent; the gravamen of Pfizer’s violation of Section 5 lay not in its allegedly obtaining the patent by misrepresentation, standing alone, but rather, in its subsequent use of that patent to exclude competition in the tetracycline product market by suing and threatening to sue its competitors.<sup>67</sup>

In other words, as much as we may deplore misrepresentation and other misconduct before the PTO, which, to be sure, can lead to the issuance of weak or questionable patents that dampen or chill innovation, it is the use of such patents to monopolize or suppress competition in a relevant goods or service market that triggers the intervention of the antitrust laws,<sup>68</sup> and the Commission’s enforcement jurisdiction

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- 62 *Id.* at 647-48. As the Supreme Court observed in *S&H, Raladam* was subsequently criticized in *FTC v. R.F. Keppel & Bros., Inc.*, 291 U.S. 304 (1934), as presenting too narrow a statement of the entire scope of Section 5’s proscription of “unfair methods of competition in commerce.” *Sperry Hutchinson*, 405 U.S. at 242-44. “Thenceforth, unfair competitive practices were not limited to those likely to have anticompetitive consequences after the manner of the antitrust laws; nor were unfair practices in commerce confined to purely competitive behavior.” *Id.* at 244. But *Raladam* was not actually overruled by either *Keppel* or *S&H*, and its description of Section 5 as an antitrust statute would seem to have continued vitality today. But see *supra* note 58 (regarding whether market definition is required when there is evidence that competition has been adversely affected).
- 63 See, e.g., *United States v. Grinnell Corp.*, 384 U.S. 563, 572-73 (1966) (explaining that the “any part of the trade or commerce” language in Section 2 of the Sherman Act refers to markets for goods or services); *Apex Hosiery Co. v. Leader*, 310 U.S. 469, 500 (1940) (explaining that Section 1 of the Sherman Act was intended to remedy public wrongs that “flow from restraints of trade in the common law sense of restriction or suppression of commercial competition”); *Brunswick Corp. v. Riegel Textile Corp.*, 752 F.2d 261, 265 (7th Cir. 1984) (Posner, J.) (explaining that to make out a Section 2 claim based on patent fraud, “[t]he patent must dominate a real market”; “[i]f a patent has no significant impact in the marketplace, the circumstances of its issuance cannot have any antitrust significance”), *cert. denied*, 472 U.S. 1018 (1985).
- 64 See, e.g., *United States v. Continental Can Co.*, 378 U.S. 441, 458 (1964) (explaining that the “line of commerce” language in Section 7 of the Clayton Act calls for an evaluation of the impact of a merger on existing competition and competition “that is sufficiently probable and imminent” in any given market).
- 65 *Am. Cyanamid Co. v. FTC*, 363 F.2d 757, 768 (6th Cir. 1966).
- 66 *Id.* at 769.
- 67 *Id.* at 769-70. See also *id.* at 771 (“We hold that the Commission had jurisdiction to determine that the conduct of the parties before the Patent Office resulting in the issuance of the patent, and the subsequent use of the fruits of such conduct may, in total, be found to constitute violation of Section 5 of the Act.”).
- 68 “The Federal Trade Commission Act may be construed *in pari materia* with the Sherman and Clayton Acts. “This construction allows for using cases decided under any of the antitrust laws in dealing with cases brought by the Commission.” *Id.* at 771 (quoting *Atl. Ref. Co. v. FTC*, 344 F.2d 599, 606 (6th Cir.), *cert. denied*, 382 U.S. 939 (1965)). See also *Atl. Ref. Co. v. FTC*, 381 U.S. 357, 369-70 (1965) (“When conduct does bear the characteristics of recognized antitrust violations it becomes suspect, and the Commission may properly look to cases applying those laws for guidance.”).



thereunder.<sup>69</sup> This enforcement approach also accords due respect to the regulatory structure of patent law – that is to say, the Commission should not be in the business, as Pfizer had charged, of “second-guessing” the PTO with respect to the examination of patent applications. Instead, the mine run of problems associated with potentially invalid or defective patents should be addressed by the PTO in the first instance.

If *American Cyanamid* is an exemplar of how the Commission should enforce Section 5 as an antitrust law against patent-based conduct, then *SCM Corp. v. Xerox Corp.*<sup>70</sup> illustrates the difficulties that can arise when an antitrust challenge to patent-based conduct is not based on a showing of actual or likely substantial harm to competition in some market for goods or services existing at the time of the conduct in question. At the outset, I should point out that *SCM* was an appeal from a private, treble-damages action brought by SCM Corporation under Sections 1 and 2 of the Sherman Act and Section 7 of the Clayton Act against Xerox Corporation. Neither Section 5 of the FTC Act, which only the Commission can enforce, nor a public law enforcement action was involved.<sup>71</sup> Nevertheless, the points made by the Second Circuit in *SCM* deserve fair consideration even in the context of a public law enforcement action, as I will explain.

The appeal primarily concerned SCM’s claim that “by 1969 Xerox had willfully acquired monopoly power in a relevant product market consisting of convenience office copiers using plain and coated paper and in a relevant submarket consisting only of plain-paper copiers, and that Xerox’s conduct excluded SCM from the relevant market and submarket.”<sup>72</sup> At trial, the jury had found that the only patent-based conduct that bore a causal relationship to SCM’s exclusion claim was a 1956 agreement between Xerox and Battelle Memorial Institute, under which Battelle transferred title to four basic patents claiming the xerographic process, which had been invented by Chester Carlson, to Xerox.<sup>73</sup> Battelle also granted Xerox an exclusive license to the remaining Carlson-Battelle patents as well as a right to receive all future xerographic patents and know-how developed by Battelle.<sup>74</sup>

In order to recover damages for its exclusion claim, SCM had to allege and prove “antitrust injury,” that is, harm that the antitrust laws were meant to redress.<sup>75</sup> Because SCM claimed only injury from Xerox’s allegedly unlawful, patent-based conduct, and because the jury found that the only patent-based conduct that could have caused that injury was the 1956 Xerox-Battelle agreement, Xerox’s patent acquisition under the 1956 agreement therefore had to be an antitrust violation in order for SCM to have suffered any “antitrust injury.”<sup>76</sup> That was the question before the Second Circuit.

The Second Circuit concluded that the 1956 agreement did not violate the antitrust laws because the relevant market and submarket in question did not exist at the time of the patent acquisition but rather, came into being some eight to thirteen years later.<sup>77</sup> Indeed, the first plain-paper copier did not even come to market until 1960.<sup>78</sup>

69 Again, my discussion here is of Section 5 as an *antitrust law*, and I leave open the question, for example, whether and under what circumstances patent-related misrepresentations might constitute an “unfair or deceptive act or practice” in violation of Section 5.

70 645 F.2d 1195 (2d Cir. 1981).

71 The Commission had brought its own enforcement action under Section 5 against Xerox in January 1973, charging a number of violations that included both patent-based and non-patent-based conduct. *See Xerox Corp.*, 86 F.T.C. 364 (1975) (complaint, decision and order). That action was settled with the entry of a consent decree in 1975, however, whereas SCM’s private case, filed in July 1973, continued to trial. *SCM Corp.*, 645 F.2d at 1201.

72 *SCM Corp.*, 645 F.2d at 1201.

73 *Id.* at 1199, 1201.

74 *Id.* at 1199.

75 *See Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 489 (1977).

76 *SCM Corp.*, 645 F.2d at 1203, 1206-07.

77 *Id.* at 1208-09 (disposing of Section 2 claim), 1209-10 (disposing of Section 1 claim), & 1211 (disposing of Section 7 claim).

78 *Id.* at 1200.

Antitrust liability under both the Sherman Act and the Clayton Act, the court held, required an assessment of the actual or likely, adverse impact of the patent acquisition on either the market power possessed by Xerox, or the level of competition, in some relevant market at the time of the acquisition.<sup>79</sup>

The Second Circuit rejected SCM's argument that antitrust liability could attach merely by showing that a "reasonably foreseeable" effect of the patent acquisition was the eventual acquisition of monopoly power by Xerox in some relevant product market.<sup>80</sup> In the court's view, this argument would penalize a purchaser of a patent not for its market position, but rather for the potential commercial success that is latent in any patent.<sup>81</sup> Such a rule could chill innovation because a purchaser would have to be concerned about reaping "too much" commercial success from a patent, lest the patent create its own relevant product market in which the purchaser would have monopoly power. Moreover, a seller of a patent would have to be concerned about being able to transfer the patent to another firm if the commercial success of the claimed invention were "virtually guaranteed," because that might give the purchaser exclusionary power in a relevant market at some point down the road.<sup>82</sup>

In summary, *American Cyanamid* and *SCM* illustrate the general requirement of relating the challenged patent-based conduct or transaction to its actual or likely impact on a relevant goods or services market existing at the time of the conduct or transaction. I need to make a couple of clarifications, however. First, the issue here is not *how* and *to what degree of precision* a relevant market will be defined but *whether* one exists at all and can be identified.<sup>83</sup> Being able to identify a relevant antitrust market is what allows us, and the courts, to recognize and assess the effects of the challenged conduct or transaction on competition. Second, in the preceding observations, I am leaving aside the occasional enforcement cases in which the patents, or the technologies and inventions claimed therein, might be properly analyzed as belonging to a relevant "technology market" or "innovation market."<sup>84</sup> For example, a case might concern a market for licenses of competing, alternative technologies that are covered by patents. In such a case, it may be less important to identify a goods or services market impacted by the challenged conduct or transaction.

### III.

A third consideration that we as a Commission should keep in mind when we are deciding whether to bring an antitrust case challenging the acquisition, assertion, or licensing of patents is the public interest. As I have said, Section 5(b) requires the Commission not only to have "reason to believe" there has been a violation of law, but also to conclude that bringing an enforcement action would be in the public interest. This means that we need to

79 See *id.* at 1208 ("In scrutinizing acquisitions of patents under § 2 of the Sherman Act, the focus should be upon the market power that will be conferred by the patent in relation to the market position then occupied by the acquiring party.") & 1211 ("The existing market provides the framework in which the probability and extent of an adverse impact upon competition may be measured.")

80 *Id.* at 1208-09.

81 *Id.* at 1208 ("The limitation that SCM would impose, however, turns not upon the market position of the acquiring party, but rather, upon the potential for commercial success a particular patent may hold.")

82 *Id.* ("Presumably, under SCM's proposed rule, where the commercial success of a patented invention virtually is guaranteed, no person other than the inventor can hold exclusive rights in the patent, at least where it is foreseeable that the products generated under the patent will create their own relevant product market.")

83 See *supra* note 58. As I have said, once we have shown the anticompetitive effects of the challenged conduct or transaction, we can "back in" to a definition of the relevant market. We do not have to define the market first before proving the existence of anticompetitive effects.

84 See U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY §§ 3.2.2 & 3.2.3 (1995), available at <http://www.ftc.gov/bc/0558.pdf>.

make sure that we are acting to protect competition and consumers, and not purely to advance the private interests of a competitor, customer, or other third party.<sup>85</sup>

The Supreme Court construed the “public interest” standard of Section 5 in its 1929 opinion in *FTC v. Klesner*.<sup>86</sup> That case arose as a proverbial tale of two merchants in Washington, D.C. – Sammons, a maker and seller of window shades who did business as “The Shade Shop,” and Klesner, an interior decorator who did business under the name of Hooper & Klesner and, from time to time, took orders for window shades. Sammons had sublet some space from Klesner for his shop but one day, he abruptly decided to move his shop to another building nearby. By vacating the premises as he did, Sammons had undoubtedly breached his agreement with Klesner. “An acrimonious controversy ensued[,]” one that ultimately led to Klesner setting up, out of pure spite, a rival, window-shade business in Sammons’ vacated space, and deliberately using the “Shade Shop” trade name in an apparent attempt to confuse customers and steal business away from Sammons.<sup>87</sup>

Based on these facts, the Commission entered a cease and desist order against Klesner enjoining him from using the words “Shade Shop” in connection with any aspect of his business. The Commission filed suit in the Court of Appeals for the District of Columbia to enforce its order, but the court dismissed the case,<sup>88</sup> finding that the words “Shade Shop” were descriptive and hence incapable of conferring any exclusive trademark rights, and that there was insufficient evidence of Klesner’s alleged deception and theft of Sammons’ customers.<sup>89</sup>

On appeal, the Supreme Court held that the dismissal could be affirmed without examining the merits because Section 5 “does not provide private persons with an administrative remedy for private wrongs[.]”<sup>90</sup> and it therefore follows that if the Commission is filing an action in its own name – as it must, then “the purpose must be protection of the public.”<sup>91</sup> Furthermore, that public interest must be “specific and substantial,” such as when the conduct or practice challenged as an “unfair method”<sup>92</sup> (1) “threatens the existence of present or potential competition,” (2) “involve[s] flagrant oppression of the weak by the strong,” or (3) causes an aggregate loss that is “so serious and widespread as to make the matter one of public consequence,” but the loss to any one affected individual is too small to warrant a private suit.<sup>93</sup>

Measured against the “public interest” standard, the case against Klesner was, in the Court’s view, essentially a private dispute.<sup>94</sup> Notably, the Commission did not file its enforcement action until *after* Sammons’ own *private* suit to enjoin Klesner’s use of the

85 Of course, an enforcement action that we bring may well benefit a particular competitor or customer, as well as protect competition and consumers. There is nothing wrong with that.

86 280 U.S. 19 (1929).

87 See generally *id.* at 23–24.

88 The court initially dismissed the Commission’s case citing a lack of jurisdiction, but that order was reversed, and the case remanded, by the *Supreme Court*. *FTC v. Klesner*, 274 U.S. 145 (1927).

89 *Klesner*, 280 U.S. at 24–25.

90 *Id.* at 25.

91 *Id.* at 27. “The protection thereby afforded to private persons is the incident.” *Id.*

92 Note that *Klesner* was decided prior to the 1938 Wheeler-Lea Amendments that added “unfair or deceptive acts or practices” to the Commission’s Section 5 jurisdiction, which thereby made clear that the Commission may act to protect consumers as well as competition. 83 CONG. REC. 391, 391-92 (1938) (statement of Rep. Clarence F. Lea, co-sponsor of the Wheeler – Lea Amendments) (explaining that the proposed addition of “unfair or deceptive acts or practices” to the Commission’s Section 5 jurisdiction will relieve the agency of the burden of having to show that an “unfair practice is injurious to a competitor” and will also allow the agency to “afford a protection to the consumers of the country that they have not heretofore enjoyed”); *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233, 244 (1972) (observing that the addition of the phrase “unfair or deceptive acts or practices” to Section 5’s original ban on “unfair methods of competition” makes clear that Congress charged the Commission with protecting consumers as well as competition).

93 *Klesner*, 280 U.S. at 28.

94 *Id.* at 28 & 30. Perhaps the conclusion might have been different had the Commission been able to challenge Klesner’s actions as an “unfair or deceptive act or practice.” See *supra* note 92.

words “Shade Shop” had been dismissed by the District of Columbia courts.<sup>95</sup> By that time, Klesner had been using the words “Shade Shop” for five years, and any confusion that might have been present at the outset would have largely been dissipated.<sup>96</sup>

In my view, notwithstanding the passing decades, *Klesner* still stands as a warning beacon to the Commission not to get involved in what are purely private disputes, with no specific and substantial public interest at stake. We should therefore proceed with caution in the patent-antitrust arena because complaints sometimes come to us from firms that are already embroiled in private, patent infringement lawsuits or disputes, and what those complainants may be expecting us to do is to use our official investigative and enforcement powers to cow the other side into submission.

For example, in *Flynn & Emrich Co. v. FTC*,<sup>97</sup> the Commission had entered a cease-and-desist order against Flynn & Emrich Company, enjoining it from threatening any person or firm with patent infringement “in bad faith for the purpose of diverting the trade of any competitor or competitors to it and without intention to sue.”<sup>98</sup> The administrative record reflected, however, a substantial factual dispute as to whether Flynn’s assertions of infringement, which were based on the advice of its patent counsel and directed only to the competing products of Perfection Grate & Supply Company, were in fact made in bad faith.<sup>99</sup> On a petition for review, the Fourth Circuit concluded that the record did not support the Commission’s finding of bad faith.<sup>100</sup>

Additionally, the court of appeals held that the Commission’s cease-and-desist order lacked the required public interest. Importantly, the only competing product targeted by Flynn was Perfection’s, and the record showed that none of the purchasers approached by Flynn’s salesmen about the risk of liability for patent infringement were actually prevented from buying Perfection’s product.<sup>101</sup> The record also reflected that in response to Flynn’s representations of patent infringement in the marketplace, Perfection had threatened suit to enjoin Flynn from continuing to make those representations but it never followed through with that threat.<sup>102</sup>

On that record the Fourth Circuit announced – and I quote:

The case here is rather a controversy of a private and personal nature between the petitioner and the Perfection Company, and could have been readily settled in the courts, and if a proper case were made an injunction would have issued against the petitioner. Certainly Congress never intended that the machinery of the Federal Trade Commission, severe as its operation can be made, should be set in motion for the

95 *Id.* at 29.

96 *Id.* In the words of the Court, “[i]f members of the public were in 1920, or later, seriously interested in the matter, it must have been because they had become partisans in the private controversy between Sammons and Klesner.” *Id.*

97 52 F.2d 836 (4th Cir. 1931).

98 *Id.* at 836.

99 Flynn denied the charges in the Commission’s complaint and explained that it did not follow through with its threats and file suit because of the expense involved in litigation, no matter the result. *Id.* at 837. Also, there was a report from the Commission’s hearing examiner who, after taking the testimony of witnesses, concluded that Flynn’s instructions to its salesmen, who were to advise customers that had purchased or were in the process of purchasing Perfection’s stokers of the alleged infringement, had been made in good faith and based on the opinion of patent counsel. The Commission attorneys argued that the report should not be part of the record, a position that the Fourth Circuit found difficult to understand since the examiner was the one who had seen and heard the witnesses, and observed their demeanor. *Id.*

100 *Id.* at 838 (“Here the petitioner, in claiming infringement, did only what its officers undoubtedly thought they had a perfect right to do and what they had been advised to do by their attorneys, who were clearly acting in perfect good faith.”). *Flynn* was decided nearly 50 years before *Handgards* but the record as described likely would not support a claim of “sham” litigation under the now prevailing *Professional Real Estate* standard either. See *supra* notes 26 & 34.

101 *Id.*

102 *Id.* at 837.

settlement of private controversies, when the courts can act. The official character of the Commission makes it all the more necessary that it act only when the public interest is involved. It was never intended that the Commission should act the part of a petty traffic officer in the great highways of commerce.<sup>103</sup>

In other words, *Flynn* and *Klesner* both involved private disputes between two parties that the courts can and do resolve without the Commission's intervention. In *Klesner*, Sammons had already unsuccessfully sought injunctive relief from the courts when the Commission decided to file suit. In *Flynn*, Perfection could have asked a court to enjoin Flynn from making the representations but it chose not to sue, for whatever reason.

Not all disputes between two parties are purely private in nature, however. Depending on the structure of the affected market, some disputes affect competition and consumers too, and in such cases, the Commission may properly intervene using Section 5 as a standalone, antitrust statute because it is broader than either the Sherman Act or the Clayton Act. A recent example is our issuance of a litigated complaint against Intel Corporation, charging a course of conduct to maintain monopoly power in the markets for central processing units (CPUs) and near-monopoly power in the markets for graphics processing units (GPUs) as a violation of Section 5.<sup>104</sup>

In a statement concurring with the Commission's view that Intel's course of conduct violated Section 5, I observed that although Intel's conduct was directed at Advanced Micro Devices ("AMD"), allegedly its only competitor in the CPU market, and at AMD and Nvidia Corporation, allegedly its only competitors in the GPU market, that conduct harmed competition and consumers as well because the markets were highly concentrated and the entry barriers were uncommonly high.<sup>105</sup> Intel's conduct therefore had the alleged effect of inhibiting the only rivals who were in a position to constrain its exercise of monopoly or near-monopoly power in those markets. "Under those unique circumstances, the oft-repeated admonition that the Sherman and Clayton Acts protect competition, not competitors, and the federal courts' attendant disinclination to protect competitors in cases brought under those statutes, do not fit well."<sup>106</sup> In my view, the *Intel* case therefore provided an appropriate situation to proceed under Section 5. We weren't just protecting AMD and Nvidia as competitors; we were also protecting the competition and consumer choice afforded by their presence as the only putative rivals in the CPU and GPU markets, respectively.<sup>107</sup>

In the patent-antitrust arena, another situation in which there may be a strong public interest element is the enforcement of patents that cover some feature or function of an adopted industry standard. If a patented feature or function faces any competition at all

103 *Id.* at 838. In a similar vein, the Supreme Court has held, in the context of a labor dispute between a union and an employer, in which there was a threat to withhold labor services, that the Sherman Act "does not purport to afford remedies for all torts committed by or against persons engaged in interstate commerce." *Hunt v. Crumboch*, 325 U.S. 821, 826 (1945).

Furthermore, Judge Posner has observed that, in the context of a lawsuit between two parties over who had superior rights to a patented process for making antistatic yarn, that "[i]f injury to a competitor, caused by wrongful conduct, were enough to bring the antitrust laws into play, the whole state tort law of unfair competition would be absorbed into federal antitrust law[.]" *Brunswick Corp. v. Riegel Textile Corp.*, 752 F.2d 261, 267 (7th Cir. 1984), *cert. denied*, 472 U.S. 1018 (1985).

104 Complaint ¶¶ 2-28, Intel Corp., No. 9341, 2009 FTC LEXIS 227, at \*3-12 (F.T.C. Dec. 16, 2009), available at <http://www.ftc.gov/os/adjpro/d9341/091216intelcmpt.pdf>.

105 Concurring and Dissenting Statement of J. Thomas Rosch, Comm'r, Fed. Trade Comm'n, at 1, Intel Corp., No. 9341 (F.T.C. Dec. 16, 2009), available at <http://www.ftc.gov/os/adjpro/d9341/091216intelstatement.pdf>. I dissented, however, from the Complaint's inclusion of "tag-along" Section 2 claims for prudential reasons. *Id.* at 3-4.

106 *Id.* at 1.  
107 *Id.* at 1-2.

from alternative technologies, that competition is effectively eliminated once that feature or function is chosen over its alternatives by the standards body for incorporation in the standard. If the standards body and industry participants make that choice in reliance on a commitment by the patent owner to make the patented feature or function available to everyone at a reasonable and nondiscriminatory royalty rate, then any subsequent conduct by the patent owner that is inconsistent with that prior commitment upsets the expectations of the standards body and industry participants, and thereby harms both competition and consumers.<sup>108</sup> Moreover, such conduct hurts innovation because it can deter firms from developing technologies and products based on the adopted standard.

For example, in *Negotiated Data Solutions LLC*,<sup>109</sup> a company called National Semiconductor Corporation had committed to license a suite of patents covering the “NWay” autonegotiation technology, which had been chosen for use in the so-called Fast Ethernet standard, for a one-time fee of \$1,000 to anyone practicing the standard.<sup>110</sup> Subsequent owners of those patents, including Negotiated Data Solutions LLC (“N-Data”), however, chose not to honor the prior commitment.<sup>111</sup> The Commission therefore charged N-Data with engaging in unfair methods of competition by renegeing on a prior commitment.<sup>112</sup> The matter settled with the entry of a consent decree, which I voted to accept and make final. I also joined the Commission majority’s statement in which we explained the rationale for our decision.<sup>113</sup>

In our view, there was no doubt that N-Data’s type of conduct harmed consumers because “[t]he process of establishing a standard displaces competition; therefore, bad faith or deceptive behavior that undermines the process may also undermine competition in an entire industry, raise prices to consumers, and reduce choices.”<sup>114</sup> We described an industry standard as an engine driving the modern economy, and N-Data’s conduct as threatening to stall that engine to the detriment of all consumers.<sup>115</sup> In the Commission’s complaint, we alleged that N-Data’s predecessor-in-interest, Vertical Networks, had not only renegeed on National’s commitment to the standards body, the Institute of Electrical and Electronics Engineers (IEEE), but it had also widely targeted 64 companies in the relevant industry with a demand for license fees and a threat of suit.<sup>116</sup> In summary, like the *Intel* case, the situation in *N-Data* was not at all like the bilateral, private disputes seen in *Klesner* and *Flynn*.

## CONCLUSION

As I said at the outset, patent law and antitrust law should be viewed as “business partners” in protecting the enterprise of innovation. Properly administered and enforced, both bodies of law have separate but complementary roles to play in ensuring that our economy and the public benefit from the fruits of innovation. Sometimes, however, one body of law may overstep its boundaries and impinge on the work of the other. In such a situation, it is appropriate to call a halt to the partnership because the mutual business objectives are no longer being advanced.

108 See, e.g., *Broadcom Corp. v. Qualcomm Inc.*, 501 F.3d 297, 313-14 (3d Cir. 2007).

109 No. C-4234, 2008 FTC LEXIS 120 (F.T.C. Sept. 22, 2008) (Final Decision and Order), available at <http://www.ftc.gov/os/caselist/0510094/080923ndsdo.pdf>.

110 Complaint ¶¶ 12-13, *Negotiated Data Solutions LLC*, No. C-4234, 2008 FTC LEXIS 119, at \*4-5 (F.T.C. Sept. 22, 2008), available at <http://www.ftc.gov/os/caselist/0510094/080923ndscomplaint.pdf>.

111 *Id.* ¶¶ 25-35, 2008 FTC LEXIS 119, at \*9-12.

112 *Id.* ¶¶ 1-2, 36-39, 2008 FTC LEXIS 119, at \*1-2, \*12-14.

113 Chairwoman Deborah Majoras and Commissioner William Kovacic dissented.

114 Statement of the Federal Trade Commission at 2, *Negotiated Data Solutions LLC*, No. C-4234 (F.T.C. Jan. 23, 2008) (footnote omitted), available at <http://www.ftc.gov/os/caselist/0510094/080122statement.pdf>.

115 *Id.* at 3.

116 Complaint ¶¶ 27-28, *Negotiated Data Solutions LLC*, No. C-4234, 2008 FTC LEXIS 119 (F.T.C. Sept. 22, 2008), available at <http://www.ftc.gov/os/caselist/0510094/080923ndscomplaint.pdf>.

# THE ROLE OF ANTITRUST IN EVALUATING THE COMPETITIVE IMPACT OF PATENT POOLING ARRANGEMENTS

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## I. INTRODUCTION

Patent pools solve specific problems, such as the clearing of blocking patents or protecting against “hold up” or “hold out” by individual patent holders, particularly in the context of the creation and implementation of technological standards. At the same time, pools may cause substantial harm in markets by raising the costs of developing new, competing technologies. Such pools can heighten infringement litigation risk for potential innovators, thereby deterring investment, as well as shield weaker patents in the pool from challenge. How competition laws and competition agencies deal with such collective arrangements is critical, especially in today’s technologically complex world, with innovation at its core.

As patent pools can have both substantial procompetitive and anticompetitive effects, the proliferation of patent pools – containing thousands of separate and often competing patents – should raise alarms from an antitrust perspective, given the potential for substantial harm to competition and innovation. Indeed, such collective arrangements are only permissible under the antitrust laws when they enable participants to generate substantial efficiencies that could not be achieved absent the collective arrangement. In contrast, when such arrangements are merely vehicles to facilitate price fixing, collective output restrictions, bundling of competing patents, or other exclusionary conduct, they are forbidden under Section 1 of the Sherman Act.<sup>2</sup>

While, to date, antitrust enforcement actions concerning patent pooling arrangements have been somewhat limited, the change in the size, scope, breadth, and function of present-day pooling arrangements may spur renewed interest by the government agencies. Indeed, in 2011, the *Wall Street Journal* reported that the Department of Justice (DOJ) opened a formal investigation into MPEG-LA’s patent pool relating to H.264, a

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Wilson Sonsini Goodrich & Rosati represents clients in connection with the MPEG-LA matter mentioned in this article and also represents Google in a variety of antitrust matters. Wilson Sonsini Goodrich & Rosati also represented VISX in connection with the FTC investigation described herein. The views expressed here, however, are the authors’ alone and do not necessarily correspond with those of any of the firm’s clients or the firm itself.

2 15 U.S.C. § 1 (2006).

widely used video codec standard, concerning its attempt to exclude competition from Google's royalty-free open-source video codec alternative.<sup>3</sup> Particularly in the wake of the *Princo Corp. v. International Trade Commission (Princo II)* decision,<sup>4</sup> which makes defending against infringement claims from patent pooling arrangements through the doctrine of patent misuse considerably more difficult, antitrust authorities can and should play a more active role in evaluating the competitive effects of particular pooling arrangements and pursue enforcement actions against those that tend to suppress (rather than enhance) competition and innovation.

To this end, this article first provides background on patent pools, focusing on how these arrangements can be both procompetitive and anticompetitive and how the likely competitive impact of these arrangements should be evaluated. Next, the article briefly reviews government enforcement actions and advisory opinions that provide guidance on the agencies' treatment of patent pooling arrangements. Finally, the article discusses how, in light of the Federal Circuit's opinion in *Princo II*, antitrust enforcement can and should take a more central role in the evaluation of the competitive effects of mass marketed patent pools containing thousands of separate and likely competing patents.

## II. WHAT IS A PATENT POOL?

Patent pools are collective licensing arrangements in which two or more parties grant licenses to their respective intellectual property to each other or to a third party that sublicenses the pooled technology to others.<sup>5</sup> In its most basic form, a patent pool entails a straightforward cross-license between two parties. In more complex arrangements, multiple patent owners contribute intellectual property rights to a pool, which may be administered by a third party as a part of (or in place of) an industry standard-setting organization.

### A. How can patent pools serve to enhance competition?

The antitrust authorities and the courts long have recognized the competitive benefits of patent pooling arrangements. By "integrating complementary technologies, reducing transaction costs, clearing blocking positions, and avoiding costly infringement litigation," patent pools can ease and expedite the full exploitation of technology and therefore advance procompetitive ends.<sup>6</sup>

First, patent pools can reduce transaction costs for licensees. Rather than requiring licensees to negotiate separate licenses with individual patent holders on a patent-by-patent basis, patent pools can offer licensees a bundle of patents providing a "one-stop

3 See Thomas Catan, *Web Video Rivalry Sparks U.S. Probe*, WALL ST. J., Mar. 4, 2011, available at <http://online.wsj.com/article/SB10001424052748703752404576178833590548792.html>. Companies like MPEG-LA – which claims to have “developed the patent pool market space” – do nothing but solicit intellectual property from patent holders in an effort to create and administer patent pooling arrangements. See *Turn your Patents into Profits*, MPEG-LA, <http://www.mpegla.com/main/Pages/PoolBenefitsHolders.aspx> (last visited Dec. 7, 2011). Indeed, MPEG-LA's primary function is to help patent holders turn their “patents into profits” by “packaging patents in order to give them *mass market appeal*.” *Id.* (emphasis added). MPEG-LA itself has also taken a more direct approach in its efforts to suppress competition from alternative technologies by attempting to create a new pool around the open-source VP8 video codec, which competes with the H.264 technology covered by an existing MPEG-LA pool. See Press Release, MPEG-LA, MPEG LA Announces Call for Patents Essential to VP8 Video Codec (Feb. 11, 2011), available at [http://www.mpegla.com/Lists/MPEG%20LA%20News%20List/Attachments/237/n\\_2\\_10\\_11.pdf](http://www.mpegla.com/Lists/MPEG%20LA%20News%20List/Attachments/237/n_2_10_11.pdf).

4 616 F.3d 1318 (Fed. Cir. 2010).

5 U.S. DEP'T OF JUSTICE & FED'L TRADE COMM'N, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY § 5.5 (1995) [hereinafter IP GUIDELINES], available at <http://www.justice.gov/atr/public/guidelines/0558.htm>.

6 *Id.*



shopping” alternative.<sup>7</sup> As a result, licensees are able to obtain the patent rights necessary to manufacture their respective products by way of a single licensing transaction.<sup>8</sup>

Second, patent pools can enhance competition by clearing “blocking patents.” A blocking patent is a patent owned by someone else that prevents a patentee from exploiting its own patent (*i.e.*, the patentee cannot practice its patents without infringing other patents). If blocking patents are included in a pool, pooling may not only be procompetitive but is also “frequently necessary” for technical advancement.<sup>9</sup> Indeed, in some circumstances, the exchange of licenses to intellectual property that would otherwise prohibit commercialization of a technology is the “only reasonable method for making the invention available to the public.”<sup>10</sup> In particular, because some products are highly integrated (*e.g.*, smartphones), there are dozens, if not hundreds of standards incorporated into a single product (*e.g.*, with regard to smartphones, the technology incorporates a variety of standards including UMTS, USB, WiFi, audio compression, video compression, among others). Thus, there is a potential for hold up on both an intra-standard and inter-standard basis, and this hold up can either delay the introduction of new and improved technologies or increase the costs of commercializing products that incorporate these technologies, leading to higher prices for consumers.

Third, patent pools can enable the widespread use of new technologies by promoting the dissemination of technology and facilitating the exchange of technical information among members of the patent pool as well as licensees to the pooled intellectual property.<sup>11</sup> Moreover, such exchange of information also encourages innovation by allowing pool members and licensees to tweak, modify, and develop new products and technologies based on the diffusion of existing technology.

Lastly, patent pools can mitigate potential “hold up” and “hold out” problems. For example, “hold up” can occur when buyers make “relationship-specific investments, after which they may face efforts by others to extract more of the surplus.”<sup>12</sup> Similarly, “hold out” can arise when buyers need multiple complementary patent rights and sellers have an incentive to delay negotiation – until they are the last bidding seller – in order to increase leverage in negotiations with the buyer.<sup>13</sup> Patent pools that mandate licensing on reasonable and non-discriminatory (RAND) terms can mitigate potential hold up and hold out problems in the competitive bargaining process.

For some technologies, particularly those subject to positive network effects, a single dominant standard can benefit both consumers and producers by ensuring compatibility and interoperability among a diverse set of products. Once market participants agree on the relevant technology standard, “any patents (or copyrights) necessary to comply with that standard become truly essential.”<sup>14</sup> Blocking patents, and

7 U.S. DEP’T OF JUSTICE & FED’L TRADE COMM’N, ANTITRUST ENFORCEMENT AND INTELLECTUAL PROPERTY RIGHTS: PROMOTING INNOVATION AND COMPETITION 65 (2007) [hereinafter ANTITRUST ENFORCEMENT AND IP RIGHTS REPORT], available at <http://www.ftc.gov/reports/innovation/P040101PromotingInnovationandCompetitionrpt0704.pdf>.

8 *Id.*

9 *See Standard Oil Co. v. United States*, 283 U.S. 163, 171 (1931) (“An interchange of patent rights and a division of royalties according to the value attributed by the parties to their respective patent claims is frequently necessary if technical advancement is not to be blocked by threatened litigation.”).

10 *Mfg. Co. v. Landon, Inc.*, 336 F.2d 723, 729 (9th Cir. 1964).

11 *See* IP GUIDELINES, *supra* note 5, § 5.5; *see also* ANTITRUST ENFORCEMENT AND IP RIGHTS REPORT, *supra* note 7, at 65.

12 ANTITRUST ENFORCEMENT AND IP RIGHTS REPORT, *supra* note 7, at 64.

13 *Id.*; *see also* Michael A. Heller & Rebecca S. Eisenberg, *Can Patents Deter Innovation? The Anticommons in Biomedical Research*, 280 SCIENCE 68, 700 (1998).

14 Carl Shapiro, *Navigating the Patent Thicket: Cross Licenses, Patent Pools, and Standard Setting*, in 1 NAT’L BUREAU OF ECON. RESEARCH, INNOVATION POLICY AND THE ECONOMY 119, at 136 (Adam Jaffe et al. eds., 2001).

issues related to hold up and hold out, are therefore particularly prevalent in the standard-setting context. Consequently, pools organized around an industry-wide standard can have a very different competitive impact than pools in markets with multiple competing technologies.

Adopters of the standard – as well as the standard itself – are “subject to holdup if these patent holders are not somehow obligated to license their patents on reasonable terms.”<sup>15</sup> In other words, standard setting requires “the creation of irreversible investments,” which has the potential to result in hold up once that irreversible investment is made.<sup>16</sup> As a result of these potential issues, standard-setting bodies often require participants to disclose, *ex ante*, any patents that are essential to an adopted standard and to license such patents on RAND terms.<sup>17</sup> Thus, standard-setting organizations, and pools formed around them, can facilitate competition both by clearing blocking positions from multiple, essential patents and by ensuring that adoption of a technological standard is not undercut by deficiencies in the bargaining process.

### B. How can patent pools serve to suppress competition?

While patent pools can be procompetitive, and indeed even necessary to advance a technology in some circumstances, such arrangements can also have serious potential anticompetitive consequences. Federal courts have long recognized that it would be improper for a single firm to attempt to obtain ownership of all the patents “relevant to an industry.”<sup>18</sup> Patent pools often walk a fine line between the legitimate exercise of a patent monopoly and anticompetitive consolidation of intellectual property. Simply and eloquently put: patent pools can “harm the market *by bringing horizontal competitors into collusion.*”<sup>19</sup>

#### i. Exclusionary conduct

First, pooling arrangements containing collective price and output restraints can have severe anticompetitive effects and may be found unlawful if they do not “contribute to an efficiency-enhancing integration of economic activity among the participants.”<sup>20</sup> Moreover, patent pools designed simply to achieve naked price fixing or market allocation are subject to challenge under the *per se* rule.<sup>21</sup> For example, in 1998, the FTC challenged (and ultimately dissolved) a patent pool created by Summit Technologies, Inc. and VISX, Inc. that contained patents relating to the manufacture and use of lasers used in vision-correcting eye surgery.<sup>22</sup> While the parties claimed that the pooling arrangement was

15 *Id.* at 128, 136. In fact, the more reasonable most patentees are, the greater the rewards to hold-up by a few co-patentees, as the few can collect the rents not collected by the many.

16 Mark A. Lemley, *Ten Things To Do About Patent Holdup of Standards (and One Not To)*, 48 B.C. L. REV. 149, 154 (2007), available at <http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=2349&context=bclr>.

17 See Mark A. Lemley, *Intellectual Property Rights and Standard-Setting Organizations*, 90 CALIF. L. REV. 1889, 1906 (2002); Daniel G. Swanson & William J. Baumol, *Reasonable and Nondiscriminatory (RAND) Royalties, Standards Selection, and Control of Market Power*, 73 ANTITRUST L.J. 1, 10-45 (2005). Although a RAND licensing restriction helps to eliminate the most severe forms of anticompetitive abuse of a standards-setting process, it is hardly a panacea. It is far from clear that these restrictions could be applied to firms with essential patents granted after the standard was set – particularly since these firms may not be members of the standard-setting body. Firms already have some incentive to delay prosecution of patents to ensure that they read on a newly-forming standard. Placing RAND licensing requirements on early participants only strengthens the incentive to avoid aggressively prosecuting patents until a standard is set (and a pool is formed).

18 See *United States v. Westinghouse Elec. Corp.*, 648 F.2d 642, 647 (9th Cir. 1981) (“Nor may a patentee attempt to monopolize an industry by acquiring all present and future patents relevant to that industry.”); see also *Kobe, Inc. v. Dempsey Pump Co.*, 198 F.2d 416, 422-24 (10th Cir. 1952).

19 Steve Carlsson, Note, *Patent Pools and the Antitrust Dilemma*, 16 YALE. J. REG. 359, 388 (1999) (emphasis added).

20 IP GUIDELINES, *supra* note 5, § 5.5.

21 *Id.*

22 See Complaint, Summit Tech., Inc., No. 9286 (F.T.C. Mar. 24, 1998), available at <http://www.ftc.gov/os/1998/03/summit.cmp.htm>.

necessary to clear blocking positions (a premise with which the FTC disagreed), the FTC found that the competitive restraints on price and entry imposed by the pool were unnecessary to achieve this purpose.<sup>23</sup> Rather, the pool was merely a vehicle to achieve what the parties could not achieve absent the arrangement: to collectively set prices and to avoid competing against one another.

Second, patent pools can also have a significant anticompetitive impact when they restrict access to the pool's patents to only pool members, or where pool members are forbidden from licensing their individual patents outside of the pool license. In this case, the pool simply comprises an anticompetitive cartel.<sup>24</sup> One of the critical factors in the Supreme Court's decision concerning the copyright pooling arrangement in *Broadcast Music, Inc. v. Columbia Broadcasting Systems, Inc.* was that individual rights holders were allowed to negotiate directly with non-participating licensees.<sup>25</sup> This type of non-exclusive license allowed licensees to purchase less than the full portfolio of pooled technology, limiting the impact of the pool on the development of alternative technologies.

Finally, a patent pool can create and wield market power more effectively than its individual member firms. For example, in *Allied Tube & Conduit Corp. v. Indian Head, Inc.*,<sup>26</sup> the Supreme Court found that the members of a standard-setting organization had colluded to exclude from an industry standard a technology that competed with their own.<sup>27</sup> In the same way, patent pools can use the collective strength of their members to exclude competing technologies, further entrenching the pool and solidifying its market power. Further, where pool participants collectively possess market power, they can use their pooling arrangement to exclude firms that need the licensed technology to compete in a downstream market, thereby reducing competition and innovation in that market as well.<sup>28</sup>

## ii. Suppressing innovation

Pooling arrangements can also have a substantial anticompetitive effect by deterring and/or discouraging participants from engaging in research and development, thereby stifling innovation.<sup>29</sup> In a comprehensive economic analysis on patent pools in 20 industries that formed from 1930 to 1938 – including Phillips screws, lecithin, variable condensers (used in radios), and stamped metal wheels (used in the production of automobiles) – Professors Ryan Lampe and Petra Moser found that patent pools discouraged innovation overall.<sup>30</sup> In studying these industries, that the authors determined that “[o]n average, technologies that are covered by 1 additional pool patent experience[d] a 16 percent decline in patenting after the creation of a pool compared with technologies that patent examiners identify as closely related.”<sup>31</sup> According to the authors, the decline in

23 Press Release, Fed'l Trade Comm'n, Summit and VISX Settle FTC Charges of Violating Antitrust Laws (Aug. 21, 1998), available at <http://www.ftc.gov/opa/1998/08/sumvisx.shtm>.

24 See, e.g., *United States v. Associated Patents*, 134 F. Supp. 74 (E.D. Mich. 1955) (striking down an agreement among manufacturers which gave each exclusive rights to build particular types of machines and noting that pool members refused to license their patents outside the pool).

25 *Broad. Music, Inc. v. Columbia Broad. Sys., Inc.*, 441 U.S. 1, 24 (1971).

26 486 U.S. 492 (1988).

27 *Id.* at 500-02.

28 See IP GUIDELINES, *supra* note 5, § 5.5; Roger B. Andewelt, *Analysis of Patent Pools Under the Antitrust Laws*, 53 ANTITRUST L.J. 611, 629-32 (1985).

29 See IP GUIDELINES, *supra* note 5, § 5.5; see also Ryan Lampe & Petra Moser, *Do Patent Pools Encourage Innovation? Evidence from the 19th-Century Sewing Machine Industry*, 70 J. ECON. HIST. 898, 899 (2010) (finding evidence that a 19th-century sewing machine pool discouraged patenting and innovation, in particular for the members of the patent pool). One open question is whether empirical evidence would support the conclusion that the creation of a pool encourages innovation in complementary markets, where competitors can focus on continuing innovation in order to differentiate from the dominant standard.

30 Ryan Lampe & Petra Moser, *Do Patent Pools Encourage Innovation? Evidence from 20 Industries in the 1930s*, (Dec. 2, 2011) (unpublished manuscript) (on file with authors).

31 *Id.* at 23-24 (emphasis added).

patenting was driven by a “decline in the intensity of competition for specific technologies within the pool.”<sup>32</sup> In other words, the pools had the effect of reducing (rather than enhancing) competition in the market for innovation among pool members.

In *United States v. Automobile Manufacturers Association*, the DOJ brought a complaint against the Automotive Manufacturers Association claiming that its members conspired to eliminate “competition in the research, development, manufacture and installation of air pollution control equipment, and . . . in the purchase of patents and patent rights from other parties covering such equipment.”<sup>33</sup> Specifically, the DOJ alleged that the manufacturers had agreed (1) to undertake air pollution control equipment development “on a noncompetitive basis”; (2) “to seek joint appraisal of patents and patent rights submitted” to the manufacturers by third parties; and (3) “to install air pollution control equipment only upon a uniform date determined by agreement.”<sup>34</sup> According to the DOJ, the parties’ royalty-free cross-licensing of patents pertaining to emission control devices was designed to – and had the effect of – delaying technical advancement.<sup>35</sup> The parties entered into a consent decree with the DOJ that prohibited certain exchange of technical information among defendants and required them to issue royalty-free licenses to any applicant interested in developing air pollution technology for motor vehicles.

Grantbacks taking the form of agreements “under which a licensee agrees to extend to the licensor of intellectual property the right to use the licensee’s improvements to the licensed technology”<sup>36</sup> can also dampen incentives to innovate. Pool licensees have less economic incentive to invest in the development of superior (*i.e.*, more competitive) technologies when they are required to share their rewards with the entire patent pool as a result of such obligations.<sup>37</sup> Despite these dangers, government regulators have relied on grantback provisions as an indicator of *procompetitive* impact in circumstances where the pooled patents are licensed freely on RAND terms.<sup>38</sup>

Finally, pools can also discourage research and development by firms outside of the pool. Not every company wants to be a part of a pool or to license its own patents to pool members; however, these are common conditions to obtaining a license from a pool.<sup>39</sup> A firm with no desire to join a pool will not invest its research and development efforts into technologies covered by pools. Moreover, patent pools can be a more formidable

32 *Id.* at 24.

33 643 F.2d 644, 645 (9th Cir. 1981).

34 *Id.*

35 *Id.*

36 IP GUIDELINES, *supra* note 5, § 5.5.

37 *Id.* (“[A] pooling arrangement that requires members to grant licenses to each other for current future technology at minimal cost may reduce the incentives of its members to engage in research and development because members of the pool have to share their successful research and development and each of the members can free ride on the accomplishments of other pool members.”).

38 For example, grantbacks encourage licensing *ex ante*, which has the effect of broadening the scope of the patent rights to be licensed under the pool. *See, e.g.*, Letter from Joel Klein, Acting Assistant Attorney Gen., Antitrust Div., Dept of Justice, to Gerald R. Beene, Esq., at 13 (June 26, 1997) [hereinafter MPEG-2 Business Review Letter], available at <http://www.justice.gov/atr/public/busreview/215742.pdf> (the grantback provision is likely to “bring other Essential Patents into the Portfolio, thereby limiting holdouts’ ability to exact a supracompetitive toll from Portfolio licensees and further lowering licensees’ costs in assembling the patent rights essential to their compliance with the MPEG-2 standard.”).

39 At least one company has gone so far as to put certain patents into a trust in order to avoid liabilities related to a pool license. *See Lucent Techs., Inc. v. Gateway, Inc.*, No. 03CV0699-B (CAB), 2007 WL 2900484, at \*1-2 (S.D. Cal. Oct. 1, 2007). When Lucent, which was not a member of the MPEG-2 patent pool, entered into merger negotiations with Alcatel, which was a pool licensor, it created the “Multimedia Patent Trust” (MPT) and assigned the trust its essential patents for the MPEG-2 standard. *Id.* Gateway, as well as a number of co-defendants, argued (ultimately unsuccessfully) that this was an improper evasion of the merged entity’s obligations under the MPEG-2 pool license. *Id.* at \*2. Lucent had to structure the MPT as a trust to avoid the inclusion of all essential patents owned by affiliates of licensees in the pool licensee’s grantback provision. An “affiliate” was loosely defined as an entity over which a licensee has *de jure* control. *See id.* at \*7. Lucent had no control over the trust beyond selecting trustees and a right to veto license of the patents to third parties, but it was a 99 percent beneficiary of the trust’s earnings. *Id.*

litigation opponent than their individual members.<sup>40</sup> Independently administered pools, such as MPEG-LA, may even be more litigious to the extent that they are not deterred by the threat of counterclaims.<sup>41</sup> Firms concerned about litigation risk may shy away from the area covered by the pool entirely, creating a penumbra around the pool in which innovation is reduced.

To illustrate how over-inclusive pools can dampen innovation by raising rivals' costs to acquire necessary intellectual property, consider a patent pool containing patents 1-1000 ("Pool 1-1,000"). Suppose Company X needed essential patents 1-10, but did not need (or want) non-essential patents 11-1,000. To the extent that Company X could not license the 10 essential patents outside of the patent pool, it would be forced to purchase the other 990 non-essential patents (as part of package deal with the 10 essential patents) and, in doing so, pay a higher price than it otherwise would absent the bundle. Suppose this time that Company X did not believe (from a preliminary review of the portfolio) that it needed to license *any* of the patents in Pool 1-1,000. It may, nonetheless, decide to take a license to Pool 1-1,000 simply because a thorough analysis of each patent would be prohibitively costly. Moreover, the risk of foregoing a license – thereby subjecting Company X to a potential infringement action by the patent aggregator (a party with both the incentives and resources to litigate an infringement action, particularly where it could allege infringement of multiple patents) – would be high, absent control of countervailing patent rights.<sup>42</sup>

Firms may face the same choice even where Pool 1-1,000 contains only essential patents. If Company X wanted to license only patents 1-10 to practice a technology related to, but not the same as, that covered by the pool, it may still take a license to the complete pool to ward off potential litigation under patents 11-1,000. This difficulty becomes more pronounced as patent pools grow and as the patents contained within them tend to cover a wider range of potential applications – both of which are characteristics of modern patent pools, which can contain hundreds or even thousands of patents that are applicable to a wide array of technologies.<sup>43</sup> The incentive to take a pool license even to practice technologies that merely overlap with the pool extends the anticompetitive effects of patent pools beyond the technologies that they cover directly and into adjacent markets, including potentially competing technologies.

Worse yet, the existence of Pool 1-1,000 could discourage Company X from innovating in the first place.<sup>44</sup> Indeed, this is precisely what Professors Lampe and Moser found in examining the effects of the Sewing Machine Combination – a patent pool in the

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40 See Lampe & Moser, *supra* note 29, at 901. To be sure, the consolidation that makes a pool a more dangerous litigation opponent (by allowing pooled resources, a pre-litigation review of pool patents, etc.) also enables the key procompetitive benefit of patent pools: one-stop shopping for licenses to many, if not all, of the patents necessary to practice a given technology. Whether the risk of wasteful litigation or anticompetitive threats to litigate outweighs the benefits of consolidated licensing cannot be decided in a vacuum. As discussed further below, the market share, litigation history, and past licensing practices, among other factors, may bear on the determination of whether a pool is on balance pro- or anticompetitive.

41 See FED'L TRADE COMM'N, TO PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW AND POLICY 31 (2003) ("Since [non-practicing entities] are not vulnerable to an infringement counter attack, [] strategies threatening infringement actions do little to constrain their willingness to seek high royalty rates from locked-in downstream actors. Thus, [non-practicing entities] can threaten other firms with infringement actions, which, if successful could inflict substantial losses, without fear of retaliation.").

42 Consider also, the incentives of the aggregator, particularly one whose sole business is to license patents or litigate against those who will not take a license—such a party's primary objective is to extract royalties and maintain its reputation as an entity that will do so at any cost.

43 For example, the H.264 pool contains over 1,700 patents. It strains credulity to imagine that each of those patents is both essential to the implementation of H.264 and useful for no other purpose.

44 By inducing risk averse parties to pay for a license, even in circumstances where they do not need all the patents contained in the pool, pooling arrangements can have the effect of driving up the cost of the intellectual property needed to pursue a particularly technology.

sewing machine industry in the U.S. existing from 1856 to 1877 – on innovation on that market.<sup>45</sup> In that study, Lampe and Moser found that the data suggested that the sewing machine pool actually *decreased* innovation in the sewing machine industry, “by creating a more formidable opponent in court” thereby “intensif[y]ng] the threat of litigation for outside firms, which lowered expected profits and discouraged innovation.”<sup>46</sup> In turn, decreased innovation levels from outside firms had the effect of reducing incentives for members of the sewing combination themselves to innovate. As a result, overall innovation slowed soon after the Sewing Machine Combination was established and did not recover until the pool was dissolved.<sup>47</sup>

Specifically, Lampe and Moser found that patenting activity by pool members spiked immediately prior to pool formation, but then became less intense while the pool was active. Similarly, patenting by non-members spiked immediately after pool formation but declined soon afterwards. Lampe and Moser, however, found that these spikes were likely the result of increased strategic patenting rather than true innovation. For example, the spike by nonmembers prior to pool formation suggests that “prospective members may have patented existing innovations more aggressively to strengthen their [pre-pool formation] bargaining position relative to other members.” Conversely, “the spike in patenting for nonmember firms immediately after the creation of the pool may represent a strategic response by nonmembers to a heightened threat of litigation.”<sup>48</sup>

Adam Mossoff cautions that Lampe and Moser’s findings rely on only a single proxy for determining the pace of innovation: the stitching speed of newly released sewing machines.<sup>49</sup> Mossoff notes that a variety of other factors – including the introduction of advanced machine-tooled interchangeable parts to the manufacturing process, innovative new business models such as rent-to-own, and even a positive impact on the inclusion of women in the workforce – all evidence an efficiency-enhancing impact of the patent pool not accounted for by Lampe and Moser.<sup>50</sup> Without the pool, Mossoff argues, the sewing machine would not have been commercialized and these follow-on benefits would never have been realized.<sup>51</sup> Evaluating the relevance of these follow-on innovations, however, requires a difficult exercise in imagining a counterfactual world in which the pool never existed. Lampe and Moser’s study shows at the very least that removing competition along one axis, in this case developments in sewing functionality itself, can have the effect of slowing further progress in that direction. As discussed further in the rest of this article, both the potential for innovation to be stunted in one area and the potential for follow-on innovation to occur in others are just factors in a holistic inquiry.

45 Lampe & Moser, *supra* note 29, at 901.

46 *Id.* The outcomes of patent suits are often very uncertain. See Dan L. Burk & Mark A Lemley, *Fence Posts or Sign Posts? Rethinking Patent Claim Construction*, 157 U. PA. L. REV. 1743, 1791-92 (2009) (“It seems no exaggeration to say that no one reading the average patent claim can begin to guess what the claim may be held to cover . . . [until] the claims have been construed by a [district court judge] and, realistically, only after the Federal Circuit has reviewed the findings of the district court judge . . .”).

47 *Id.* at 901-02. For example, pool members “produc[ed] an average of three patents per year from 1857 to 1861 and only two patents per year from 1866 to 1870. Members continued to patent less until the pool dissolved in 1877, and quickly resumed patenting afterwards, producing five patents in 1878, nine in 1879, and eight in 1880.” *Id.* at 909-10. Moreover, sewing speeds stayed roughly consistent for the duration of the pool and, similarly, began to advance only after the pool dissolved in 1877. *Id.* at 917; see also Ryan Lampe & Petra Moser, *Patent Pools and the Direction of Innovation – Evidence from the 19th Century Sewing Machine Industry 2* (Oct. 30, 2011) (unpublished manuscript) [hereinafter Lampe & Moser, *Sewing II*], available at <http://ssrn.com/abstract=1468062> (“Patenting declined after creation of the pool, both in absolute levels and relative to other industries. Patenting also declined relative to Britain, which did not have a pool.”).

48 Lampe & Moser, *supra* note 29, at 915-16.

49 Adam Mossoff, *The Rise and Fall of the First American Patent Thicket: The Sewing Machine War of the 1850s*, 56 ARIZ. L. REV. 165, 210 n.239 (2011).

50 *Id.*

51 *Id.*

Lampe and Moser also found that the existence of the sewing machine combination that aggressively defended patents “may have shifted innovation by nonmembers towards substitute technologies [such as an inferior stitching mechanism] not covered by the pool.”<sup>52</sup> In other words, by intensifying the threat of litigation, pooling arrangements can affect the behavior of rival firms to innovate (or raise the cost of that innovation through the extraction of licensing fees for non-essential patents), even in circumstances where the potential innovator does not believe he or she would actually infringe any of the patents in the pool.<sup>53</sup> Such increased litigation risks not only lowers expected profits and discouraged investment by outside firms, but also encourages them to “divert their research efforts away from improving key technologies that are covered by the pool towards substitutes that [were] still ‘freely’ available.”<sup>54</sup>

*C. How can patent pools that tend to enhance competition be distinguished from those that tend to suppress competition?*

Given that patent pools have the potential for both promoting competition as well as seriously undermining it, depending on the circumstances, the key question is what distinguishes a procompetitive pooling arrangement from an anticompetitive one?

The DOJ has set forth one framework for evaluating the likely competitive impact of a patent pooling arrangement. Under the DOJ’s approach, the relevant analysis considers (1) whether the proposed licensing program is likely to integrate complementary patent rights and (2) if so, whether the resulting competitive benefits are likely to be outweighed by competitive harm posed by other aspects of the program.<sup>55</sup>

The inquiry into whether the pool contains complementary patents (covering different aspects of the same technology, process, or product) or competing patents (claiming alternative non-infringing means of accomplishing the same end) is critical to assessing the competitive impact of the arrangement. Most importantly, when a patent pool contains patent rights that are substitutable for one another – or would otherwise compete against each other – that creates incentives for the patent holders to use the pool to eliminate competition among themselves<sup>56</sup> and/or serve as a vehicle to accomplish price

52 *Id.* at 916; *see also* Lampe & Moser, *Sewing II*, *supra* note 47, at 22 (“In the early years after the pool had formed, outside firms produced six times as many patents for substitutes relative to the pre-pool period.”).

53 Indeed, litigation data showed that nonmembers were at a greater risk of being sued while the pool was active and that pool members acted as plaintiffs in most of these cases. Lampe & Moser, *supra* note 29, at 901.

54 *Id.* at 917. Patent pools may encourage innovation in technically inferior substitutes, “creat[ing] a market-niche for outside firms to enter [the market] with lower quality and less expensive substitutes, which increases the expected returns of R&D to improve substitutes.” Lampe & Moser, *Sewing II*, *supra* note 47, at 3. Such a market niche is “particularly attractive relative to improving the pool technology, if the creation of a pool increases litigation risks for outside firms.” *Id.* at 22.

55 *See* Letter from Charles A. James, Assistant Attorney Gen., Antitrust Div., Dep’t of Justice, to Ky P. Ewing, Esq. (Nov. 5, 2002) [hereinafter 3G Business Review Letter], *available at* <http://www.usdoj.gov/atr/public/busreview/200455.htm>; Letter from Joel Klein, Acting Assistant Attorney Gen., Antitrust Div., Dep’t of Justice, to Carey R. Ramos, Esq. (June 10, 1999) [hereinafter DVD-6 Business Review Letter], *available at* <http://www.usdoj.gov/atr/public/busreview/2485.htm>; Letter from Joel Klein, Acting Assistant Attorney Gen., Antitrust Div., Dep’t of Justice, to Gerrald R. Beeney, Esq. (Dec 16, 1998) [hereinafter DVD-3 Business Review Letter], *available at* <http://www.usdoj.gov/atr/public/busreview/2121.htm>; MPEG-2 Business Review Letter *supra* note 38.

56 *See, e.g., United States v. Hartford Empire Co.*, 46 F. Supp. 541 (1942), *modified*, 323 U.S. 386 (1945). The pool invalidated in *Hartford* contained patents covering two types of glass feeding machines, gob and suction feeders. The court evidence that the pool was intended to prevent competition between the two technologies to be persuasive. *Id.* at 561 (noting a letter between pool members that states, “We [pool members] recognize that there is a distinct field for each of these processes. It would seem then to be the proper thing to let the two processes go along side by side and each develop the proper field as the demand from the industry would naturally work it out. But, of course, we both also recognize that it would be unfortunate to have this parallel development of the two processes reach a stage where competition between the two became generally destructive and unstabilized.”).

fixing.<sup>57</sup> On the other hand, the combination of complementary patents that cover separate aspects of a given technology, and do not compete with each other, tend to increase efficiencies and lower prices to consumers.<sup>58</sup>

To assess whether a pool contains only complementary patents, each patent is evaluated to determine whether it is “essential” to effectuate the underlying purpose of the patent pool (*e.g.*, implementation a technological standard). By definition essential patents have no substitutes, as “one needs licenses to each of them in order to comply with the standard.”<sup>59</sup> In contrast, because competing patents are alternative means to achieve the same end, they would be considered “non-essential” patents, unless, as discussed above, they are blocking patents.<sup>60</sup> To reduce antitrust risk, patent pools often employ an independent expert to assess “essentiality” by reviewing the portfolio to ensure that the portfolio does not contain competing patents.<sup>61</sup>

If the pool is found to contain only complementary patents, the procompetitive benefits of the pooling arrangement will be evaluated against the potential anticompetitive harm. For example, antitrust regulators have often focused on whether or not pool members are permitted to individually license their patents, separate from the pool license, in determining whether or not a pool serves a procompetitive purpose.<sup>62</sup> Other relevant questions might include:

- What are the efficiencies generated by the pooling arrangement (*i.e.*, integrating essential patents into a bundle for dissemination to licensees in a single transaction)?
- What are likely impacts of the pooling arrangement on innovation and incentives to engage in research and development related to the licensed technology?
- What are the competitive restrictions imposed on the pool members and licensees and are these restrictions necessary to achieve the underlying purpose of the pool?
- Is the pooling arrangement likely to impede competition in any adjacent or downstream markets by foreclosing competing technologies?

The answers to these questions provide indications of whether or not the pooling arrangement is likely to impede competition and innovation. The remainder of this article will first explore how the antitrust agencies as well as the federal courts have approached these questions in the past and will conclude by highlighting some additional factors that may help to differentiate procompetitive from anticompetitive pools in the future.

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57 However, in circumstances where two patents are competitive *and* blocking, and the patents are licensed on RAND terms, a pool combining these potentially substitutable patents may not be anticompetitive.

58 ANTITRUST ENFORCEMENT AND IP RIGHTS REPORT, *supra* note 7, at 66; *see also* HERBERT HOVENKAMP, MARK JANIS & MARK LEMLEY, IP AND ANTITRUST: AN ANALYSIS OF ANTITRUST PRINCIPLES APPLIED TO INTELLECTUAL PROPERTY LAW §34.4 (2010).

59 *See* 3G Business Review Letter, *supra* note 55, at 10.

60 *See supra* note 58 and accompanying text.

61 MPEG-2 Business Review Letter, *supra* note 38, at 10.

62 *See, e.g., Broad. Music, Inc. v. Columbia Broad. Sys., Inc.*, 441 U.S. 1, 24 (1971); MPEG-2 Business Review Letter, *supra* note 38, at 11.



### III RECENT GUIDANCE FROM THE AGENCIES AND THE COURTS CONCERNING PATENT POOLING ARRANGEMENTS

#### A. DOJ Business Review Letters

Between 1997 and 2002, the DOJ evaluated four separate patent pools in business review letters, announcing the DOJ's enforcement intentions with respect to the various pooling arrangements.<sup>63</sup> As described in more detail below, in each case the DOJ concluded that the "patent-pooling proposals were likely to create substantial integrative efficiencies by reducing the time and expense of disseminating the patents to interested licensees, clearing blocking positions, and integrating complementary technologies."<sup>64</sup>

First, in 1997, the DOJ issued a business review letter concerning a pooling arrangement – among nine companies holding twenty-seven patents – related to the MPEG-2 video compression technology standard. The DOJ found that the MPEG-2 portfolio was likely a procompetitive aggregation of intellectual property because it limited the portfolio to patents that were "technically essential" to comply with the MPEG-2 standard. Moreover, the DOJ found significant that the assessment of "essentiality" was made by an independent expert who would have a continuing role whenever a legitimate question was raised regarding whether a particular patent belonged in the portfolio.<sup>65</sup> Finally, the DOJ noted that all the portfolio patents were available individually from their owners or assignees.<sup>66</sup>

Second, in 1998 and 1999, the DOJ issued two separate business review letters concerning pooling arrangements related to DVD-Video and DVD-ROM standards. The 3C DVD pool business review letter, issued in 2008, involved three firms licensing a total of 210 patents, while the 6C DVD business review letter, issued in 2009, involved six firms licensing a total of 51 patents.<sup>67</sup>

Notably, the DVD pools broadened the scope of the definition of essentiality. Whereas in the MPEG-2 pool essential patents were limited to those that were "technically essential," the DVD pools found essential patents that were "necessary (as a practical matter)" or for which there was no "realistic" alternative.<sup>68</sup> Moreover, essentiality for the DVD pools was determined by an expert that was retained directly by the patent pool participants.<sup>69</sup> Despite expressing some concern over a more subjective definition of essentiality, to be determined by a hired expert, the DOJ found that both arrangements were likely to combine complementary patent rights. Importantly, in determining that these arrangements were unlikely to impede competition, the DOJ relied on the parties' representations that the experts would remain independent from the pool licensors – even though they were hired by the licensors – because "the expert's compensation [would] not be affected by his or her determinations as to essentiality."<sup>70</sup>

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63 See sources cited *supra* note 55.

64 ANTITRUST ENFORCEMENT AND IP RIGHTS REPORT, *supra* note 7, at 71.

65 MPEG-2 Business Review Letter, *supra* note 38, at 10.

66 *Id.*

67 See DVD-3 Business Review Letter, *supra* note 55; DVD-6 Business Review Letter, *supra* note 55.

68 DVD-3 Business Review Letter, *supra* note 55, at 11; DVD-6 Business Review Letter, *supra* note 55, at 12.

69 DVD-3 Business Review Letter, *supra* note 55, at 12; DVD-6 Business Review Letter, *supra* note 55, at 13.

70 DVD-6 Business Review Letter, *supra* note 55, at 13.

Finally, in 2002, the DOJ issued a fourth business review letter related to the Third-Generation Mobile Communications System (3G), a wireless communication technology.<sup>71</sup> The pool was formed by a nineteen-company partnership, which proposed to divide licensing functions among five separate and independent “platform” companies, one for each of the five 3G radio interface technologies. Again, the DOJ concluded that the pooling arrangements were likely to combine complementary patents because the separate platform companies were “structured to take into account substitutability between 3G technologies by creating an independent PlatformCo to handle all licensing matters, including setting of actual royalty rates, with respect to each individual 3G technology.”<sup>72</sup> Moreover, while the essential patent rights for each technology were not integrated into a single bundle for dissemination to licensees in a single transaction, the pooling arrangements “create[d] the opportunity to reduce the cost of individual negotiation with each licensor and afford the ministerial service of issuing [standard] license forms.”<sup>73</sup>

### B. *The FTC’s decision in Summit Technologies*

In addition to the DOJ’s Business Review Letters, the FTC has also taken some enforcement action related to patent pooling arrangements. In *Summit Technologies*, the FTC challenged a patent pool that contained patents relating to the manufacture and use of lasers used in photo-refractive keratectomy (PRK), a form of vision-correcting eye surgery.<sup>74</sup> The pooling agreement included a cross-license between Summit and VISX and provided that each company would pay the pool a \$250 royalty for each PRK procedure performed.

The Summit-VISX pool would arguably have achieved one of the key procompetitive benefits of collective licensing arrangements: the introduction of new technologies to the market. Both Summit and VISX were in the early stages of clinical trials for their respective PRK procedures. Further, each company had strong patents that potentially covered both PRK techniques,<sup>75</sup> and the uncertainty surrounding PRK technologies stemming from each company’s patents made it difficult to secure funding to further develop the technology.<sup>76</sup> The pool’s cross-license eliminated the risk of destructive patent litigation. Moreover, the royalty agreement would have allowed both companies to recoup the some of the research and development expenses embodied in their respective patents in the event that only one of the procedures made it out of clinical trials.

Despite these apparent benefits, the FTC obtained a consent order dissolving the patent pool arrangement.<sup>77</sup> Curiously, the FTC did not apply the rule of reason in

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71 See 3G Business Review Letter, *supra* note 55.

72 *Id.* at 10.

73 *Id.* at 11.

74 Complaint, Summit Tech., Inc., No. 9286 (F.T.C. Mar. 24, 1998), available at <http://www.ftc.gov/os/1998/03/summit.cmp.htm>.

75 See Joshua A. Newberg, *Antitrust, Patent Pools, and the Management of Uncertainty*, 3 ATLANTIC L.J. 1, 25 (2000), available at <http://www.ftc.gov/opp/intellect/020417joshuanewberg.pdf>.

76 *Id.*

77 Press Release, Fed’l Trade Comm’n, Summit and VISX Settle FTC Charges of Violating Antitrust Laws (August 21, 1998), available at <http://www.ftc.gov/opa/1998/08/sumvisx.shtm>.

evaluating the pool. Both the case law<sup>78</sup> and agency guidelines<sup>79</sup> make it clear that rule of reason analysis should be employed whenever a licensing restriction contributes to efficiency enhancing activity. However, the FTC discounted the pool's procompetitive effects on bringing PRK technologies to market and chose to analyze only whether there was a less restrictive alternative than the pool. As the agency explained, "Summit and VISX could have achieved these efficiencies by any number of significantly less restrictive means, including simple licenses or cross-licenses that did not dictate prices to users or restrict entry."<sup>80</sup> In other words, even if it were true that the pooling arrangement were necessary to clear blocking positions and bring PRK technologies to the market, and even if the benefits of the pool outweighed any negative effects, the competitive restraints imposed by the pool were unnecessary to achieve this purpose.

The FTC observed that the pool contained a number of anticompetitive features. Notably, while the pool provided a mechanism for Summit and VISX to license their patents to third parties, no such licenses were ever granted during the course of the six-year existence of the patent pool.<sup>81</sup> Moreover, the pool required Summit and VISX to pay a \$250 fee to the pool for each PRK procedure performed, which had the effect of establishing a price floor and resulted in the companies charging identical prices to ophthalmologists utilizing their technology.<sup>82</sup> Nevertheless, although the FTC has in other contexts acknowledged that the rule of reason should have governed the decision,<sup>83</sup> it gave little consideration to any procompetitive effects that the pool might have had in its public comments at the time.

The invalidated Summit-VISX pool provides a stark contrast to a pool recently announced by MPEG-LA. Although the FTC was not ultimately persuaded, there is at least a colorable argument that the pool helped bring PRK technologies to the market. MPEG-LA, on the other hand, has attempted to create a burdensome pool around a technology already on the market – in other words the pool is not necessary to commercialize the technology because the technology already has been commercialized. The open-source VP8 video codec has been available since May 2010. Nevertheless, in February 2011 MPEG-LA solicited patent holders to submit patents they believe cover the technology, intending to create a licensing pool for VP8.<sup>84</sup> The VP8 pool clearly is not intended to help bring the technology to the market; instead, it appears that MPEG-LA is

78 See, e.g., *Standard Oil Co. v. United States*, 283 U.S. 163 (1931) (applying rule of reason analysis); *Carpet Seaming Tape Licensing Corp. v. Best Seam, Inc.*, 616 F.2d 1133, 1142 (9th Cir. 1980) ("The accumulation of patents is not per se illegal. A patent pool may, however, be rendered unlawful if accompanied by an illegitimate purpose or anticompetitive consequences beyond those inherent in the grants of the patents in question."); *Wuxi Multimedia, Ltd. v. Koninklijke Philips Elecs., N.V.*, No. 04cv1136 DMS (BLM), 2006 WL 6667002, at \*5 (S.D. Cal. Jan. 5, 2006); *Boston Scientific Corp. v. Schneider AG*, 983 F. Supp. 245, 271 (D. Mass. 1997); see also *Broad. Music, Inc. v. Columbia Broad. Sys., Inc.*, 441 U.S. 1, 24 (1979) (holding that blanket licenses "should be subject to a more discriminating examination under the rule of reason.").

79 See, e.g., IP GUIDELINES, *supra* note 5, § 3.4, 3G Business Review Letter, *supra* note 55, at 9 ("Accordingly, as with a patent pool, the following analysis addresses (1) whether the proposed Platform is likely to integrate complements and (2) if so, whether the resulting competitive benefits are likely to be outweighed by competitive harm posed by any other aspect of the Platform."); DVD-6 Business Review Letter, *supra* note 55, at 10 ("As with any aggregation of patent rights for the purpose of joint package licensing, commonly known as a patent pool, an antitrust analysis of this proposed licensing program must examine both the pool's expected competitive benefits and its potential restraints on competition."); DVD-3 Business Review Letter, *supra* note 55, at 9 ("As with any aggregation of patent rights for the purpose of joint package licensing, commonly known as a patent pool, an antitrust analysis of this proposed licensing program must examine both the pool's expected competitive benefits and its potential competitive hazards."); MPEG-2 Business Review Letter, *supra* note 38.

80 Analysis of Proposed Consent Order To Aid Public Comment, 63 Fed. Reg. 46,452, 46,454 (Sept. 1, 1998), available at <http://www.ftc.gov/os/1998/08/d09286ana.htm>.

81 *Id.* at 46,453.

82 *Id.*

83 See Sheila F. Anthony, *Antitrust and Intellectual Property Law: From Adversaries to Partners*, 28 AIPLA Q.J. 1 (2000).

84 See Press Release, *supra* note 4.

attempting to extract rents from firms already using the technology<sup>85</sup> and to encumber VP8 so as to protect the competing H.264 standard, which was already subject to an MPEG-LA pool.

### C. *The DOJ investigation into MPEG-LA*

Most recently, in March 2011, the DOJ opened an investigation into MPEG-LA, which as discussed earlier, advertises itself as “world’s leading packager of patent pools.”<sup>86</sup> The investigation centers on MPEG-LA’s patent pool for the high-definition video encoding standard known as H.264, in which MPEG-LA manages over 1,700 patents purportedly relating to the standard. According to a *Wall Street Journal* article, the DOJ and California State Attorney General’s office are “investigating whether MPEG-LA, or its members, are trying to cripple an alternative format called VP8 that Google released last year – by creating legal uncertainty over whether users might violate patents by employing that technology.”<sup>87</sup>

Indeed, in course of creating the H.264 patent pool, MPEG-LA formally solicited patents from “any party that believes it has patents that are essential to the VP8 video codec specification . . . for a determination of their essentiality by MPEG-LA’s patent evaluators.”<sup>88</sup> Notably, a short time before MPEG-LA made its call for any VP8-related patents, Google announced that it was open-sourcing its own video codec, based on VP8 technology, that would be subject a royalty-free, open license. This would enable software developers to use the technology to develop an alternative video format to the incumbent, dominant H.264 standard.<sup>89</sup> In that light, it perhaps is not surprising that MPEG-LA – the administrator of the competing royalty-bearing H.264 patent standard – issued a call for patents concerning the free, competitive alternative to the codec that supported its dominant video format.

### D. *The Federal Circuit’s Decision in Princo II*

In addition to the recent guidance from the antitrust authorities with respect to patent pooling arrangements, the Federal Circuit has also recently issued in an opinion concerning patent pooling arrangements in *Princo Corp. v. International Trade Commission* (*Princo II*).<sup>90</sup>

*Princo* involved two sets of patents – Philips’s “Raaymakers” patents and Sony’s “Lagadec” patents – designed to encode position information in a compact disc.<sup>91</sup> After reviewing each technology, Sony and Philips agreed to use Philips’s encoding solution, rather than Sony’s, and incorporated the Raaymakers technology into a technical standard for CD-Rs and CD-RWs known as the “Orange Book” standard.

85 Cf. FED. TRADE COMM’N, THE EVOLVING IP MARKETPLACE: ALIGNING PATENT NOTICE AND REMEDIES WITH COMPETITION (2011), available at <http://www.ftc.gov/os/2011/03/110307patentreport.pdf> (explaining that competition is harmed when patents are valued according to their potential for extracting rents from firms already practicing the covered technology).

86 *Revolutionizing Intellectual Property Rights Management*, MPEG-LA, <http://www.mpeg-la.com/main/Pages/About.aspx> (last visited Sept. 26, 2011).

87 See Catan, *supra* note 3.

88 Stephen Shankland, MPEG-LA Patent Move Blemishes Google’s Web Video Plan, CNET.COM (Feb. 11, 2011), [http://news.cnet.com/8301-30685\\_3-20031525-264.html](http://news.cnet.com/8301-30685_3-20031525-264.html).

89 *Id.*

90 *Princo Corp. v. Int’l Trade Comm’n (Princo II)*, 616 F.3d 1318 (Fed. Cir. 2010).

91 *Id.* at 1322.

To commercialize the technology, the companies combined their patents into a patent pool. Philips administered a licensing program, which offered package licenses to the pooled patents (*i.e.*, the Raaymakers and Lagadec patents). Princo licensed the bundled patents, stopped paying for the license, and was sued by Philips for infringement of the Raaymakers patents, but not the Lagadec patents. Princo defended the patent infringement suit by claiming that Sony and Philips tied the essential Raaymakers patents to the non-essential Lagadec patents, and that Philips and Sony foreclosed potential competition between them by agreeing that the Lagadec patents would be available only through package licenses by way of the patent pool.

In its *en banc* opinion, the Federal Circuit addressed only one issue: whether an agreement between Sony and Philips to suppress the Lagadec technology – by making it available only through package licenses when the technology was unnecessary (from a technical standpoint) to manufacture Orange Book compliant discs – would constitute patent misuse. In rejecting Princo’s misuse defense, the court first set forth an extremely narrow definition of patent misuse, stating that “the doctrine of patent misuse has largely been confined to a handful of specific practices by which the patentee seemed to be trying to ‘extend’ his patent grant beyond its statutory limits.”<sup>92</sup> Elaborating on this narrow standard, the majority “emphasized that the defense of patent misuse is not available to a presumptive infringer simply because a patentee engages in some kind of wrongful commercial conduct, even conduct that may have anticompetitive effects.”<sup>93</sup> In other words, even if a pooling arrangement facilitates anticompetitive conduct – such as, by including competing, non-essential patents – patent misuse will not be found unless the temporal scope of the pool (*i.e.*, the expiry date of the patents in the pool) is lengthened or extended by the inclusion of such non-essential technology.<sup>94</sup>

In addition, the court found that a key element of patent misuse is *patent leverage*, which requires that the asserted patents significantly contribute to the misconduct at issue.<sup>95</sup> Princo, however, had failed to establish the required connection between any misconduct and the enforced Raaymakers patents. Philips’s licensing program did not restrict the availability of the Raaymakers patents and therefore did not use those patents for leverage. Moreover, any antitrust violation based on an alleged agreement between Philips and Sony to suppress the Lagadec technology was unrelated to the issue of misuse of the Raaymakers patents.<sup>96</sup>

Finally, applying rule of reason analysis, the court concluded that substantial evidence supported the Commission’s factual finding that Philips and Sony did not suppress a potentially viable alternative to the Orange Book standard. The Commission had found that Lagadec technology was inferior and that Philips and Sony entered into their pooling arrangement for technical reasons, rather than a conspiracy to suppress the Lagadec technology. Moreover, the Commission found insufficient evidence that a potential licensee would have developed a disc based on the Lagadec technology and that this technology was likely to have competed against the Raaymakers technology absent the agreement between Sony and Philips.<sup>97</sup>

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<sup>92</sup> *Id.* at 1329.

<sup>93</sup> *Id.*

<sup>94</sup> The narrow definition of patent misuse applied in *Princo II* echoes the approach used in *Princo I*. In fact, Judge Bryson, who wrote the majority opinion in *Princo II*, also drafted a concurring opinion in the *Princo I* case. In both instances, Bryson remains unresponsive to the potential costs and anticompetitive effects of inflating patent pools with non-essential patents; he writes “the profit-maximizing price for the license would be the same regardless of whether it included no unwanted patents or dozens of them, as long as it contained all the patents needed to make Orange Book compliant discs.” *Princo Corp. v. Int’l Trade Comm’n (Princo I)*, 563 F.3d 1301, 1322 (Fed. Cir. 2009).

<sup>95</sup> *Id.* at 1331-33.

<sup>96</sup> *Id.* at 1332.

<sup>97</sup> *Id.* at 1340.

#### IV. THE ROLE OF ANTITRUST IN LIGHT OF *PRINCO II* AND AGENCY GUIDANCE ON PATENT POOLING ARRANGEMENTS

Given the Federal Circuit's decision in *Princo II*, as well as the guidance from the antitrust authorities on patent pooling arrangements, what is the proper (and likely) role of antitrust enforcement in this area going-forward? We argue that the impact is twofold. First, the *Princo II* decision, which set a very high bar to demonstrate patent misuse, will likely strengthen the need for antitrust enforcement with respect to suspect patent pooling arrangements. Second, the DOJ's Business Review Letters should not signal acquiescence by the agencies that patent pooling arrangements (without mandatory RAND licensing) are generally procompetitive. Indeed, the size, scope, breadth, and function of present-day patent pools vis-à-vis the patent pools evaluated in the DOJ's Business Review Letters have changed dramatically. As a result, several of the premises on which the DOJ based its decisions not to pursue enforcement actions may no longer hold true, and thus we may expect to see renewed interest by the agencies in the investigation and challenge of pooling arrangements.

##### A. *Princo II's effect on patent misuse defense in infringement cases brought by patent pool licensors*

As discussed above, the *Princo II* decision sets a very high burden to demonstrate patent misuse in the context of patent pooling arrangements. In *Princo II*, the Federal Circuit rejected a theory of patent misuse based on an agreement to pool patents in order to suppress potentially competing technologies. According to the court, the patent actually asserted had to significantly contribute to the misconduct at issue. Suppression of the Lagedec technology (the potentially competing technology bundled with the Raaymakers technology) did not relate to the Raaymakers patents (the patents actually asserted), and, therefore, such misconduct could not constitute patent misuse.<sup>98</sup>

This analysis, however, is flawed for multiple reasons. First, the Court explicitly contradicts the approach taken by the DOJ in its Business Review Letters to evaluate the competitive effects of patent pooling arrangement by evaluating essentiality.<sup>99</sup> Indeed, the court explicitly states that the doctrine of patent misuse is not available – *even if* the patent holder engages in wrongful conduct with anticompetitive effect – unless the temporal scope of the patents in the pool is increased. As a result, the addition of non-essential, competing patents to a pooling arrangement is outside the realm of the misuse doctrine unless such additions extend the expiration date of the pool.

Moreover, an agreement between Sony and Philips to bundle the Lagedec and Raaymakers patents together in an effort to exclude Lagedec technology should, in theory, constitute misuse of *both* sets of patents. In other words, since suppression of the Lagedec technology could not be achieved without bundling Lagedec patents together with the Raaymakers technology, the misconduct clearly relates to the Raaymakers patents. Again, but for the pooling arrangement combining the potentially competing Lagedec and Raaymakers technologies, Sony (or whoever held the rights to the Lagedec patents) would

<sup>98</sup> *Id.* at 1331-33.

<sup>99</sup> While the DOJ Review Letters evaluated patent pooling arrangements in the context of antitrust liability, whereas *Princo II* evaluated the same in the context of patent misuse, both are relevant to the essentiality test for patent pools. For the DOJ, essentiality was critical to a finding that a particular pooling arrangement did not harm competition. In contrast, the *Princo II* court found that essentiality was irrelevant to the affirmative defense of patent misuse. Indeed, under the Federal Circuit's analysis, the addition of non-essential patents to a patent pool simply does not implicate the misuse doctrine, unless the inclusion of such patents increases the temporal scope of the pool. *See id.* at 1329.

have an incentive to develop and commercialize the Lagedec technology as an alternative solution to encoding position information in a compact disc.

Lastly, the Federal Circuit also required *Princo* to show a reasonable probability that the Lagedec technology would have developed into a competitive technology in the market.<sup>100</sup> Considering that *Princo* alleged that Philips and Sony sought to suppress the Lagedec technology from the start by bundling it with the potentially competing Raaymakers patents, it is unclear what evidence, if any, could ever be sufficient to establish “reasonable probability” that the Lagedec technology would have developed into a competitive technology. The requirement to demonstrate reasonable probability ignores the dynamic quality of innovation. The actual development trajectory of Lagedec technology, which was cut short by the pooling agreement, is a very poor indicator of how the technology might have fared if the pool had not existed and Sony had economic incentives to develop the technology so that it *would* have been competitive (versus Sony’s incentives once it had combined with Philips, which was to abandon such efforts and suppress any efforts by others).

Where a pool forms around an industry standard, the requirement that a plaintiff demonstrate with reasonable probability that other viable alternatives would have developed absent the chosen standard is particularly onerous and inevitably speculative. The path of nascent innovation is necessarily, and artificially, terminated when another technology is chosen as the standard. As such, it is difficult, but not impossible, to demonstrate whether such prematurely terminated technologies would have developed into a viable alternative to the technology that ultimately was declared the winner at the time the pool (or standard-setting body) was formed.

It is clear that *Princo II* marks a decisive win for proponents of Patent pools by providing patent holders with a blueprint to avoid misuse: Patent holders can bundle potentially competing patents in order to suppress one technology as long they do not assert infringement of the patent(s) allegedly suppressed by the pooling arrangement. Moreover, *Princo II* sanctions the additions of non-essential, competing patents to a pool without regard to the enormous transactions costs that these additions impose on potential licensees.<sup>101</sup> As discussed in more detail below, the proliferation of the size and scope of present day pooling arrangements makes it unrealistic for innovators to assess whether they infringe on a particular pool’s patents. In many circumstances, simply taking a license to the pool is less expensive than investing the resources in evaluating non-infringement and/or invalidity of each of the pooled patents, especially if the pool has been packed with a large number of non-essential patents.<sup>102</sup>

By setting an extremely high (if not unobtainable) bar to demonstrate patent misuse by patent pools, the *Princo II* decision serves to further embolden patent holders to use patent pools aggressively. In other words, *Princo II* removes a key defense for patent infringement defendants asserting that plaintiffs acted anticompetitively in the procurement

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<sup>100</sup> See *id.* at 1338-39.

<sup>101</sup> See Lampe & Moser, *supra* note 29, at 899 (“[P]ools that combine substitute patents can increase license fees for outside firms.”).

<sup>102</sup> See *supra* notes 39-54 and accompanying text. A patent pool is both a more formidable litigation opponent and likely to be more aggressive in asserting its patents. Moreover, independently administered pools cannot be deterred by the threat of an infringement counterclaim. Pools also limit the disincentives for patent holders with weak claims to pursue a lawsuit. It is significantly less expensive to add a claim to the pool’s suit than to launch an individual suit. Moreover, the pool spreads the costs of litigation among the pool members, limiting the downside risk of aggressively asserting weak or potentially irrelevant patents. For these reasons, pool licensors collectively impose a greater risk and potential cost of litigation than they would if they each had to bring a separate claim. Taking a pool license, or joining the pool, is often less expensive than conducting the detailed review of the pool’s patents necessitated by the increased threat of litigation that the pool poses.

and the selective enforcement of their “patent rights,” in order to suppress technologies that compete with the pooled patents. As a result of this decision, it would be economically rational for patent pools to continue to aggregate many more patents than are required for essentiality. In the meantime, licensees will be forced to either take a licensee to the pool – or worse yet, may fail to innovate altogether – or spend considerable resources in evaluating and challenging pools containing non-essential patents. Both of these avenues waste resources and involve dead weight loss, serving neither consumers nor innovation. As a result of these harmful effects of the *Princo II* decision on competition and innovation, it will be even more critical for antitrust enforcement to play a substantial role in evaluating these types of agreements in the future.

*B. Antitrust enforcement can and should play an active role in evaluating the competitive impact of patent pooling arrangements.*

In addition to the likelihood that antitrust enforcement will *need* to play a stronger role in light of the *Princo II* decision, we also believe that it *can* and *should* do so.

The patent pools evaluated by the DOJ in its 1997-2002 Business Review Letters contained anywhere from 27 to 210 patents. Many patent pools in today’s market are enormous by comparison. MPEG-LA’s patent pool relating to the H.264 pool – which is currently being investigated by the DOJ – contains over 1,700 patents.<sup>103</sup> Moreover, patent pools can grow quickly after they are formed, particularly when they incorporate grantback clauses.<sup>104</sup> For example, the MPEG-2 patent pool, which contained just twenty-seven patents when reviewed by the DOJ, grew to encompass over eight hundred patents over its lifetime.<sup>105</sup> The growth of individual patent pools reflects the growing importance and value of intellectual property rights. As of 2005, three-quarters of the value of publicly traded firms was in intangible assets such as intellectual property rights, up from only forty percent two decades prior.<sup>106</sup> Even extremely large and well-established firms, such as Microsoft and Hewlett Packard, have experienced significant growth in revenue from intellectual property licensing in the past decade.<sup>107</sup> This trend shows no sign of abating, and we can likely expect to see patent pools continue to grow and proliferate in the years to come.<sup>108</sup>

103 Charles Arthur, *US Justice Department Reportedly Investigating MPEG-LA over VP8 Threats*, GUARDIAN UK (Mar. 4, 2011), <http://www.guardian.co.uk/technology/blog/2011/mar/04/justice-department-antitrust-mpeg-la-vp8>.

104 The MPEG-2 pool license required licensees to offer every pool licensor a license to any patents necessary to implement the MPEG-2 standard (so-called “essential patents”) at a fee determined by the licensor’s per-patent share of pool royalties. In the alternative, a licensee with essential patents could join the pool. See Letter from Joel Klein, Acting Assistant Attorney Gen., Antitrust Div., Dept of Justice, to Gerrald R. Beeney, Esq., at 7 (June 26, 1997) [hereinafter MPEG-2 Business Review Letter], available at <http://www.justice.gov/atr/public/busreview/215742.pdf>. Faced with the choice between a compulsory license to every pool licensor and obtaining a share of pool profits by joining, most firms would likely choose the latter. See 3G Business Review Letter, *supra* note 55, at 12 (“Although . . . membership is voluntary, [the pool contains] some significant requirements that tend to bring in additional licensors and patents, including the obligation upon licensors who participate in the [pool] at all to submit all of their essential patents for evaluation and certification rather than strategically withholding some patents, and the ‘grant-back’ obligation on licensees who accept a Standard or Interim License requiring them to also submit any essential patents they hold for certification.”).

105 *Nero AG v. MPEG LA*, No. 10-cv-3672-MRP-RZ, 2010 WL 4366448 (C.D. Cal. Sept. 14, 2010) (internal citation omitted).

106 See Kenneth Cukier, *A Market for Ideas: A Survey of Patents and Technology*, THE ECONOMIST, Oct. 22, 2005, at 1.

107 See *id.* at 4, 8.

108 The proliferation of patent grants exacerbates the problem, and the fact that the Patent Office issues patents often when they should not be issued greatly contributes to this proliferation. This in turn increases the problem with some patent pools, as many likely include patents that should never have issued in the first place. See Paul R. Michel, *Enabling the Jury to Apply Patent Law Rationally*, 1 YALE SYM. L. & TECH. 1, ¶ 2 (1998) (“You can ask very good patent lawyers in this country whether a certain device infringes a given patent, and a lot of them will tell you, ‘Well I’m not sure.’ Some will say, ‘I think yes,’ and others will say, ‘I think no.’ Any system that routinely produces such a scattering of conclusions from competent, intelligent, and well-informed lawyers indicts itself in my view.”).



**Patent Pool Sizes (At Formation)**

1997-2002						Today	
Date	1997	1998	1998	1999	2002	2011	2011
Patent Pool	MPEG-2	DVD-3	Summit & VISX	DVD-6	3G	AVC/H.264 Pool	DVD-6
No. of Patents	27	210	25	51	N/A	1,700+	1,400+

Two overarching factors were critical to all of the DOJ's decisions in its Business Review Letters not to initiate enforcement actions. First, the DOJ assumed, based on the submitting parties' representations, that the pooling arrangement contained only complementary (*i.e.*, essential) patents.<sup>109</sup> Second, the DOJ assumed that this "essentiality" would be determined by an independent, nonbiased expert. When considering the sheer size, scope, and power of today's patent pooling arrangements, however, neither of these premises are likely to hold true.

First, with respect to complementarity, it is one thing to say that each of the twenty-seven patents in the MPEG-2 patent pool were "technically necessary" to implement to the MPEG-2 video compression technology standard; it is quite another thing, however, to say that each of the over 1,700 patents in MPEG-LA's H.264 pool are "technically necessary," or even "necessary (as a practical matter)" to the video codec standard. In such a vast patent pool it is highly unlikely – if not impossible – that every single patent contained in the pool is truly "essential" to the relevant technology. But it is *only* this essentiality that makes these types of collective arrangements permissible under the antitrust laws. Indeed, "the competitive relationship of the patents in the pool" is the paramount consideration in assessing whether a particular pool is likely to have procompetitive or anticompetitive effects.<sup>110</sup>

Notably, in its Business Reviews Letters, the DOJ emphasizes that pools containing substitute patents that "could be licensed and used in competition with each other . . . raise serious competitive concerns."<sup>111</sup> Thus, if essentiality is unlikely or undeterminable in pools containing thousands of patents, there is no basis for permitting such collaboration among actual and potential competitors, at least absent a firm commitment to open RAND licensing. Nor can one reasonably assume the patent validity of thousands of patents contained in a massive pooling arrangement given that the patent office frequently approves "ridiculous, broad, meaningless patents."<sup>112</sup> Again, based on the parties' representations, the DOJ presumed patent validity in its Business Review Letters without any examination of the individual patents in the pool. The problem of patent pools containing invalid patents is only further exacerbated as the size, scope, and power of the pools in question continue to increase.

<sup>109</sup> See, e.g., DVD-3 Business Review Letter, *supra* note 55, at 11 ("Based on what you have told us, however, the definition of 'necessary (as a practical matter)' that the expert will be employing is sufficiently clear and demanding that the portfolio is unlikely to contain patents for which there are economically viable substitutes.").

<sup>110</sup> Richard Gilbert, *Antitrust for Patent Pools: A Century of Policy Evolution*, 2004 STAN. TECH. L. REV. 3, ¶ 118, <http://str.stanford.edu/pdf/gilbert-patent-pools.pdf>.

<sup>111</sup> DVD-6 Business Review Letter, *supra* note 55, at 10.

<sup>112</sup> Mike Masnick, *When Patents Attack: How Patents Are Destroying Innovation in Silicon Valley*, TECHDIRT (July 25, 2011), <http://techdirt.com/articles/20110724/22250715225/when-patents-attack-how-patents-are-destroying-innovation-silicon-valley.shtml>.

Second, to what extent are the patent experts evaluating the pool – who are hired and compensated by the pooling organization – truly independent, nonbiased arbitrators of “essentiality”? For example, MPEG-LA, whose sole business is the formulation and maintenance of pooling arrangements, has a strong financial interest in the inclusion of as many patents as possible to maximize the pool’s license, formation, and administration fees.<sup>113</sup> Even if patent experts focusing on the evaluation of patent pools are not technically compensated based on the number of patents they deem essential, clearly they have an incentive to align their interests with those of their client, or risk losing that client’s business in the future (and, of course, the more patents in the pool, the more work – and total compensation – for the expert). Considering that MPEG-LA is the self-proclaimed world leader in the packaging of patents, retaining such a client is likely critical for patent experts with proficiency in the evaluation of patent pools.

To the extent that the expert tasked assessing essentiality is not truly independent, it is simply not realistic for potential licensees to serve as a watchdog for patents included in the pool, given the size and breadth of present day patent pooling arrangements. Again, hiring a patent attorney to provide a non-infringement opinion for a pool containing twenty-seven patents may be reasonable; however, few, if any, potential licensees have the resources at their disposal to procure non-infringement opinions – or an independent expert determination of essentiality – for a pool containing *thousands* of patents. Indeed, is far cheaper for a potential licensee to simply take a license to the pool, whether or not the patents in the pool are truly essential, because the alternatives – spending considerable time and money to conduct an independent assessment or not do so and run the risk of infringement liability – are prohibitively expensive. Given such incentives, mechanisms by which licensees can raise questions about whether a particular patent belongs in the portfolio are impractical.<sup>114</sup>

While there are no hard lines that can clearly separate procompetitive pools from anticompetitive pools, there are a number of relevant factors that antitrust authorities should carefully consider. First, the size of the patent pool is relevant. A large patent pool containing only complementary patents for a certain technology may well benefit competition by providing a “one stop shop” for acquiring patent rights. But, as discussed above, as a pool grows it becomes more likely to contain non-essential or substitute patents. Over the course of the past ten years, the size of a typical technology patent pool has grown considerably and this trend shows no sign of abating.<sup>115</sup> Evaluating the validity and coverage of the patents in today’s pools is an impossible task for a new entrant (and a

113 MPEG-LA also has every incentive to induce the creation of new collective licensing arrangements. See, e.g., *Librassy: Pathway to Precision*, MPEG-LA <http://www.mpegla.com/> (last visited Dec. 8, 2011); *Wani To Form a Pool?*, MPEG-LA <http://www.mpegla.com/main/Pages/FormPool.aspx> (last visited Dec. 8, 2011).

114 MPEG-2 Business Review Letter, *supra* note 38, at 11 (finding relevant procedure by which essentiality of pooled patents could be challenged).

115 In 1990 Zvi Griliches wrote that: “A well-established major firm does not depend as much on current patenting for its viability or the survival of its market position. Thus, even at equal underlying true inventiveness rates, the propensity to patent may be lower for large firms, at least relative to the successful new entrants in their field.” Zvi Griliches, *Patent Statistics as Economic Indicators: A Survey*, 28 J. ECON. LITERATURE 1661, 1677 (1990). However, Griliches seems to have underestimated the growing role that a large, comprehensive patent portfolio would have in determining the negotiating strength of companies in high technology markets. The number of patent awards first topped 100,000 in 1994; in 2010 the PTO granted over 200,000 patents. Joe Wilcox, *IBM Received Nearly 23 Patents per Working Day in 2010—Will Big Companies Become Patent Trolls?*, BETANEWS (2011), <http://betanews.com/2011/01/10/ibm-received-nearly-23-patents-per-working-day-in-2010-will-big-companies-become-patent-trolls/>. The three most prolific patentees in 2010 were IBM (5,896 overall, or roughly 16 per day), Samsung (4,551 overall, or roughly 12 per day), and Microsoft (3,094 overall, or roughly 8.5 per day). *Id.* From these numbers it is clear that, even if lower relative to new entrants when adjusted for size or some other factor, the patenting rate of “well-established major firms” in technology industries is still extremely high. If the rate of patenting continues to increase, Adam Mossoff’s somewhat hyperbolic prediction that in 150 years technologies may require a license to tens of millions of patents, seems not so hyperbolic. Mossoff, *supra* note 49, at 205.

difficult one for regulators as well). While there is no “magic number” of patents should be considered suspect, regulators should be more skeptical of the feasibility of self-regulation.<sup>116</sup>

The composition of the pool’s membership is also relevant to assessing a pool’s competitive impact. The market power that the pool’s members wield, both collectively and independently and both within and without the market for the technology covered by the pool, has a significant effect on the bargaining position of potential licensees vis-à-vis the pool. Beside market power, the past litigation practices of the pool’s members (or the pool administrator) should be examined to determine whether the pool will engage in anticompetitive litigation. Similarly, the members’ and administrator’s past licensing practices bear on whether not a commitment to RAND licensing will be upheld.

Finally, the antitrust agencies should scrutinize the potential for pools that share members or are administered by the same entity to coordinate. As discussed at the outset of this paper, patent pooling arrangements in today’s market, like MPEG-LA, that are designed to turn “patents into profits” by “packaging patents in order to give them mass market appeal” deserve antitrust scrutiny, like any other aggregation of potentially overlapping assets, held or managed by market competitors or patent aggregators.<sup>117</sup> When several pools covering related technologies are administered by the same entity, antitrust regulators should be especially vigilant. The suppressive effect of a single administrator governing two pools for competing technologies is similar to the effect of including two substitute technologies in a single pool. In the case of the 3G pool, the creation of five independent PlatformCos to manage the competing technologies covered by the pool was a critical factor in the DOJ’s decision not to pursue an enforcement action. A single administrator for overlapping pools greatly increases the risk of anticompetitive coordination between pools or anticompetitive subordination of a particular pool technology.<sup>118</sup>

To date, the FTC and DOJ have rarely had the opportunity to evaluate pools that clearly present these difficulties, but by every indication technology patent pools will continue to grow larger and more complex. Antitrust authorities have already made encouraging progress in considering the impact of patent pools on competing technologies that, for various reasons, cannot be readily shielded by a defensive patent portfolio. In particular, as discussed more fully in the following section, antitrust authorities have begun to recognize the distinct potential for patent pools to anticompetitively impede the development of open-source technologies. In addition, the agencies have begun to account for some of the factors listed here in the closely related context of patent portfolio acquisitions.

*C. The competitive impact of patent pools depends on a broad collection of heterogeneous factors, and antitrust authorities must undertake a holistic inquiry.*

In addition, the DOJ’s evaluation of pooling arrangements in its Business Review Letters did not specifically take into account the effect such arrangements might have on

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116 In its business review letters of patent pools, the DOJ has noted that pool members have an incentive to kick out invalid or non-essential patents from the pool so as to receive a greater share of the pool royalties. See, e.g., DVD-6 Business Review Letter, *supra* note 55, at 13. However, as the number of patents grows, the incentive to examine each patent contributed by the other members is blunted. This same phenomenon explains the adoption of royalty-free cross licenses, rather than a patent-by-patent accounting, when the covered patents are particularly numerous or difficult to value. A royalty-free cross license may be an ideal outcome to a patent suit from a competition perspective under some circumstances. See Shapiro, *supra* note 14, at 123. However, a reduced incentive to police a pool license for non-essential patents certainly is not.

117 MPEG-LA, *supra* note 3.

118 See *supra* notes 71-73 and accompanying text.

open-source alternatives. According to the International Data Corporation (IDC), open-source revenues are growing at a 22.4 percent compound annual growth rate and will reach \$8.1 billion by 2013.<sup>119</sup> However, the substantial innovation and market disruption spurred by open-source alternatives can be severely depressed when alternative technologies are not developed because of concerns of potential patent infringement. In essence, collaborators may be unlikely to engage in efforts to create, develop, and launch free open-source alternatives – which have immense procompetitive benefits – to the extent they are fearful of entering a patent mine field. Patent aggregation through patent pools can serve to exacerbate this problem by escalating potential litigation risk.<sup>120</sup> Open-source technologies are also less likely to be supported by a strong defensive patent portfolio owned or administered by a single, centralized entity.

To this end, it is encouraging that the DOJ's current investigation into MPEG-LA appears to focus, in part, on the effects of the H.264 pool on the royalty-free open-source VP8 alternative. Indeed, the H.264 pool has the potential to suppress competition in two distinct, yet complementary ways. Not only does it extract profits from innovators that are unable to challenge the essentiality of the pool due to its size and scope, but also it serves to stifle innovation by suppressing potentially competing alternatives like VP8. Indeed, MPEG-LA has attempted to create a patent pool around VP8 itself,<sup>121</sup> a technology that had been available to the industry for several years, and competes against MPEG-LA's dominant H.264 technology. While some patentees may be willing to join such a pool, others may be coerced into joining under the threat of litigation by the H.264 pool or its members implied by MPEG-LA's call for VP8-essential patents.

As noted above, pools covered substitute technologies administered by the same entity pose a particular risk of anticompetitive effect. Creating a pool around an already established technology is unlikely to have procompetitive effects (the central benefit of pools being to facilitate the *introduction* of new technology to a market) and appears instead to be intended to encumber VP8 with litigation uncertainty and license fees and protect the H.264 pool.<sup>122</sup> When assessing the overall competitive effect of such pools, the deterrence of competing technologies – and the corresponding competitive harm – is a critical variable in the equation. Moreover, by bringing the VP8 technology under its control, MPEG-LA will be able to extend its dominant position in the market for video decoding standards if key H.264 patents expire or VP8 supplants H.264 as the industry-favored technology.

In fact, a number of recent patent acquisitions (and accompanying antitrust investigations) clearly demonstrate the potential for patent portfolios jointly held by competitors to distort competition and suppress competing alternatives – related to cellular

119 *Open Source Software Market Accelerated by Economy and Increased Acceptance From Enterprise Buyers, IDC Finds*, BUSINESSWIRE (July 29, 2009, 8:00 AM), [http://www.businesswire.com/portal/site/home/permalink/?ndmViewId=news\\_view&newsId=20090729005107&newsLang=en](http://www.businesswire.com/portal/site/home/permalink/?ndmViewId=news_view&newsId=20090729005107&newsLang=en) (citing MICHAEL FAUSCETTE, INT'L DATA GROUP, WORLDWIDE OPEN SOURCE SOFTWARE 2009–2013 FORECAST (2009)).

120 Again, an open source developer may believe that it does not infringe any of the patents in a particular pooling arrangement. Nonetheless, it could be deterred from development because it perceives the infringement litigation risk from the patent aggregator to be higher than that of individual patent holders if the patents were disaggregated. *See, e.g., supra* notes 39–54 and accompanying text.

121 *See* Press Release, *supra* note 3. It should go without saying that if a pool organizer attempts to create pools with competing technology, that immediately should raise suspicion as to *why* that organizer would seek to create technology pools that compete against its established technology.

122 MPEG-LA has argued that, as an independent operator, it is indifferent as to which standard prevails. *See* Catan, *supra* note 3. It is far from clear that MPEG-LA is indeed indifferent. The company has invested considerable resources in evaluating and assembling patents for the H.264 pool. It is likely that MPEG-LA would benefit most from continuing to support its entrenched H.264 standard by simply encumbering VP8 with patents of uncertain application or validity, rather than investing in the detailed examination necessary to operate a viable VP8 pool. Even accepting MPEG-LA's argument, however, it is clear that a pool operator like MPEG-LA has an incentive to "capture" technologies that compete with those serviced by its pools. Competition between technologies both covered by pools operated by the same entity is weakened and may even be eliminated entirely.

telephone technology markets, an extremely lucrative industry subject to an extraordinary amount of patent litigation. The FTC has acknowledged that competition suffers when transferred patents are valued according to the ability to extract rents from firms that have already put covered products on the market.<sup>123</sup> This practice becomes even more troubling when competing firms join together to purchase patent portfolios in order to exclude an alternate technology or to raise rivals' costs. Patent aggregations of this sort can effectively function as private, unregulated patent pools created not to clear blocking positions, but to *create* them.

In September 2011, MOSAID reached an agreement to acquire (at no cost) two thousand Nokia patents. MOSAID would be responsible for asserting these patents against mobile device manufacturers and would split the resulting revenues with Nokia and Microsoft, essentially serving as the administrator of a Nokia-Microsoft pool.<sup>124</sup> Like MPEG-LA, MOSAID is a non-practicing entity and can therefore be more aggressive in extracting rents from practicing firms because it is not vulnerable to counterclaims. MOSAID is an aggressive licensor, boasting that achieved "complete saturation" of the DRAM memory chip market and at one point licensed "all DRAMs on the planet."<sup>125</sup> With Nokia's patents, MOSAID is targeting over \$500 billion in "unlicensed" revenues for mobile devices over five years, estimating that it can extract over \$1 billion in licensing fees for technologies already on the market.<sup>126</sup> Particularly troubling is the potential for Microsoft and Nokia to use MOSAID to increase the costs of competing mobile operating systems, such as Google's open-source Android operating system, while exempting themselves from licensing fees. Like an anticompetitive patent pool, MOSAID need only set a royalty rate less than the cost of evaluating and attacking its vast collection of patents to impose a tax on technologies that rival those of its partners.

Similarly, CPTN, a holding company owned equally by Microsoft, Oracle, Apple, and EMC, attempted to acquire nearly one thousand of Novell's patents in late 2010 in conjunction with Novell's merger with Attachmate; the DOJ opened an investigation into the acquisition and subsequently required it to be modified. As with a patent pool, placing the acquired patents in a holding company under joint control distributed and muted the downside risks of aggressively asserting the patents. Moreover, each of the owners of CPTN had a history of attacking competing open-source technologies, raising concerns that CPTN would attempt to use the increased litigation pressure of a pooled patent portfolio to suppress open-source software such as the Linux operating system. Consequently, the Department of Justice opened an investigation into the transaction, and in response to the DOJ's concerns, CPTN made a number of modifications to the acquisition agreement to limit the potential for anti-competitive assertion of Novell's patents by the consortium. In particular, all the acquired patents would be subject to the GNU General Public License and licensed to the Open Invention Network, which manages a collection of patents intended to help members defend Linux from patent attacks.<sup>127</sup>

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123 See FED. TRADE COMM'N, *supra* note 85.

124 Chris Velazco, *Mosaïd Acquires 2,000+ Nokia Patents, Will Handle Licensing & Litigation For a Cut*, TECHCRUNCH (Sept. 1, 2011), <http://techcrunch.com/2011/09/01/mosaïd-acquires-2000-nokia-patents-will-handle-licensing-litigation-for-a-cut/>. Microsoft's inclusion in this arrangement is somewhat puzzling as it does not appear to have contributed anything to the collaboration's assets.

125 Interview with John Lindgren, CEO, MOSAID, *CEO of MOSAID talks magnitude of Nokia / Microsoft Deal*, Sept. 13, 2011, <http://www.youtube.com/watch?v=37yzFT9xpys>.

126 Press Release, MOSAID Updates Shareholders on Special Committee Process, Addresses Wi-LAN Mischaracterizations (Sept. 12, 2011), *available at* <http://www.mosaïd.com/corporate/news-events/releases-2011/110912.php>.

127 Press Release, U.S. Dep't of Justice, CPTN Holdings LLC and Novell Inc. Change Deal in Order to Address Department of Justice's Open Source Concerns (Apr. 20, 2011), *available at* <http://www.justice.gov/opa/pr/2011/April/11-at-491.html>.

Finally, in mid-2011, the Rockstar Bidco consortium, comprised of Microsoft, Apple, Research in Motion, and other leading mobile companies, acquired Nortel's patent portfolio, containing roughly six thousand patents covering communications technologies<sup>128</sup> with a final bid of \$4.5 billion.<sup>129</sup> Like the MOSAID arrangement, Rockstar's acquisition of the Nortel patents allows established players to suppress competing open-source technologies by seeking excessive license fees for technologies that have already been incorporated into products on the market and even into industry standards.<sup>130</sup> This anticompetitive intent appears all the more evident as Microsoft, one of the principal backers of Rockstar, already had acquired a worldwide, perpetual license to the Nortel patents, calling into question why it needed to acquire the patents in the first place.<sup>131</sup>

These examples demonstrate the potential for collections of patents held by competing firms to be used to raise the cost of developing and deploying rival technologies, particularly those not backed by a strong defensive patent portfolio.<sup>132</sup> Clearing blocking positions and reducing transaction costs are the essential procompetitive justifications by which patent pools (and other similar patent aggregations) are valid under the antitrust laws. Antitrust regulators can and should take a stricter approach where competitors aggregate patents not to bring a new technology to the market but to create a blocking position in order to inhibit the development of alternative technologies.

## V. CONCLUSION

The use of patents pools to facilitate anticompetitive conspiracies to set prices, restrict output, or thwart emerging technologies is precisely what the courts and the antitrust authorities have cautioned against in evaluating pooling arrangements.<sup>133</sup> Patent pools were designed to solve specific problems – such as the clearing of blocking patents or to protect against “hold up” or “hold out” in the implementation of a technological standard – in order to *enhance* competition. When pooling arrangements are instead used as a weapon to suppress and/or raise the costs of actual and potential competitors because (1) the pool members have an incentive to eliminate competition, and (2) the pool administrator has the incentive to maximize profits through the inclusion of non-essential, invalid patents, the precompetitive justification for collective licensing arrangements is undermined. Hopefully, the DOJ's recent investigation involving MPEG-LA demonstrates a renewed vigor to more carefully assess the competitive impact of these arrangements, including close scrutiny of the purposes behind their formation. Given that the *Princo II* decision has further encouraged the aggregation of patents – irrespective of essentiality – such scrutiny is (and will to continue to be) sorely needed.

128 *Nortel Closes Patent Sale to Rockstar Bidco*, TECHFINANCE (July 29, 2011), <http://news.techfinance.ca/nortel-closes-patent-sale-to-rockstar-bidco/>.

129 The patents had a pre-auction estimated value of just \$1 billion. David Drummond, *When Patents Attack Android*, GOOGLE BLOG (Aug. 3, 2011), <http://googleblog.blogspot.com/2011/08/when-patents-attack-android.html>.

130 See Letter from Am. Antitrust Inst. to U.S. Dept of Justice (July 6, 2011), *available at* <http://www.antitrustinstitute.org/sites/default/files/Nortel%20letter%20to%20DOJ.7.6.11.pdf>.

131 Mary Jo Foley, *Will Microsoft Try To Outbid Google for Nortel's Patents?*, ZDNET (Apr. 4, 2010, 10:03 AM), <http://www.zdnet.com/blog/microsoft/will-microsoft-try-to-outbid-google-for-nortels-patents/9088>.

132 In February 2012, the DOJ closed its investigation into both the CPTN and Rockstar acquisitions following assurances and voluntary modifications to the transactions by the acquiring parties. See Press Release, U.S. Dept of Justice, Statement of the Department of Justice's Antitrust Division on its Decision to Close its Investigations of Google Inc.'s Acquisition of Motorola Mobility Holdings Inc. and the Acquisitions of Certain Patents by Apple Inc., Microsoft Corp, and Research in Motion Ltd. (Feb. 13, 2012), *available at* [http://www.justice.gov/atr/public/press\\_releases/2012/280190.htm](http://www.justice.gov/atr/public/press_releases/2012/280190.htm). Without passing on the correctness of the DOJ's determination that none acquisitions, as modified, presented a significant risk of anticompetitive effect, it is encouraging to note that the agency has acknowledged the relevance of some of the factors identified above in evaluating patent acquisitions. The FTC and DOJ must carry this focus forward to the analysis of patent conglomerations as well.

133 *Andewelt*, *supra* note 28, at 618 (“When competitive patents owned by different members are pooled, the members should be viewed as horizontal competitors, since they are alternative suppliers of competitive products, i.e., licenses under patents which can be used to accomplish similar functions.”).

# THE SEARCH FOR CLARITY IN FEDERAL PLEADING STANDARDS: ARE WE CLOSE TO LIMITING THE INTENDED (AND UNINTENDED) CONSEQUENCES OF *TWOMBLY* AND *IQBAL*?

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## I. INTRODUCTION

The majority opinions in *Twombly* and *Iqbal*<sup>2</sup> have become a resource that resembles *Bartlett's Familiar Quotations* in briefs supporting motions to dismiss in antitrust cases. Justice Souter, writing for the majority in *Twombly*, said that, to survive dismissal, an antitrust complaint alleging a conspiracy must contain “enough factual matter (taken as true) to suggest that an agreement was made”; a plaintiff must allege “enough fact to raise a reasonable expectation that discovery will reveal evidence of illegal agreement”; and the plaintiff must at the pleading stage present “allegations plausibly suggesting (not merely consistent with) agreement.”<sup>3</sup> The actual holding of the case is eminently quotable: “[b]ecause the plaintiffs here have not nudged their claims across the line from conceivable to plausible, their complaint must be dismissed.”<sup>4</sup> Many of us defense lawyers can write these quotes without having to refer to the opinion.

Justice Kennedy, writing for the majority in *Iqbal*, also authored quotes that defendants commonly reference. He wrote that “the tenet that a court must accept as true all of the allegations contained in a complaint is inapplicable to legal conclusions” and that “determining whether a complaint states a plausible claim for relief will . . . be a context specific task that requires the reviewing court to draw on its judicial experience and common sense.”<sup>5</sup> On the plaintiffs’ side, about the only quotable sentence in either opinion is Justice Souter’s conclusion in *Twombly* that the decision’s holding “do[es] not require heightened fact pleading of specifics, but only enough facts to state a claim to relief that is plausible on its face.”<sup>6</sup>

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<sup>2</sup> *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007); *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

<sup>3</sup> *Twombly*, 550 U.S. at 556-57.

<sup>4</sup> *Id.* at 570.

<sup>5</sup> *Iqbal*, 556 U.S. at 674-75.

<sup>6</sup> *Twombly*, 550 U.S. at 570.

The two opinions' repetitious articulation of the "plausibility" standard appears to be an attempt to ensure that there is no ambiguity in the message to district courts as to how to apply the "not-new" rule. District courts are to assess the sufficiency of a complaint by applying their own subjective judgment to determine whether a complaint's factual allegations are "plausible." This is actually an astonishing directive from a conservative Court. The Senate Judiciary Committee pilloried both Elena Kagan and Sonia Sotomayor during their confirmation hearings for suggesting that a judge's own experience should inform his or her decisions.<sup>7</sup> But, given that the Supreme Court is the final arbiter of the federal rules of civil procedure, judges have the freedom – or, obligation – to assess the sufficiency of pleadings through their own lenses.

In the five years since *Twombly*, trial judges have had ample opportunity to apply their own "common sense and experience" in assessing a complaint's plausibility. As numerous judges have observed, it certainly may be questioned whether the use of this standard either promotes judicial efficiency or results in consistent decisions.<sup>8</sup> This point was made most succinctly by a trial judge, sitting by designation on the appeal of the grant of a *Twombly* motion in an antitrust case.<sup>9</sup> There, the plaintiff alleged that Tempur-Pedic had conspired with its distributors to fix resale prices. He alleged that the agreement was a per se violation of the Sherman Act. After he filed his complaint, the Supreme Court decided *Twombly*, and also *Leegin*.<sup>10</sup> Defendants successfully moved to dismiss the complaint, arguing that the plaintiff did not allege a plausible relevant market (now a required element of the offense since *Leegin* had held that a court must assess a resale price maintenance claim under the rule of reason). They also argued that he failed to allege a plausible conspiracy since uniform prices among the distributors could suggest either conspiracy or independence. The district court dismissed without leave to amend. On appeal, two appellate judges affirmed the dismissal, holding that the plaintiff's relevant market allegations and conspiracy claims were implausible.

Judge Kenneth J. Ryskamp, a district court judge from the Southern District of Florida, wrote a strong dissent. He argued that the majority went too far in its application of *Twombly*'s plausibility standard, especially in concluding, on the basis of its own "judicial experience and common sense", that the plaintiffs' claims were not plausible. "My judicial experience and common sense", he wrote, "leads me to conclude that it is entirely plausible that [the defendant] and its distributors colluded to set prices. Indeed, it is totally implausible that [the defendant] and its distributors set prices independently of each other."<sup>11</sup> Judge Ryskamp used the difference between his view of plausibility and the majority's to illustrate what he saw as the problem with the *Twombly*/*Iqbal* standard. He argued that "[w]hen plausibility is based on a judge's common sense and experience,

7 See Orrin G. Hatch, The Case Against Confirmation, National Review Online, July 12, 2010 (arguing that now-Justice Kagan's writings, including her statement that "the judge's own experience and values become the most important element in the decision" of most Supreme Court cases today disqualified her from becoming a Supreme Court justice); A Judge's View of Judging Is On The Record, New York Times, May 14, 2009 (quoting now-Justice Sotomayor's "Wise Latina" speech).

8 Colleen McMahon, *The Law of Unintended Consequences: Shockwaves in the Lower Courts After Bell Atlantic Corp. v. Twombly*, 41 SUFFOLK U. L. REV. 851, 852 (2008) ("Because *Twombly* is so widely cited, it is particularly unfortunate that no one quite understands what the case holds."). Judge McMahon is a judge on the U.S. District Court for the Southern District of New York. See also *Robbins v. Oklahoma ex rel. Dep't of Human Servs.*, 519 F.3d 1242, 1247 (10th Cir. 2008) ("We are not the first to acknowledge that [*Twombly*]'s new formulation is less than pellucid."); *Shionogi Pharma, Inc. v. Mylan, Inc.*, No 10-1077, 2011 U.S. Dist. LEXIS 58774 at \*3 (D. Del. May 26, 2011) ("The undersigned, formerly a member of the Advisory Committee on Civil Rules, knows that many practitioners and judges share in the confusion resulting from *Iqbal*'s seemingly strong requirement of factual pleadings in the absence of any specific overruling of prior cases allowing traditional notice pleading.")

9 *Jacobs v. Tempur-Pedic International, Inc.* 626 F.3d 1327 (11th Cir. 2010).

10 *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007).

11 *Jacobs*, 626 F.3d at 1346 (Ryskamp, J. dissenting).



different judges will have different opinions as to what is plausible, resulting in a totally subjective standard for determining the sufficiency of a complaint.”<sup>12</sup>

Recent experience in antitrust cases that contain similar factual allegations supports Judge’s Ryskamp’s point. The disarray that has resulted from this new standard, let alone the burden imposed on the judges from it, may well be one of the unintended consequences of *Twombly* and *Iqbal*. Below, we illustrate the issue with two examples. We then offer some observations regarding what these decisions suggest about where the federal appellate courts are heading in their application of *Twombly* to antitrust cases. We end with some concluding thoughts.

## II. DOCTRINAL DISARRAY ON DISPLAY: THE SET-TOP BOX CASES AND THE FUEL SURCHARGE OPINIONS

### A. The Set-Top Box Cases

In 2008 and 2009, nine cable television companies, including Comcast, Time Warner Cable, Cox and 6 others, were each hit with separate class actions, all alleging that each company tied the sale of a product called “premium cable services” to the lease of a set top box. Each set of plaintiffs alleged that, while customers of each cable company can access basic digital cable programs through TIVO devices, or through cable card-enabled TVs, they can only access two-way services such as Pay Per View, On Demand, and interactive program guides, by leasing a set top box from the local cable TV company. Consumers can also access TV programming through multiple options, such as direct broadcast satellite companies like Direct TV, and in some markets, through the fiber optic offerings of telco providers like Verizon (FIOS) and U-Verse (AT&T). However, because municipalities and market areas typically contract with only one cable company, plaintiffs filed separately against each cable provider. As a result, nine district courts in eight separate districts have been managing the cases (there are two cases pending in the Southern District of New York, one against Time Warner Cable, and one against Mediacom).<sup>13</sup>

In each case, the defendant moved to dismiss on the grounds that plaintiffs failed to plead facts sufficient to state a plausible claim for relief under the *Twombly* standard. In analyzing the pleadings, all of the district courts recognized that, to state a tying claim, plaintiffs must allege the following elements: (1) two separate products; (2) sufficient market power to coerce customers to buy the tied product, including market power in the relevant product and geographic markets; (3) actual coercion; and (4) anticompetitive effects in the market for the tied product. All of the courts cited *Twombly* for the standard under which they would judge the sufficiency of the plaintiffs’ complaints. Yet, the district courts in these cases came to sometimes wildly different conclusions about the sufficiency of plaintiffs’ claims.

Unbelievably, there are thirteen separate opinions considering motions to dismiss in these cases.<sup>14</sup> In the case against Time Warner Cable in the Southern District of New

12 *Id.* at 1346-47, citing Arthur R. Miller, From Conley to *Iqbal*: A Double Play of the Federal Rules of Civil Procedure, 60 DUKE L.J. 1, 30 (2010) (“[I]nconsistent rulings on virtually identical complaints may well be based on individual judges having quite different subjective views of what allegations are plausible”) and Rajiv Mohan, A Retreat from Decision by Rule in *Ashcroft v. Iqbal*, 33 HARV. J.L. & PUB. POL’Y 1191, 1197 (2010) (basing the plausibility determination on judicial experience and common sense “suggests that plausibility is not meant to be guided by clear principles, but instead by the wisdom of judges”).

13 A chart listing each case and its related opinions is attached as Appendix A.

14 See App. A, *supra*.

York before Judge Castel, the court twice granted a motion to dismiss and the case is now on appeal at the Second Circuit. However, the Mediacom case, before Judge Kimba Wood in the same district, survived a motion to dismiss a virtually identical complaint and is now in discovery. In the Cablevision cases in the District of New Jersey, the court granted three separate motions to dismiss, all with leave to replead. In response to Cablevision's fourth motion to dismiss, the court granted it in part and denied it in part. The first judge assigned to the Insight case in the Northern District of Kentucky granted the motion to dismiss, with leave to replead, but the second judge assigned to the case denied it. Finally, judges in the four other cases where defendants moved to dismiss on *Twombly* grounds all denied the motions and those cases are proceeding through discovery at various paces.<sup>15</sup>

A few examples from these various opinions illustrate how the different judges treated the same issue but came to such different conclusions. The judge in the Time Warner Cable case held that plaintiffs' allegations that Time Warner Cable coerced them to lease a set top box were implausible because subscribers can access premium cable services through the use of TiVo, or a cable card enabled TV. The court also held that plaintiffs' allegation that Time Warner Cable did not sufficiently publicize the fact that customers could access most of the tying product through cable cards did not constitute implicit coercion.<sup>16</sup> The judge considering Cox's motion to dismiss held the opposite. It found that Cox did coerce the lease of a set top box because customers could not access *all* aspects of premium cable services without a leased set top box and that the allegations that Cox minimized the viability of cable cards by not promoting their use did state a plausible claim of implicit coercion.<sup>17</sup>

Similarly, Judge Wood in the Mediacom case held that plaintiffs adequately alleged a geographic market composed of the collective of the defendant's service areas in 23 states.<sup>18</sup> Judge Castel, in the Time Warner Cable case in the same district, held that plaintiffs' allegation that the geographic market was "the collective" of the markets in which Time Warner Cable does business was insufficiently alleged, but found that the complaint did plausibly allege 53 separate local markets (he dismissed the complaint because plaintiffs failed to plead that Time Warner Cable had market power in each local geographic market).<sup>19</sup>

Of course, it is impossible to conclude from these opinions what aspect of each judge's "judicial experience and common sense" led them to the conclusions that they reached, or whether the judges that granted motions to dismiss these cases with leave to replead used the liberal amendment rule to assist plaintiffs in staying in court. We would suggest that, under the simpler notice pleading under Rule 8 prior to *Twombly*, the results might be more uniform, and the cases certainly would not have spawned so many separate opinions.

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15 Comcast has not filed a *Twombly* motion in its case, instead filing a motion to compel arbitration. Motion To Compel Arbitration, In re Comcast Corp. Set-Top Cable Television Box Antitrust Litigation, Civ. No. 09-MD-02034 (E.D. Pa. July 22, 2011, ECF No. 127). Mediation proceedings remain ongoing.

16 In re *Time Warner Cable Set-Top Cable Television Box Antitrust Litig.*, No. 08-7616, 2010 WL 882989, \*6 (S.D.N.Y. Mar. 5, 2010) ("Time Warner I").

17 In re *Cox Enters., Inc. Set-Top Cable Television Box Antitrust Litig.*, No. 09-2048, 2010 WL 5136047, \*3 (W.D. Okla. Jan. 19, 2010).

18 *Knight v. Mediacom Communications Corp.*, No. 10-01730, slip op. at 9 (S.D.N.Y. Mar. 30, 2011, ECF No. 19).

19 In re *Time Warner Cable Set-Top Cable Television Box Antitrust Litig.*, No. 08-7616, 2011 WL 1432036 (S.D.N.Y. Apr. 8, 2011).

## B. The Fuel Surcharge Opinions

Another example is presented in *In re Rail Freight Fuel Surcharge Litigation* and *In re LTL Shipping Services* cases.<sup>21</sup> These cases also considered similar claims by plaintiffs based on similar factual allegations, but received different treatment by the district court judges who considered the motions to dismiss. Both cases involved the allegation that freight carriers (rail in one case and less-than-truckload (“LTL”) truck carriers in the other) had conspired to fix the amount of fuel surcharges that they imposed as a result of the run-up on oil prices in the summer of 2003.<sup>22</sup> In both cases, a federal agency, the Surface Transportation Board, had concluded that the defendants had imposed fuel surcharges in excess of the actual increase in fuel costs.<sup>23</sup> In both cases, plaintiffs alleged that defendants had imposed higher surcharges than were necessary to cover fuel costs and had thus made large profits from the surcharges.<sup>24</sup> Plaintiffs also alleged that defendants in both cases reached and implemented these agreements, in part, during trade association meetings.<sup>25</sup> Nonetheless, like the set top box cases, the district courts in these cases reached opposite results.

In the *Rail Freight* litigation, the court held that plaintiffs had pleaded sufficient factual allegations to suggest a plausible inference of conspiracy.<sup>26</sup> The court found that the allegation that defendants faced a common problem, escalating fuel costs not captured in their existing contracts, demonstrated the likelihood of a conspiracy.<sup>27</sup> The court found also that plaintiffs’ allegation that defendants established identical complex and new fuel surcharge programs within a nine month period supported the conspiratorial inference.<sup>28</sup> The court also pointed to allegations that the defendants met at trade association meetings on specific dates in the fall of 2003 and “created and implemented coordinated fuel surcharge programs” as suggestive of a conspiracy.<sup>29</sup>

The *LTL Shipping Services* court held that the plaintiffs had not pled a plausible conspiracy based on virtually identical real world allegations. It held that the industry structure, rather than being conducive to conspiracy, as the *Rail Freight* judge had found, instead gave each defendant the same independent incentive to reduce fuel costs.<sup>30</sup> The court also noted that allegations showing a dramatic increased volatility in fuel prices around the time that the alleged conspiracy began suggested that the defendants had independent motives to alter their respective fuel surcharge fee structures.<sup>31</sup> The court also found that plaintiffs’ allegations of simultaneous imposition of surcharges were not persuasive because plaintiffs failed to plead the simultaneous price increase within a “defined and narrow date or date window.”<sup>32</sup> In contrast to the *Rail Freight* court, the *LTL Shipping Services* court found that the complaint’s allegations that all of the defendants were members of the same trade association and that the trade association had multiple meetings on specific dates between 2003 and 2007 did not plausibly suggest that defendants had agreed to do anything.<sup>33</sup>

20 *In re Rail Freight Fuel Surcharge Antitrust Litig.*, 587 F. Supp. 2d 27 (D.D.C. Nov. 7, 2008).

21 *In re LTL Shipping Servs. Antitrust Litig.*, No. 08-01895, slip op. (N.D. Ga. Jan. 29, 2009, ECF No. 256).

22 *Id.* at 4; *Rail Freight*, 587 F. Supp. 2d at 36.

23 *Rail Freight*, 587 F. Supp. 2d at 36, n. 5; Am. Compl., *LTL Shipping Servs.*, No. 08-01895, at ¶ 57 (N.D. Ga. May 23, 2008, ECF No. 237).

24 *LTL Shipping Servs.*, slip op. at 11; *Rail Freight*, 587 F. Supp. 2d at 31.

25 *LTL Shipping Servs.*, slip op. at 10-11 (plaintiffs alleged that defendants communicated by posting fuel surcharge rates on public web sites); *Rail Freight*, 587 F. Supp. 2d at 30 (plaintiffs alleged meetings at restaurants and other facilities); 33-34 (plaintiffs alleged that defendants reached agreement at trade association meetings in 2003).

26 *Rail Freight*, 587 F. Supp. 2d at 29.

27 *Id.* at 34.

28 *Id.* at 25-26.

29 *Id.* at 34 (quoting complaint).

30 *LTL Shipping Servs.*, slip op. at 40, 45.

31 *Id.* at 43-44.

32 *Id.* at 37, n. 9.

33 *Id.* at 38.

Again, it is impossible to assess how each judge's "common sense and experience" affected their different conclusions. But it is an odd result that two cases *alleging virtually the exact same facts* – parallel imposition of fuel surcharges, a finding by a federal agency that the imposition was an unreasonable practice, opportunity to conspire at trade association meetings – had such different results.

### III. PUSHBACK ON *TWOMBLY* FROM COURTS OF APPEAL

The inconsistencies in the *Set-Top Box* and *Fuel Surcharge* opinions are not an accident. *Twombly* left considerable ambiguity in its wake and both district and appellate courts have been able to seize on that ambiguity to reach their desired result in antitrust cases. As context, it is important to recall that, at least initially, the conventional wisdom was that *Twombly* (and subsequently *Iqbal*) had dramatically changed Rule 8's application. With rare exception, the initial federal appellate cases in *Twombly* and *Iqbal's* wake held that the plaintiffs' allegations were insufficient to state a claim. As a result, the plaintiffs in those cases were denied the discovery they needed to prove liability and, just as significantly, to extort the pricey settlements that inevitably often followed regardless of liability. There can be no mistake that taking this "settlement leverage" off the table was, at least in part, the *Twombly* court's objective. As the *Twombly* Court observed, "it is only by taking care to require allegations that reach the level suggesting conspiracy that we can hope to avoid the potentially enormous expense of discovery in cases with 'no reasonably founded hope that the [discovery] process will reveal relevant evidence.'"<sup>34</sup>

Indeed, writing in dissent, Justice Stevens took particular exception to the "transparent policy consideration" of "protecting defendants – who in this case are some of the wealthiest corporations in our economy – from the burdens of pretrial discovery."<sup>35</sup> In his view, the majority's opinion was completely inconsistent with the entire scheme of the Federal Rules of Civil Procedure as conceived by the drafters and as the Supreme Court had uniformly interpreted in multiple cases including *Conley v. Gibson*<sup>36</sup>, the cases upon which *Conley* relied, and the cases that have followed *Conley*. But Justice Stevens also took particular exception to the majority's elimination of the plaintiffs' claim, before defendants had denied that they had participated in a conspiracy, and before plaintiffs had had any opportunity for discovery. He acknowledged that "if [he] had been the trial judge in this case, [he] would not have permitted the plaintiffs to engage in massive discovery based solely on the allegations in this complaint." Instead, he would have permitted plaintiffs to propound what he termed "limited discovery," that would include the opportunity to take the deposition of a principal witness quoted in the complaint, and "at least one responsible executive representing each of the other defendants" before deciding to dismiss the complaint. Justice Stevens squarely rejected the majority's view that "the success of judicial supervision in checking discovery abuses has been on the modest side," insisting that a trial court can weed out weak claims through careful case management.<sup>37</sup>

The tide, however, may be turning in Justice Stevens' direction. Although *Twombly* and *Iqbal's* ambiguities may never lend themselves to a completely coherent precedent, recent opinions from the Second, Third and Seventh Circuits suggest that the federal appeals courts are trying to rescue district judges (and, maybe, plaintiffs) from

<sup>34</sup> *Twombly*, 550 U.S. at 559, (quoting *Dura*, 544 U.S., at 347, 125 S. Ct. 1627, 161 L. Ed. 2d 577 (quoting *Blue Chip Stamps*, *supra*, at 741, 95 S. Ct. 1917, 44 L. Ed. 2d 539; alteration in *Dura*)).

<sup>35</sup> *Id.* at 596 (Stevens, J., dissenting).

<sup>36</sup> *Conley v. Gibson*, 355 U.S. 41 (1957).

<sup>37</sup> *Twombly*, 550 U.S. at 596 (considering majority's discussion at *Twombly*, 550 U.S. at 572) (Stevens, J., dissenting).

*Twombly* and *Iqbal*'s intended consequences – i.e., to save defendants from the expense of discovery. A review of the most recent opinions from these three appellate courts suggests that some courts of appeal agree with Justice Stevens in dissent.

### ***A. Anderson News and Sony BMG: From The Court Reversed in Twombly***

In a pair of opinions, the Second Circuit has led the way in rolling back *Twombly*. In the first case, *Song BMG*, plaintiffs, individual purchasers of internet music, alleged that defendants, major record labels, agreed, in violation of Section 1 of the Sherman Act, to fix the prices and terms of the web-based sale of electronic music.<sup>38</sup> As in *Twombly*, plaintiffs did not allege any direct evidence of conspiracy and based their claims on circumstantial evidence such as parallel conduct.<sup>39</sup> The district court granted defendants' motion to dismiss, concluding that the allegations were consistent with independent conduct and therefore were insufficient to plead a plausible conspiracy.<sup>40</sup> The Second Circuit reversed.<sup>41</sup>

The Second Circuit gave lip service to the *Bartlett's Familiar Quotations Twombly* excerpts. It said that, to survive a motion to dismiss, a complaint "does not need detailed factual allegations" but "requires more than labels and conclusions and a formulaic recitation of the elements of a cause of action will not do."<sup>42</sup> It quoted *Twombly* in holding that "[f]actual allegations must be enough to raise a right to relief above the speculative level, on the assumption that all allegations in the complaint are true (even if doubtful)."<sup>43</sup>

However, when it applied this standard to the complaint, it held that plaintiffs' allegations did plausibly raise an inference of conspiracy. The court rested its conclusion on plaintiffs' allegations that (1) defendants participated in one or two joint ventures that imposed identical "unpopular terms" and pricing strategies, (2) their prices did not decrease as much as would be expected by the substantial costs savings realized by the electronic format, (3) they took actions that would be against their economic self interest in the absence of a conspiracy, (4) they implemented uniform policies and price changes, and (5) federal and state authorities launched investigations into defendants' conduct.<sup>44</sup> The Second Circuit also rejected defendants' argument that *Twombly* required plaintiffs to plead facts alleging a specific time and place of meetings to allege a plausible conspiracy. The court interpreted *Twombly* to only require these details in cases where the claim is not based on sufficient allegations of the parallel conduct.<sup>45</sup>

These factors (even the investigations referenced) do not prove a conspiracy, but are at least as susceptible of stating a plausible one as were the allegations in *Twombly*, as this same circuit court had actually held in the *Twombly* case itself. One wonders if the *Sony BMG* opinion is merely *Twombly* redux.

Further complicating matters is the Second Circuit's more recent decision in *Anderson News*.<sup>46</sup> There, the plaintiff (Anderson News) was a wholesaler of single-copy magazines to retail outlets, including newsstands, bookstores, and mass merchandisers that resold to consumers. The plaintiff alleged that the national magazine publishers, distribution

38 *Starr v. Sony BMG Music Entertainment*, 592 F.3d 314, 317 (2d Cir. 2010).

39 *Id.* at 322.

40 *In re Digital Music Antitrust Litig.*, 592 F. Supp. 435, 441-42 (S.D.N.Y.) (J. Loretta A. Preska).

41 *Starr*, 592 F.3d at 317.

42 *Id.* at 321 (quoting *Twombly*, 550 U.S. at 555).

43 *Id.*

44 *Id.* at 323-324.

45 *Id.* at 325.

46 *Anderson News v. Am. Media, Inc.*, 2012 U.S. App. LEXIS 6715 (2d Cir. Apr. 3, 2012).

service companies, and wholesalers that competed with plaintiff entered into group boycott in violation of Section 1 of the Sherman Act to exclude plaintiff and another wholesaler (Source Interlink Distribution) from the market for single-copy magazine distribution.

Yet again, as in *Twombly*, the plaintiff did not allege any direct evidence of conspiracy and based their claims on circumstantial evidence such as parallel conduct.<sup>47</sup> Moreover, as to “plus factors,” the complaint was severely lacking. Principally, Anderson News alleged that the defendant distributors decided to boycott Anderson News and another wholesaler after the two wholesalers imposed a 7-cent-per-magazine surcharge on the defendants. The defendants’ conduct, of course, would be consistent with the defendants’ unilateral economic self-interest insofar as the defendants likely did not want to do business with Anderson News if it would cost them more to do so. Following *Twombly*’s lead, the district court granted defendants’ motion to dismiss, concluding that the allegations were consistent with independent conduct and therefore were insufficient to plead a plausible conspiracy.<sup>48</sup> The court also denied the plaintiff’s motion for leave to file an amended complaint and observed that “[t]he addition of numerous conclusory allegations does not cure the deficiencies of the Complaint.”<sup>49</sup> The Second Circuit reversed.<sup>50</sup>

The Second Circuit panel struggled to articulate what the *Twombly* Court intended when it held that, to state a cognizable Section 1 conspiracy claim, a plaintiff relying on circumstantial evidence must allege more than consciously parallel conduct.<sup>51</sup> The district court read *Twombly* to mean, consistent with Section 1 summary judgment standards (and *Twombly*’s citations thereto), that a Section 1 plaintiff must plead plus factors. The Second Circuit, however, was more equivocal. On the one hand, the panel acknowledged that a “claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.”<sup>52</sup> In antitrust parlance, then, this would have to mean that a plaintiff must plead plus factors since such allegations would be necessary to create a “reasonable inference” of liability. On the other hand, however, the panel rebuked the district court for dismissing the complaint on the grounds that, as pled, “unilateral parallel conduct [by the defendants wa]s completely plausible.”<sup>53</sup> Thus, while allegations of plus factors are necessary to create an inference of liability, the Second Circuit retreated to the more ambiguous view that a plaintiff can carry its burden to plead a Section 1 conspiracy claim even if one can infer from the complaint that there was an innocuous basis for the defendants’ consciously parallel conduct.<sup>54</sup>

Squaring *Anderson News* and *Sony BMG* on the one hand, with *Twombly* on the other hand, is not easy. Are plaintiffs required to allege facts that, if proven, would show the defendant did not act in its economic self-interest or otherwise act unilaterally? Or is something less sufficient so long as it is plausibly consistent with a conspiracy? The Second Circuit will now be left to clean up this doctrinal uncertainty in future decisions.

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47 *Id.*

48 *In re Digital Music Antitrust Litig.*, 592 F. Supp. 435, 441-42 (S.D.N.Y.) (J. Loretta A. Preska).

49 *Anderson News v. Am. Media, Inc.*, 732 F. Supp. 2d 389, 407 (S.D.N.Y. 2010).

50 *Starr*, 592 F.3d at 317.

51 *Twombly*, 550 U.S. at 556-57 (“It makes sense to say, therefore, that an allegation of parallel conduct and a bare assertion of conspiracy will not suffice. . . . Hence, when allegations of parallel conduct are set out in order to make a § 1 claim, they must be placed in a context that raises a suggestion of a preceding agreement, not merely parallel conduct that could just as well be independent action.”).

52 732 F. Supp. 2d at 45 (citing *Iqbal*, 129 S. Ct. at 1949).

53 *Id.* at 66.

54 *Id.* at 67 (“Consequently, although an innocuous interpretation of the defendants’ conduct may be plausible, that does not mean that the plaintiff’s allegation that that conduct was culpable is not also plausible.”).

## **B. West Penn: The Third Circuit Further Muddies the *Twombly* Waters**

The Third Circuit's decision in *West Penn Allegheny Health System v. UPMC*<sup>59</sup> illustrates how the Third Circuit has similarly pushed back on *Twombly*. In *West Penn*, the Third Circuit reversed the district court's decision to grant the defendants' *Twombly* motion. The plaintiff (West Penn) was a hospital system in Pennsylvania that alleged that another Pennsylvania hospital system (University of Pittsburgh Medical Center or "UPMC") and a Pennsylvania health insurer (Highmark) conspired to protect each other from competition in violation of sections 1 and 2 of the Sherman Act. The district court granted defendants' motion to dismiss the complaint, concluding that it was "long on innuendo and frequently [repeated] the buzz word that the defendants 'conspired'" but lacked any allegations of "any facts which evidence a concerted action."<sup>56</sup>

In its opinion reversing, the Third Circuit also pretended that it was following *Twombly*. It defined the pleading standard established in *Twombly* as that "a complaint must contain factual allegations that, taken as a whole, render the plaintiff's entitlement to relief plausible."<sup>57</sup> It went on to note that *Twombly* "does not impose a probability requirement at the pleading stage, but instead simply calls for enough facts to raise a reasonable expectation that discovery will reveal evidence of the necessary element."<sup>58</sup>

The Third Circuit concluded that plaintiff had sufficiently alleged a plausible conspiracy and reversed the district court's decision.<sup>59</sup> Plaintiff alleged that defendants entered into an agreement in the summer of 2002 to use their respective power to strengthen each other and weaken each other's rivals. Plaintiff alleged that in 2005 and in 2006, one of the defendants told the plaintiff about defendants' agreement with the other defendant in two different contexts and at one time acknowledged that the agreement was "probably illegal."<sup>60</sup> In addition, plaintiffs alleged that during an internal meeting, one of defendant's CEOs acknowledged the agreement with the co-defendant.<sup>61</sup> The court concluded that these allegations were "sufficient to survive a motion to dismiss."<sup>62</sup>

Significantly, the Third Circuit's *West Penn* decision followed the court's earlier decision in *Insurance Brokerage Litigation*.<sup>63</sup> In that case, the panel applied a somewhat different analytical approach to analyze conspiracy claims. In *Insurance Brokerage*, the court addressed in detail the plaintiffs' allegations of plus factors, whether the plaintiffs' theory was economically plausible, and other specific allegations regarding the defendants' alleged anticompetitive conduct. Ultimately, the Third Circuit dismissed plaintiffs' many conspiracy claims, with the exception of one hard-core bid-rigging claim. The court concluded that plaintiffs had plausibly alleged that claim. The Third Circuit's approach in *Insurance Brokerage Litigation* stands in stark contrast to *West Penn*: in the former, the court applied a *Twombly*-esque analysis; in the latter, it applied a more cursory and superficial analysis where it simply asked whether, harkening back to a pre-*Twombly* era, it was possible that the plaintiff could prevail on the facts alleged.

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55 *West Penn Allegheny Health Sys. v. UPMC*, 627 F.3d 85 (3d Cir. 2010).

56 *Id.* at 97.

57 *Id.* at 98 (citing *Twombly* 550 U.S. at 556).

58 *Id.* at 98 (quoting *Twombly*, 550 U.S. at 556).

59 *Id.* at 100.

60 *Id.*

61 *Id.*

62 *Id.*

63 *In re Ins. Brokerage Litig.*, 618 F.3d 200 (3d Cir. 2010).

### C. Text Messaging: The Seventh Circuit's "Non-Negligible Probability" Gloss

The Seventh Circuit's decision in *In re Text Messaging Antitrust Litigation* is perhaps the most significant post-*Twombly* decision, not only because the panel included some of the most esteemed "antitrust expert" judges (Judges Posner and Wood), but also because the panel took the unusual step of hearing an interlocutory appeal on the question of whether the district court erred when it held that the plaintiffs sufficiently pled a Section 1 conspiracy.

The *Text Messaging* plaintiffs alleged that defendants, regional telephone companies, violated Section 1 of the Sherman Act by colluding to prevent competition in the market for text messaging services. The district court initially granted the defendants' motion to dismiss with leave to file an amended complaint and later denied the motion to dismiss based on that amended complaint.<sup>64</sup> Writing for a unanimous panel, Judge Posner affirmed the district court's decision. Judge Posner said that the Seventh Circuit accepted the certification for interlocutory appeal because "[p]leading standards in federal litigation are in ferment after *Twombly* and *Iqbal*, and therefore an appeal seeking a clarifying decision that might head off protracted litigation is within the scope of Section 1292(b)."<sup>65</sup>

Judge Posner began by noting that, as in *Twombly*, the court was presented with a case in which the plaintiffs alleged, at best, circumstantial evidence of a conspiracy. The legal question, then was what quantum of circumstantial evidence a plaintiff must plead to carry its burden under *Twombly*, *Iqbal*, and Rule 8. *Twombly* resolved that question in a context largely analogous to the one before the Seventh Circuit when the court held that a plaintiff must allege more than parallel behavior and, more specifically, must allege facts that are inconsistent with unilateral behavior. The court summarized this standard as requiring "plausible grounds to infer an agreement."<sup>66</sup> Judge Posner, however, sought to push back on *Twombly* by suggesting that *Twombly* did not create a black and white rule. Instead, he explained, a plaintiff's allegations should be viewed on a sliding scale.

Judge Posner parsed through *Iqbal's* language that "the 'plausibility standard is not akin to a 'probability requirement' but asks for more than a sheer possibility that a defendant has acted unlawfully."<sup>67</sup> He lamented the lack of clarity because "plausibility, probability, and possibility overlap." To resolve this question, Judge Posner provided the following formulation: "The fact that the allegations undergirding a claim could be true is no longer enough to save a complaint from being dismissed; the complaint must establish a nonnegligible probability that the claim is valid..."<sup>68</sup> Judge Posner then concluded that the complaint satisfied his new "nonnegligible probability" gloss on *Twombly*.<sup>69</sup> The court cited the industry structure, where a small group of companies controlled 90 percent of the market, as one that could "[facilitate] collusion."<sup>70</sup> In addition, the court pointed to plaintiffs' allegation that defendants' participation in trade association and "elite 'leadership council'" meetings where they exchanged price information.<sup>71</sup> Also, the court held that the allegation that prices increased while costs were decreasing dramatically suggested an agreement because ordinarily when costs decrease sellers have the incentive to decrease

<sup>64</sup> *Text Messaging*, 630 F.3d 624-25, 628.

<sup>65</sup> *Id.* at 627.

<sup>66</sup> 550 U.S. at 556.

<sup>67</sup> *Id.* at 629 (quoting *Iqbal*, 129 S. Ct at 1949).

<sup>68</sup> *Id.* at 629.

<sup>69</sup> *Id.* at 627.

<sup>70</sup> *Text Messaging*, 630 F.3d at 628.

<sup>71</sup> *Id.*



prices to gain customers.<sup>72</sup> Finally, the court highlighted the allegation that all of the companies shifted to the same complex price structure at the same time.<sup>73</sup> These allegations provided what the court held was “a sufficiently plausible case to warrant allowing plaintiffs to proceed to discovery.”<sup>74</sup>

At least in the Seventh Circuit, going forward the issue posed by a Rule 12(b)(6) motion is whether there is a “nonnegligible probability” that the plaintiff will succeed with its conspiracy claim. Superficially, at least that standard seems potentially far more plaintiff-friendly insofar as it replaces *Twombly*’s requirement that a plaintiff allege certain facts that disprove unilateral conduct with judicial discretion relating to the “probability” that a plaintiff will ultimately prevail. If nothing else, if Judge Posner intended to leave more to the eye of the judicial beholder, he certainly accomplished that much.

#### IV. THE QUEST FOR MIDDLE GROUND: TRENDS FOR THE FUTURE

##### A. Limited Discovery at Pleadings Stage?

The appellate cases discussed above essentially hold that, where the complaint allegations raise competing inferences of independent and collusive conduct, the plaintiff is entitled to go forward and impose the burden of discovery on the defendants (and, as Justice Stevens noted in his *Twombly* dissent, on themselves). Arguably, *Twombly* holds the opposite; if there is a tie between the inferences, the defendants win.

Justice Stevens’ dissent presents an alternative to a straight up or down vote on the inferences. As discussed, he suggested that, if he were the trial judge, he would permit plaintiffs a period of “limited discovery” to see if they could find conspiracy evidence before letting them have massive discovery. This suggestion seems impractical at best, unfair to defendants at worst, and potentially unworkable.

But one district judge is trying it out. In *In re National Association of Music Merchants* (“NAMM”), *Musical Instruments and Equipment Antitrust Litigation*, plaintiffs alleged that defendant Guitar Center had orchestrated a conspiracy among the major vendors of guitar amplifiers and “fretted musical instruments” such as acoustic and electric guitars, banjos and mandolins, to implement and enforce minimum advertised price policies that had the effect of fixing resale prices on the Internet.<sup>75</sup> The complaint alleged that defendants reached and implemented this agreement at specifically identified trade association meetings between 2004 and 2007.<sup>76</sup>

The district court reviewed plaintiff’s forty-eight page complaint and concluded that it failed to meet the *Twombly* plausibility standard, noting two specific deficiencies: (1) the market definition was too broad to be plausible because it included instruments that are not reasonably interchangeable (i.e., mandolins and electric guitars) and guitar amplifiers<sup>77</sup> and (2) the lack of specific detail in the conspiracy allegations.<sup>78</sup> The court said that “it is not clear who conspired with who, what exactly they agreed to, and how

72 *Id.* at 628.

73 *Id.*

74 *Id.* at 629.

75 *In re National Association of Music Merchants* (“NAMM”), *Musical Instruments and Equipment Antitrust Litigation*, No. 09-2002, slip op. at 4 (S.D.Ca. Aug. 22, 2011) (granting in part motion to dismiss).

76 *Id.* at 4.

77 *Id.* at 6.

78 *Id.* at 3.

the conspiracy was organized and carried out” and noted that “at this point plaintiffs frankly admit that they lack the information to plead specific facts in good faith, and seek discovery so they can learn who attended the meeting they have generally identified, what was said, and what was agreed.”<sup>79</sup>

Now, because plaintiffs lacked that detail, it should mean under *Twombly* that, if they cannot do a better job on the allegations, then they are out of court. But that is not what Judge Burns held. Instead, he commented that “Defendants haven’t put forward convincing arguments showing [that plaintiffs] couldn’t state a claim if given the opportunity. Nor is there anything in the complaint to show that whatever Defendants may have been doing was necessarily protected or lawful”.<sup>80</sup> So, to help the plaintiffs out, the judge has ordered a period of “limited discovery” so that they can state a conspiracy claim.<sup>81</sup> This may well be every defendant’s worst nightmare; they won the motion to dismiss and they still are going to be subject to discovery to help the plaintiffs state a claim against them.

This result is probably the product of “judicial experience and common sense” if any one is. If defendants did reach an agreement, “the proof is largely in the hands of the conspirators” and the judge apparently believes that plaintiffs should be able to try to win their case if that is so. So, in an odd way, the decision embraces the tenets of *Iqbal* and reaches a result that could not be farther from the intended consequences of *Twombly*.

## B. More Interlocutory Appeals?

The *Twombly* Court’s unambiguous intent was to limit costly and time-consuming discovery when the plaintiff has not carried its pleading burden. This is a laudable goal and one that is difficult to criticize. Notwithstanding this fact, however, appellate courts have generally been loath to grant petitions for interlocutory review under Section 1292(b) by defendants who argue that a district court erred in denying a motion to dismiss.

The Seventh Circuit’s decision in the *Text Messaging* decision suggests that a change to this practice may be overdue when it comes to complex litigations that are likely to spur costly discovery. There, Judge Posner wrote that when a district court by “misapplying the *Twombly* standard allows a complex case of extremely dubious merit to proceed, it bids fair to immerse the parties in the discovery swamp . . . and by doing so create irrevocable as well as unjustifiable harm to the defendant that only an immediate appeal can avert.”<sup>82</sup> He added that “[s]uch appeals should not be routine, and won’t be, because as we said both district court and court of appeals must agree to allow an appeal under section 1292(b); but they should not be precluded altogether by a narrow interpretation of question of law.”<sup>83</sup>

Any doubt on the merit of that position can be resolved by looking at any number of the large class actions that are currently in year three or four of litigation at the district court level. To take one example, in 2007, following *Twombly*, several plaintiffs filed a putative class action against several of the largest private equity companies in the District of Massachusetts based on allegations that the defendants conspired to rig deals to take various

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79 *Id.* at 8.

80 *Id.* at 12.

81 *Id.* at 13.

82 630 F.3d at 626.

83 *Id.*

public companies private. The defendants filed a motion to dismiss on various grounds, including that the plaintiffs failed to state a claim under Rule 8. In December 2008, Senior Judge Edward Harrington denied the motion to dismiss and in February 2009, Judge Harrington refused to certify his dismissal order for interlocutory appeal. More than three years of discovery has now passed in that case encompassing dozens of defendants, numerous major plaintiff and defense law firms, and costing tens of millions of dollars. Only when that litigation is complete (assuming that the defendants do not settle because the legal fees compel them to do so), will the First Circuit have the opportunity to evaluate, among other things, whether the district court erred when it denied defendants' motion to dismiss. Had the district court certified its order (and the First Circuit agreed to accept the defendants' 1292(b) petition), however, it is possible that literally tens of millions and dollars could have been saved.

It is inevitably avoiding these types of costs that Judge Posner and the *Twombly* Court had in mind. Since *Text Messaging*, there is some indication that courts of appeals are becoming more receptive to interlocutory appeals of decisions denying motions to dismiss in complex antitrust cases.<sup>84</sup> Whether this is a long-term trend is too soon to say, but Judge Posner's rationale in *Text Messaging* coupled with the *Twombly* Court's policy pronouncements may give courts more support to do so in the future.

### C. More Dismissals of Antitrust Claims That Do Not Require An Inference of A Conspiracy?

The vast majority of the federal appellate decisions that apply *Twombly* to antitrust claims concern Section 1 horizontal conspiracy allegations. As our discussion illustrates, these cases confront the question of how, on the one hand, to require a plaintiff to plead a "plausible claim" and, on the other hand, to remain faithful to the summary judgment cases that set forth the standards for a "plausible conspiracy." This issue, however, falls away when a motion to dismiss challenges whether a plaintiff has sufficiently pled an element of an antitrust cause of action that is unrelated to a conspiracy. These circumstances arise, for example, when a defendant alleges that the plaintiff has not pled a cognizable relevant market, does not allege that the defendant possess market power, or fails to allege that the defendant's conduct has an anticompetitive effect.

In these cases, there is some evidence that the appellate courts are being more faithful to the letter and spirit of *Twombly*. In the Eleventh Circuit's decision in *Tempur-Pedic*, for example, the court held that the plaintiff failed to allege a relevant submarket comprised of the "visco-elastic foam mattresses" that Tempur-Pedic is well known for selling.<sup>85</sup> The court observed that the complaint was devoid of "factual allegations of the cross-elasticity of demand or other indications of price sensitivity that would indicate whether consumers treat visco-elastic foam mattresses differently than they do mattresses in general."<sup>86</sup> The court similarly found that the plaintiff failed to allege an anticompetitive effect. The court noted that other than "the bald statement that consumers lost hundreds of millions of dollars" as a result of the defendants' alleged resale price maintenance agreement, "there is nothing establishing the competitive level above which [Tempur-Pedic's] allegedly anticompetitive conduct artificially raised prices."<sup>87</sup>

<sup>84</sup> See, e.g., *Robertson v. Sea Pines Real Estate Cos.*, 2012 U.S. App. LEXIS 9694 (4th Cir. May 14, 2012 (same)); *Minn-Chem, Inc. v. Agrium Inc.*, 657 F.3d 650 (7th Cir. 2011).

<sup>85</sup> *Tempur-Pedic*, 626 F.3d at 1338.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* at 1339. The court also affirmed the dismissal of the defendant's horizontal price-fixing claims because "when the inference of conspiracy is juxtaposed with the inference of economic self-interest" there were insufficient allegations from which one could infer a plausible conspiracy. *Id.* at 1343.

Similarly, in the remand proceedings following the Supreme Court's decision in *Leegin*, the Fifth Circuit affirmed the district court's dismissal of the complaint on largely the same basis as *Tempur-Pedic*.<sup>88</sup> First, the court held that the plaintiff failed to "plausibly define the relevant product and geographic markets" because the plaintiff's product markets did not "encompass[] reasonable substitute products."<sup>89</sup> Second, the court held that the plaintiff's alleged theory of economic harm was economically implausible.<sup>90</sup> Specifically, the court held that the plaintiff's claim that the defendant's resale price maintenance program forced consumers to pay "artificially" high prices for Brighton products "def[ie]d the basic laws of economics" given that plaintiff did not allege that the defendant had market power.<sup>91</sup>

It may be that *Twombly* has emboldened courts to dismiss antitrust claims where the insufficiently pled element – be it the product market, the presence or absence of market power, or anticompetitive effects – implicates *facts* that are more likely to be publicly known or reasonably within the plaintiff's possession. Courts, after all, periodically dismissed complaints on this basis long before *Twombly*.<sup>92</sup>

The trickier issue, of course, is how courts should react when a defendant's primary argument for dismissing the plaintiff's complaint is that some element of the complaint, as pled, cannot be squared with basic economic principles. Those principles, of course, are arguably "publicly known" (much like market facts) insofar as they are accessible to both plaintiffs and defendants. The trouble, however, is that different judges may reach different conclusions in applying those principles at the pleading stage. This, after all, seems to be what is driving much of the disagreement between the district courts and appellate courts in *Anderson News*, *Text Messaging*, and the other decisions discussed above. Looking ahead, it seems safe to assume that, when an allegation falls short because it fails to allege objective facts that may be publicly known, courts will be more receptive to apply *Twombly* and *Iqbal's* strictures. In contrast, when a defendant argues that the plaintiff's theory is economically implausible or that a court cannot infer wrongful conduct from plaintiffs' factual allegations, the subjective nature of that judgment call may provide appellate courts with enough doctrinal room to push back on *Twombly* and side with the plaintiff(s).

## V. CONCLUSION

It seems clear that courts are increasingly resistant to applying *Twombly* and *Iqbal's* holdings literally. They appear to be engaging in a kind of "*Twombly* nullification", by quoting its standard but not following it, or permitting plaintiffs multiple opportunities to amend, or using their own "common sense and judicial experience" to interpret the plausibility of plaintiffs' allegations in plaintiffs' favor. We have come a long way from letting a complaint go forward when it contains "a short plain statement of the claim showing that the pleader is entitled to relief", as Rule 8(a) literally requires. But if courts are to apply *Twombly* and *Iqbal* consistently, it seems we still have a long way to go.

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88 *PSKS, Inc. v. Leegin Creative Leather Prods., Inc.*, 615 F.3d 412 (5th Cir. 2010).

89 *Id.* at 417-19.

90 *Id.* at 419.

91 *Id.* The court also held that the plaintiff failed to allege its horizontal restraint claims because it did not allege an agreement among the defendant's distributors, which was a critical element to its hub-and-spoke theory.

92 See, e.g., *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, 124 F.3d 430, 443 (3d Cir. 1997) ("Because plaintiffs failed to plead any relevant tying market, the claim was properly dismissed."); *Tanaka v. Univ. of S. Cal.*, 252 F.3d 1059, 1063 (9th Cir. 2001) ("Failure to identify a relevant market is a proper ground for dismissing a Sherman Act [restraint of trade] claim.").

## APPENDIX A:

**Set Top Box Cases:  
Opinions Deciding Motions to Dismiss**

<b>Motions Granted:</b>
<i>Downs v. Insight Communications Co.</i> , No. 09-00093, 2010 WL 2228295 (W.D. Ky. June 3, 2010).
<i>Marchese v. Cablevision Sys. Corp.</i> , No. 10-2190, 2010 WL 3311842 (D.N.J. Aug. 18, 2010).
<i>Marchese v. Cablevision Sys. Corp.</i> , No. 10-2190, 2011 WL 149917 (D.N.J. Jan. 14, 2011).
<i>Marchese v. Cablevision Sys. Corp.</i> , No. 10-2190, 2011 WL 3022529 (D.N.J. July 21, 2011).
<i>In re Time Warner Cable Set-Top Cable Television Box Antitrust Litig.</i> , No. 08-7616, 2010 WL 882989 (S.D.N.Y. Mar. 5, 2010).
<i>In re Time Warner Cable Set-Top Cable Television Box Antitrust Litig.</i> , No. 08-7616, 2011 WL 1432036 (S.D.N.Y. Apr. 8, 2011).
<b>Motions Denied:</b>
<i>Parsons v. Bright House Networks, L.L.C.</i> , No. 09-0267, 2010 WL 5094258 (N.D. Ala. Feb. 23, 2010).
<i>Scott v. Cable One, Inc.</i> , No. 09-212, 2010 WL 3023526 (S.D. Miss. July 28, 2010).
<i>Bodet v. Charter Communications Inc.</i> , No. 09-3068, 2010 WL 5094214 (E.D. La. July 26, 2010).
<i>In re Cox Enters., Inc. Set-Top Cable Television Box Antitrust Litig.</i> , No. 09-2048, 2010 WL 5136047 (W.D. Okla. Jan. 19, 2010).
<i>Downs v. Insight Communications Co.</i> , No. 09-00093, 2011 WL 1100456 (W.D. Ky. Mar. 22, 2011).
<i>Knight v. Mediacom Communications Corp.</i> , No. 10-01730 (S.D.N.Y. Mar. 30, 2011).
<i>Marchese v. Cablevision Systems Corp.</i> , No. 10-2190, 2012 WL 78205 (D.N.J. Jan. 9, 2012).



# THY KINGDOM COME: THE RISE OF PRIVATE DAMAGES ACTIONS IN THE UNITED KINGDOM

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## INTRODUCTION

Whilst the United States' public policy has always used private enforcement actions as a key weapon in the fight against cartels and monopolies, the EU has largely relied on the heavy-handed axe of the public enforcement system, where the EU's Competition Commission ("Commission") acts as judge, jury and executioner.<sup>2</sup> In doing so, the Commission imposes fines which represent considerable financial punishment to infringers<sup>3</sup> but offers no compensation to their victims; whilst private enforcement has been encouraged, the EU has taken no practical steps to make private enforcement a reality.

With claimants crying out for a means of recourse, the emergence of a refreshing legal framework for private actions within the EU has seen several important cases brought through the courts. Within this framework, the UK – specifically England and Wales – is increasingly becoming an attractive forum to hear competition (antitrust) disputes, with the frontiers being pushed further in each case. This paper outlines the development of private damages actions in the UK and identifies the reasons why it has become such an attractive jurisdiction for claimants in competition matters.

## PRIVATE ACTIONS BY CLAIMANTS

Breaches of UK or EU competition law, or both, give rise to claims for damages (or other types of relief) in the English courts.<sup>4</sup> Any party who has suffered a loss as a result of an infringement of the following provisions therefore has an actionable claim for damages in either the High Court (Chancery Division or Commercial Court) or the Competition Appeal Tribunal ("CAT").

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2 In addition to the Commission, the UK also relies on the Office of Fair Trading, OFCOM (the regulator for the UK communications industries), OFGEM (the regulator for UK gas and electricity) and OFWAT (the regulator for UK water services) to tackle domestic infringements of competition law. These UK-specific regulatory authorities possess concurrent powers with the Commission in enforcing EU competition law.

3 On 21 February 2007, the Commission announced that it had imposed fines totalling €992 million on companies involved in the lift (elevator) and escalator cartel.

4 See *Garden Cottage Foods Ltd v. Milk Marketing Board* [1984] AC 130, which establishes this principle.

Articles 101 and 102 of the Treaty of the Functioning of the European Union (“TFEU”)<sup>5</sup> form the backbone of competition law within the EU. Article 101(1) prohibits parties from entering into anti-competitive agreements (such as price-fixing arrangements) which have an appreciable effect on trade between member states. This applies to horizontal agreements (e.g. between retailers) and vertical agreements<sup>6</sup> (e.g. between retailers and suppliers). Article 102 prohibits parties from conduct which amounts to an abuse of a dominant position, and which has an appreciable effect on trade between member states.

The Chapter I and II prohibitions in the UK’s Competition Act 1998 (“Competition Act”) largely mirror the prohibitions contained in Articles 101 and 102 of TFEU, but apply where trade within England and Wales is affected, rather than trade between EU member states.

The European Court of Justice (“ECJ”) held in *Manfredi v. Lloyd Adriatico Assicurazioni SpA*<sup>7</sup> that “any individual” (or business) who has been damaged by a breach of directly effective European competition law has a right to claim compensation where a causal link can be established between that damage and an agreement or practice prohibited under Article 101. The Commission considers that this principle clearly also applies to harm suffered as a result of a breach of Article 102. The Commission also considers that the reference to “any individual” includes indirect purchasers. This means, for example, that in cases where direct purchasers of cartelised products have passed on inflated prices charged by cartellists, the market participants or consumers further down the supply chain have the right to sue for compensation where they can show resulting damage.

This broad interpretation of “any individual” is not solely reserved for claims from UK claimants within the UK courts however.<sup>8</sup> Article 1 of the Brussels Regulation states that claims should ordinarily be heard in the jurisdiction in which the defendant is domiciled, regardless of its nationality.<sup>9</sup> In the case of legal persons or firms, domicile is determined by the country where they have their statutory seat, central administration or principal place of business. In certain circumstances, a defendant may, however, be sued in the courts of another EU country. For example, Article 5 of the Brussels Regulation stipulates that a claim in tort may also be brought in the EU member state where the harmful event occurred.

In the case of a cartel, the relevant cause of action in English law is the tort of breach of statutory duty and the relevant harmful event is the implementation of the cartel arrangements i.e. selling the cartelised products. Furthermore, under Article 6, multi-jurisdictional claims may be consolidated and heard as a single claim before the courts of a particular member state where the claims are “so closely connected that it is expedient to hear and determine them together to avoid the risk of irreconcilable judgments resulting from separate proceedings.”<sup>10</sup> In a preliminary application by the Defendant to strike out the claim in *Provimi Limited v. Aventis Animal Nutrition*<sup>11</sup> (“*Provimi*”), the High Court indicated that it would interpret this provision broadly, finding in that case that it had jurisdiction to hear

5 Articles 101 and 102 of TFEU were formerly known as Article 81 and 82 of the EC Treaty.

6 *Consten & Grundig v. Commission* [1966] E.C.R. 299

7 *Manfredi v. Lloyd Adriatico Assicurazioni SpA* (C-295/04) [2001] Bus. L.R.188

8 The Brussels Regulation (Council Regulation (EC) No. 44/2001) and the Lugano Convention of 30 October 2007 set out the rules on jurisdiction for claims involving parties located in different European states

9 Article 3, Brussels Regulation

10 Article 6(1) Council Regulation (EC) No 44/2001

11 *Provimi Limited v. Aventis Animal Nutrition* [2003] EWHC 961 (Comm) (*Provimi*)



claims from European purchasers of cartel-affected goods against the English subsidiary of one of the cartelist in respect of all of the European losses, despite there being no direct contractual relationship between the purchasing company and the English subsidiary. Nonetheless, as articulated by the High Court in *SanDisk Corporation v. Koninklijke Philips Electronics NV*<sup>12</sup> (“SanDisk”), there has to be some connection to England and Wales before a court will assert such jurisdiction.<sup>13</sup>

### ***Cooper Tire & Rubber Company Ltd & Ors v. Dow Deutschland & Ors***

On 23 July 2010 the Court of Appeal in London handed down its judgment in *Cooper Tire & Rubber Company Ltd & Ors v. Dow Deutschland Inc & Ors*<sup>14</sup> (“Cooper Tire”). The case involved a follow-on action on the back of a Commission decision fining five group companies €519 million for operating a price fixing cartel in the sale of synthetic rubber between 1996 and 2002. Two preliminary issues had arisen at an early stage and were the subject of the appeal.

The first of these questions presented to the court was whether a subsidiary company that was neither party to and/or not aware of, the anti-competitive practice adopted by another company in its group could nevertheless be liable to victims of such practices, on the basis that it had nevertheless implemented the infringing agreements by selling the goods at the prices set by its cartelist group company.

English domiciled claimants sought to pursue their claims in the English Courts against an English subsidiary of the cartelist group which was not an addressee of the Commission decision. The Court of Appeal held that it did have jurisdiction to hear the claims under Article 6(1)<sup>15</sup> of the Brussels regulation due to the close relationship between the claims against English domiciled defendants (who were not addressees of the Commission’s cartel infringement decision) and the claims against non-English defendants. The Court did not, however, have to decide the issue of whether the English companies could be said to be liable for the competition law infringements, despite having no direct knowledge of and/or involvement in the cartels. The particulars of claim were broad enough to cover a claim based on general involvement and/or innocent implementation in the cartel arrangements such that the claims against the English defendants could not be struck out at a preliminary stage.<sup>16</sup>

The second important question to be answered by the Court of Appeal was whether it should uphold the Commercial Court’s decision not to stay the damages action despite the fact that proceedings based on the same decision had also been brought in the Italian courts.

Article 27 of the Brussels Regulation provides that where proceedings involving the same cause of action and between the same parties are brought in the courts of different member states, any court other than the court first seized shall of its own motion

12 *SanDisk Corporation v. Koninklijke Philips Electronics NV* [2007] EWHC 332 (Ch).

13 In *SanDisk*, the court held that there was no connection to England and Wales. This was because there was neither evidence that the first steps of the alleged infringing conduct had occurred in the UK, nor that the immediate damage had been caused to San Disk in the UK as a result of that alleged conduct.

14 *Cooper Tire & Rubber Company Ltd & Ors v. Dow Deutschland Inc & Ors*, [2010] EWCA Civ 864 (23 July 2010).

15 Article 6(1) of the Brussels Regulation states that, where a person is one of a number of defendants to a claim he can be sued in the courts of the state where any one of them is domiciled as long as the claims are so closely connected that it is expedient to hear and determine them together to avoid the risk of irreconcilable judgements resulting from separate proceedings.

16 Please see *Court of Appeal dismisses appeal against High Court ruling that refused to stay English proceedings in cartel damages action*, Practical Law Company, 23 July 2010, <http://ld.practicallaw.com/5-502-8831:null>

stay its proceedings until such time as the decision of the court first seized is established. Article 28 of the Brussels Regulation provides that any court other than the court first seized may stay proceedings before it where related actions are pending in the courts of different member states.

This issue was also decided in the Claimants' favour with the Court of Appeal upholding the trial judge's decision not to stay the proceedings under Article 28 of the Brussels Regulation. The Commercial Court concluded that a stay was not justified on the basis that:

1. Proceedings were now more advanced in England, since the Italian proceedings had been dismissed and, even though "likely" to be restored by the Court of Appeal of Milan to a relevant extent, such restoration would be unlikely to occur before 2012;
2. While the proceedings were not particularly proximate to England and were more proximate to Italy, there was no court which could be said to be the centre of gravity in what was a Europe-wide conspiracy;<sup>17</sup> and
3. Furthermore the Court of Appeal did not regard the fact that a company (*Eni S.p.A*) that was an addressee of the Commission's decision had commenced proceedings in Italy operated as a "trump card" effectively barring claims in other jurisdictions. The Court of Appeal also held that the Commercial Court had not erred in noting that proceedings in Italy would take a long time. Rather than being a criticism of the Italian legal system it was merely a reality. The mandatory stay under Article 27 was not considered because the Italian proceedings involved different parties.

In their review of the first instance judgment handed down by the Commercial Court, Maton and Dhillon asserted that:

*If the decision stands, it will be a step forward towards access to justice for victims of infringements of EC competition law*<sup>18</sup> ... it will reiterate the willingness of the English courts to apply a pragmatic treatment to multi-jurisdictional disputes in the context of cartels, which is in harmony with the Commission's objective of ensuring all victims of cartels access to effective redress mechanisms so that they can be fully compensated for their loss.<sup>19</sup>

The authors warned however, that:

*The decision must be followed carefully. Insofar as it relates to an application for a stay, future litigants must have regard to the peculiar circumstances of the 'Italian Torpedo' case before the court and the varying types of relief sought by the defendants (acting as claimants in the Italian courts) and compare this to their own circumstances.*

<sup>17</sup> Ibid.

<sup>18</sup> Opinions, *Cooper Tire & Rubber Co v. Shell Chemicals UK Ltd* [2009] EWHC 2609, Anthony Maton and Rhea Dhillon. Global Competition Litigation Review, Volume 3 Issue 1/2010.

<sup>19</sup> Ibid.

The Court of Appeal's decision was handed down with impressive speed. As the authors had hoped, the Court maintained its position on jurisdiction and demonstrated a willingness to offer a 'claimant friendly forum.' This judgment will increase the already popular status of the English Courts as a forum in which considerable pressure can be applied to defendants through the bundling of Europe-wide claims into one action.

## BENEFITS OF BRINGING AN ACTION IN ENGLAND AND WALES

### Disclosure:

One of the highlights of litigation in England and Wales is the extensive disclosure regime, particularly compared to other EU states.<sup>20</sup> In proceedings brought in the High Court, the Civil Procedure Rules require not only that parties make a reasonable search for and disclosure of document on which they intend to rely, but also the disclosure of documents that could assist the other side.<sup>21</sup> The ramifications of this, particularly in the context of damages actions pursuant to cartels is immense, given the likelihood that most of the material in relation to the cartel and its activities, such as pricing, will only rest with the defendants. Whilst the disclosure provisions in the CAT are less specific than in the High Court, defendants are generally required to disclose evidence that could help claimants.

The recent ECJ decision of *Pfleiderer AG v. Bundeskartellamt*<sup>22</sup> may go some way towards improving access to documents in cartel cases even further. *Pfleiderer* concerned an application from a purchaser to the German competition authority for the disclosure of leniency material. The ECJ ruled that Council Regulation (EC) No 1/2003 would not preclude the claimant from accessing leniency materials, but it would be up to national courts of Member States to determine the conditions under which materials were disclosed. The English courts are yet to rule on the full implications of the *Pfleiderer* decision, with an application before the English High Court (for disclosure of a confidential version of a Commission decision) in *National Grid Electricity Transmission Plc v. ABB*<sup>23</sup> currently adjourned. But it seems clear that the English rules on disclosure will allow claimants access to documents submitted to the Commission during an investigation other than for the purposes of leniency.

### Costs:

While litigation in England is expensive, the general rule is that the losing side has to pay the other side's costs. This has been supplemented with conditional fee arrangements which allow lawyers who act in such cases to be paid either nothing (in the event that the claim is unsuccessful), or an uplift of up to 100% of their normal fees (if the claim is successful). In addition, insurance policies allow the risk of adverse costs to be covered with deferred and contingent premiums. Lastly, the existence & activity of funders in the London market mean that the costs of litigation can also be passed on to a funder. The result of all of these features is that it allows claimants to issue proceedings with relatively little or no cost or risk to themselves.

20 By way of comparison, German civil procedure is governed by the principle of 'party control' where each party is responsible for presenting the relevant facts and evidence on which they rely. Claimants in Germany are therefore unable to request relevant documents from the defendant.

21 Civil Procedure Rules 31.6(a) and 31.6(b) respectively.

22 *Pfleiderer AG v. Bundeskartellamt* (C360/09) [2011] ECR0 (Pfleiderer).

23 *National Grid Electricity Transmission plc v. ABB* [2011] EWHC 1717 (Ch) (National Grid).

### Specialist Judges and Tribunals:

The CAT came into effect in June 2003 as a product of the Enterprise Act 2002, which supplemented the existing Competition Act 1998. It has jurisdiction to hear follow on damages cases. The purpose behind the Tribunal was so that there would be within the UK Court system, a specialist tribunal capable of handling the specialist nature of competition litigation. The CAT has its own set of rules of procedure separate to the Civil Procedure Rules and is flexible in how it proceeds with litigation, for example its limitation periods (see below). However, there are problems with this and while the CAT has jurisdiction for follow on actions, the High Court also has jurisdiction to hear such matters. Furthermore, the High Court, and the experienced Judges who sit in the Court, has shown itself very pro-active in its approach to follow on damages claims in the National Grid & Rubber decisions.

### Limitation:

The courts of England and Wales offer some of the most favourable limitation periods in the EU for claimants. For cases brought in the High Court, claimants have six years in which to bring their claim, with time running from the date of notice of the infringement. The German courts, by contrast, offer a much smaller three year limitation period. On its face the CAT offers even more favourable limitation periods than the High Court however. Under Rule 31 of the CAT's Rules, claims must be brought within the later of: (i) two years from the date on which the right to bring an appeal against the relevant decision expires; or (ii) the date on which such an appeal is determined or the date on which a cause of action accrued. The position was, until recently, that limitation did not begin to run until *all* appeals against the original infringement decision had been completed, as set out in *Emerson Electric v. Morgan Crucible*<sup>24</sup> ("*Emerson 1*"). In *Deutsche Bahn v. Morgan Crucible*<sup>25</sup> however, the CAT reversed its decision in *Emerson 1*. The CAT has since acknowledged that such conflicting decisions require clarification in the Court of Appeal,<sup>26</sup> who should hopefully provide guidance on this point within the next twelve months.

### Collective Actions:

Although England and Wales does not have an opt-out class action system as conceived of in the United States,<sup>27</sup> groups of claimants can pursue claims either through a "representative action" where claims are substantially similar<sup>28</sup> and brought by lead claimants, or by way of a "group litigation order" (GLO) where individual claims are filed and then brought together by the courts.<sup>29</sup> Group actions are often chosen because they allow the sharing and defraying of costs. This gives a greater concentration of leveraging power and economies of scale. The experience to date suggests that this model is likely to trigger settlements earlier in the litigation process, if indeed proceedings are required to be commenced at all.

### Choosing Judicial Forum:

There are several factors which might influence a claimant's decision when choosing between the High Court and the CAT. These include: whether a claimant seeks to

<sup>24</sup> *Emerson Electric Co v. Morgan Crucible Company plc* [2007] CAT 28.

<sup>25</sup> *Deutsche Bahn AG v. Morgan Crucible Company plc* [2011] CAT 16 ("*Deutsche Bahn*").

<sup>26</sup> *Deutsche Bahn AG v. Morgan Crucible Company plc* [2011] CAT 22 [8].

<sup>27</sup> The Civil Justice Council proposed the introduction of an opt-out mechanism in their paper "Reform of Collective Redress in England and Wales: A Perspective of Need." Momentum behind this proposal has since diminished however.

<sup>28</sup> Pursuant to CPR 19.6.

<sup>29</sup> Pursuant to CPR 19.11.

bring the case on a “stand-alone” or “follow-on” basis;<sup>30</sup> the type of relief sought; the level of expertise required of the court; and the timing of the action.

### **Stand-Alone v. Follow-On:**

Where there has been a prior infringement decision by a regulatory authority, a claimant may bring a follow-on claim for damages in either the High Court or before the CAT. If, however, a claimant elects to bring a private action on a stand-alone basis, the action will need to be brought before the High Court. Bringing an action on a follow-on basis offers several advantages.

First, regulatory authorities are in a far stronger position than individual claimants to obtain the evidence needed to establish a breach of competition law. For example, competition authorities will be able to collate market information and commission reports into particular markets and will have statutory powers to obtain information from companies under investigation. In the UK, under sections 26 to 28 of the Competition Act, competition authorities have specific powers to obtain information from parties that are the subject of a complaint in order to make an assessment of that claim. One such power is that provided by section 27 of the Competition Act, which allows the Office of Fair Trading (“OFT”) to search and enter into company premises without a warrant in order to investigate an allegation of infringing behaviour.

Second, national courts in the UK are bound by OFT and Commission decisions.<sup>31</sup> Thus, where a breach of competition law has been determined, a claimant will only need to prove causation and the quantum of loss suffered in a follow-on claim for damages. This significantly reduces the time and cost involved in litigation, compared to the position where a claimant had to bring a stand-alone action before the courts.

The House of Lords made clear in *Crehan v. Inntrepreneur Pub Company*<sup>32</sup> that decisions of competition authorities will only be binding in relation to the same agreement between the same parties that were the subject of the regulatory authority’s decision. Where a court is faced with a dispute involving different parties, the Commission’s decision will not be binding (even if the conduct concerned relates to the same product or market, or both) and the action will need to be pursued as a stand-alone action. The Commission’s decision may nevertheless still be persuasive in the related action, and therefore, may still be beneficial to a claimant pursuing a claim before the courts.

Despite the attractions of a follow-on action, there are circumstances in which a claimant may wish to commence an action on a stand-alone basis. In certain cases, for example, it may be strategically important to issue a claim at an early stage if there is a threat of a rival claim being filed in an EU jurisdiction outside England and Wales. In this way the claimant would ensure that the English Courts are seized with jurisdiction to hear

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30 A stand-alone action is where there has been no prior infringement decision by a regulatory authority in the matter, or where the relief sought extends beyond a claim for damages. A follow-on action for damages follows on from the decision of a regulatory authority as to whether there has been an infringement of English or EU competition law, or both.

31 Pursuant to article 16 of Regulation 1/2003, national courts will be bound by decisions taken by the European Commission in respect of allegations of breach of European Competitions Law (insofar as the decision in question relates to addresses of the Commission’s decision). Sections 58 and 58A of the Competition Act contain analogous provisions to article 16 within the domestic regime, stipulating that national courts are bound by decisions made by the OFT with respect to a breach of competition law (provided that that decision is no longer appealable).

32 *Crehan v. Inntrepreneur Pub Company* [2006] UKHL 38.

the claim rather than running the risk of being “Italian Torpedoed”<sup>33</sup> by one of the defendant companies. According to barrister Daniel Beard of Monkton Chambers:

*The need to progress without delay has resulted in a reduction in the number of complaints being lodged at the UK's Competition Appeals Tribunal (CAT), as permission is required to file a case. This increases the risk of other claimants filing elsewhere, or for 'torpedo' actions. Consequently, all recent private litigation has been filed at the English High Court*

The “Italian torpedo” tactic came to the fore in relation to the *Cooper Tire* case which has been discussed in more detail above. It will be recalled that, in that case the Italian defendants sought negative declarations before the Italian courts in an attempt to prevent claims for damages being brought in England or elsewhere. As a result, commentators such as Oliver and McCann assert that potential claimants in cross-jurisdictional litigation should commence proceedings in the court most favourable for their claim without delay to ensure that it is the first seized of the dispute.<sup>34</sup> Having done this the claimants can then seek to agree to stay proceedings for settlement discussions and information exchange prior to the litigation being pursued.

### **The Passing-On Defence:**

One of the key difficulties in assessing the damage caused by cartels is establishing who suffered a loss as a result of any increase in price in the cartel product. Direct purchasers paying inflated prices due to a cartel on the manufacturer level, may be able to pass all or part of their additional costs on to indirect buyers, such as distributors and/or the end consumer. Being sued for damages by direct buyers, the defendant may invoke this fact as the so called “passing-on” defence, i.e. that damages to be paid to the claimant should be reduced by the amount of the loss passed on down the supply chain.

It has yet to be conclusively determined whether the passing-on defence is applicable under English law. If applicable, it would preclude claimants from recovering damages on losses passed on to customers by way of higher prices, on the grounds that compensation should only be recoverable in respect of losses actually suffered. The applicability of the defence under English law was raised in an interlocutory application for security of costs in *BCL Old Co Ltd v. Aventis SA*.<sup>35</sup> In that application, the third and fourth defendants argued (in support of their application for security of costs) that the claimant had not in fact suffered any loss, having passed on all of its loss to other purchasers by way of higher prices and should therefore provide security for costs. The court held that the applicability of the passing-on defence under English law raised “*novel and important issues*” in that case and for future cases, and “*would be an important consideration to potential claimants when considering whether to issue proceedings in the future.*” However, the court deemed it premature to consider fully the issue at that stage

33 The term ‘Italian Torpedo’ was coined to describe the pre-emptive strike launched by Eni, the Italian tire manufacturer, prior to the *Cooper Tire & Rubber Company Ltd & Ors v. Dow Deutschland Inc & Ors* (“*Cooper Tire*”) proceedings in the UK. Eni sought a number of declarations from the Italian court, including a declaration that the cartel had had no effect on prices charged to rubber customers. That, of course, was precisely the question that would have been before the English court in the claims being threatened by the tyre manufacturers.

Placing that question before the Italian courts, and joining all the tyre manufacturers as defendants to that claim for declaratory relief, meant that the English courts were prevented from hearing a claim between the same parties relating to that subject matter under the doctrine of *lis pendens*.

34 *Commercial & Chancery Special Report: Brussels clout*; Keith Oliver and Steve McCann, 16 March 2009. [www.thelawyer.com/commercial-and-chancery-special-report-brussels-clout/137158.article](http://www.thelawyer.com/commercial-and-chancery-special-report-brussels-clout/137158.article)

35 *BCL Old Co Ltd v. Aventis SA* [2005] CAT 2, [33], [38].

in proceedings, arguing that it should only be assessed when all the relevant facts had been established.<sup>36</sup>

There is no direct ruling on this point at the EU level either. But, given the case law of the ECJ giving the right to anyone who has been damaged by a breach of directly effective EC law to claim compensation, it seems highly unlikely that the ECJ would follow the practice of the US Supreme Court and bar claims by indirect purchasers who could establish a loss.

## REMEDIES

### *Compensatory damages*

Compensatory damages are the most common type of remedy awarded by English courts for breach of competition law. Such damages compensate claimants for losses suffered as a result of a defendant's wrongdoing. As articulated by the High Court in *Devenish Nutrition Ltd v. Sanofi-Aventis SA* ("*Devenish*"),<sup>37</sup> English courts will generally use the "but-for" test to calculate the loss to be compensated to claimants, attempting to return the claimant to the financial position that it would have been in "but-for" the infringement. In order to do this, a court will generally ask what the difference is between the claimant's actual position and the position that it would have been in "but-for" the illegal conduct.<sup>38</sup> The damages figure payable to claimants will usually be accompanied by a sum for interest and costs.

The ECJ has confirmed that "*a claim in compensation includes a claim for loss of profits in the event that a claimant can show that the operation of the cartel had, for example, a dampening effect on demand due to the higher prices being charged, this is likely to be difficult to prove.*"<sup>39</sup>

The method used to calculate the amount of loss will largely depend on the facts. If a cartel was shown to have made agreements to increase prices by a certain percentage, then it would make sense for the courts to also use percentages to estimate overcharge in order to calculate damages. The courts have stated in *Tullis Russell Papermakers Limited v. Inveresk Limited*<sup>40</sup> that: "*It is accepted economic practice to use more than one benchmark, in order to reflect more of the underlying data and to reduce the effect of biases in individual approaches.*" It would therefore seem logical that in situations where several methods could be reasonably used to estimate overcharge, the English courts will consider them all.

### *Exemplary damages*

While exemplary damages (awarded so as to punish or deter grossly unlawful behaviour) may theoretically be awarded in England and Wales, it seems clear from *Devenish* that they are not likely to be available in the context of follow-on actions for breaches of competition law. In that case, the court held that the principle of "*ne bis in idem*" – which dictates that a person should not be sanctioned more than once for the same

36 *BCL Old Co Ltd v. Aventis SA* [2005] CAT 2, [33], [38].

37 *Devenish Nutrition Ltd v. Sanofi-Aventis SA* [2007] EWHC 2394 (Ch) (*Devenish*).

38 *Devenish Nutrition Ltd v. Sanofi-Aventis SA* [2007] EWHC 2394 (Ch) [21], citing paragraphs 126 and 127 of the Commission Staff Working Paper annexed to the Commission's Green Paper on Damages Actions for Breach of the EC Anti-Trust Rules.

39 *Cartel Damages Claims*, Patrick Boylan and Tony Woodgate:

<http://uk.practicallaw.com/0-501-6802?q=cartel+damages+claims&qp=&qo=&qe=>

40 *Tullis Russell Papermakers Limited* [2010] CSOH 148 [183].

illegal conduct – precluded the award of exemplary damages in cases in which defendants had already been fined by the Commission.<sup>41</sup> Furthermore, the court held that Article 16 of Regulation 1/2003, which dictates that Commission decisions will be binding on national courts, precluded the court from making a decision counter to the one already adopted by the Commission in respect of the same facts.<sup>42</sup> Thus, even before it needed to assess the relevant principles under domestic law, the court held that European Community law precluded the award of exemplary damages on the facts of the case.

Nonetheless, it remains to be seen whether courts will in the future deem it appropriate to award exemplary damages in stand-alone actions, where no penalty has been imposed by a regulatory authority, such as where a cartel member has been exempt from fines where it was the first amnesty applicant notifying the Commission of the cartel arrangement.

### *Restitutory damages*

Restitutory damages are aimed at stripping unjust profits from the wrongdoer, rather than measuring the loss to the victim. In the Court of Appeal's decision in *Devenish*, it held that restitutory damages would only be available in exceptional circumstances, such as where compensatory damages would not be an adequate remedy for the claimant.<sup>43</sup>

### *Future developments*

On 17 June 2011, the European Commission launched a public consultation on a Draft Guidance Paper on quantifying harm in actions for damages based on breaches of the EU antitrust rules. It is stated that the aim of the Guidance Paper is to offer assistance to national courts of EU Member States and parties involved in actions for damages by making more widely available information relevant for quantifying the harm caused by competition law infringements. The paper sets out insights into the harm caused by anti-competitive practices and provides an overview and illustration of the main methods and techniques available to quantify such harm in practice.

### *Assignment of a cause of action in tort*

The ability to transfer a party's right to claim damages to another can be a tactical advantage in anti-trust litigation, improving both the strength of a claim and the efficiency of litigation, subject to public policy considerations. English law historically prohibited the assignment of bare causes of action including claims in tort on the basis of the principle of champerty or maintenance. That principle prohibits the participation in litigation by a person who has no legitimate concern in the litigation and without just cause or excuse.<sup>44</sup>

However, since the decision in *Trendtex Trading Corp v. Credit Suisse*,<sup>45</sup> a more relaxed and commercial approach has been taken by the courts to such questions, placing greater emphasis on whether the assignee has a "genuine commercial interest in the enforcement of the claim of another." For example, in *Trendtex* itself, Lord Roskill said at 703:

*If the assignment is of a property right or interest and the cause of action is ancillary to that right or interest, or if the assignee had a genuine commercial*

41 *Devenish Nutrition Ltd v. Sanofi-Aventis SA* [2007] EWHC 2394 (Ch) [52].

42 *Devenish Nutrition Ltd v. Sanofi-Aventis SA* [2007] EWHC 2394 (Ch) [53].

43 *Devenish Nutrition Ltd v. Sanofi-Aventis SA (France)* [2009] 3 All ER 27, [130].

44 See *Factortame* (No 8) [2002] EWCA Civ 932 at paragraph 32.

45 *Trendtex Trading Corp v. Credit Suisse* [1982] AC 679.



*interest in taking the assignment and in enforcing it for his own benefit I see no reason why the assignment should be struck down as an assignment of a bare cause of action or as savouring of maintenance.*

In the subrogation context, it has been stated that an assignment to enhance or support an existing interest is valid, albeit that the assignor may thereby recover in respect of more than the loss he himself has suffered – see *Compagnia de Seguros v. Pacific Steam Navigation Co* [1965] QB 101 Roskill J at 121, discussed by Lord Roskill in *Trendtex* at 703). This principle may be applicable to those claims which have simply been enlarged by claims relating to an earlier period.

## CONCLUSION

The myriad of strategic advantages to private enforcement in England and Wales has resulted in continual growth in this sector, with at least 10 EU Cartel findings being litigated before the Courts. These actions have inevitably thrown up many issues that have yet to be conclusively settled and others which the Courts are yet to resolve (e.g. the issue in *Deutsche Bahn* regarding limitation in the CAT). Nonetheless, the parameters of English competition litigation – on disclosure, limitation, jurisdiction, and damages – are steadily being established so that a clear route map is emerging which will allow claimants to bring litigation in confidence in England in the future.



# WALKING THE TIGHTROPE – JUDICIAL MANAGEMENT OF THE CHALLENGES POSED BY COORDINATION OF DISCOVERY BETWEEN SIMULTANEOUS CLASS AND INDIVIDUAL ACTIONS

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## INTRODUCTION

Efficiency. Relevance. Fairness. These are the values that any court must balance managing complex litigation before it. This balancing is a challenge in any complex, multi-party litigation, but it becomes even more challenging in an action with both class plaintiffs and individual (non-class) plaintiffs. Such cases were formerly quite rare, typically arising only in mass tort or product liability cases. In the last few years, however, such cases have become much more common in other types of actions, including antitrust and securities cases. You will hear the panel on this topic discuss the many issues and problems that arise at each stage of complex litigation that involves class and individual actions proceeding simultaneously against one or more common defendants (“simultaneous actions”), from initial pleadings, through discovery and motion practice, mediation/settlement, trials and all the way through to appeals. However, since any comprehensive treatment of these issues would occupy hundreds of pages, this paper will focus principally on just the issues related to discovery in simultaneous actions.

## DISCOVERY IN SIMULTANEOUS ACTIONS

The Manual for Complex Litigation prescribes that discovery in complex cases should be driven by an emphasis on the “orderly and cost-effective acquisition of relevant information.”<sup>2</sup> But when courts attempt to coordinate discovery in simultaneous actions, it can be difficult to identify how best to serve efficiency, relevance, and fairness when ruling on discovery issues raised by the parties involved. Consider the following two scenarios that courts can face when managing the discovery process in a simultaneous action – scenarios that invite the possibility of “mischief” by increasing the risk of inconsistent judicial orders or one party gaining an unfair advantage over the other parties involved:

1. Class Plaintiffs move the court to compel discovery related to a particular issue (“Issue X”). The court orders and receives formal

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<sup>2</sup> *Manual for Complex Litigation* §(4th ed. 2004).

briefing on Issue X and hears oral argument. The court is now ready to rule on Issue X. Individual Plaintiffs – having attended the hearing and reviewed the motion papers filed by the Class Plaintiffs – then send a letter to the court stating that because Individual Plaintiffs soon plan to file their own motion to compel discovery on Issue X, the court should postpone deciding Class Plaintiffs’ motion until it has heard Individual Plaintiffs’ position on Issue X. Class Plaintiffs oppose this request on the grounds of undue delay, but Defendants support the Individual Plaintiffs’ request because they usually prefer delay. Should the court stay its decision until it has heard from the Individual Plaintiffs, or should it rule now?

2. Individual Plaintiffs serve a discovery request that requires Defendant to identify and produce any document that Defendant has produced or will produce to Class Plaintiffs. Defendant refuses to comply with this request, deeming it an improper “blockbuster” that is not limited to the discovery of evidence relevant to the Individual Plaintiffs’ claims (*e.g.*, evidence related to class certification, but not the merits). Individual Plaintiffs then move the court for an order compelling Defendants to comply with their request, emphasizing they merely seek to ensure that Defendant does not withhold documents relevant to the simultaneous action from the Individual Plaintiffs while producing such documents to the Class Plaintiffs. But Defendant replies that granting Individual Plaintiffs’ request would let Individual Plaintiffs unfairly exploit a broader range of discovery that only Class Plaintiffs merit due to their class claims. How should the court rule on Individual Plaintiffs’ motion?

Any court confronted with these scenarios will have to grapple with a variety of arguments from the parties couched in concerns for efficiency, relevance, and fairness. The critical question is whether each of these values deserves equal weight in the court’s decision-making process when coordinating discovery in a simultaneous action, or whether one of these values is presumptively more important than the others – and whether such prioritization may ultimately be the only way for the court to advance the lesser-ranked values over the course of the entire litigation (even if such prioritization admittedly undercuts these lesser-ranked values during the discovery process).

This paper explores this question in the context of the two scenarios above, serving to expose the underlying interests in conflict and the solutions that courts can utilize (and have utilized) to minimize the risk of “mischief” involved. This paper concludes, however, that whatever the best solution to these scenarios may be, courts must articulate them in a manner that clarifies what values must take priority in the management of simultaneous action discovery, thereby highlighting the importance of formal motion practice over more informal dispute resolution procedures.

### EXAMINING THE INTERESTS: THE “CONCURRENT RESOLUTION” SCENARIO

Should a court coordinate discovery in a simultaneous action so as to ensure that it has heard from both Class Plaintiffs and Individual Plaintiffs before deciding any major discovery issue – or should it decide such issues on a “first come, first served” basis? The interests of the relevant parties – the Class Plaintiffs, the Individual Plaintiffs, the Defendant(s), and the court itself – are ultimately best examined via the efficiency/

relevance/fairness rubric that inherently pervades all discovery practice. We conclude that these interests are best served by the court entering an early Case Management Order anticipating the issues discussed herein and providing for procedures to be followed by the parties to maximize efficiency, relevance and fairness in discovery, and minimizing the opportunities for mischief. However, even a well-drafted CMO may not always solve the problems posed by the two scenarios above.

**Efficiency.** For the Defendant(s), Class Plaintiffs, and the court, this value tends to point to the same conclusion: The court should decide Issue X *now* because it has been briefed, and the instant parties should not be forced to accept further delay when the discovery clock is already ticking and disputes over costly, time-consuming discovery obligations must be resolved. Indeed, the court has a vital interest in ensuring that the discovery timeline for Class Plaintiffs' case is not held hostage by Individual Plaintiffs' motion practice. But Individual Plaintiffs can also cite a compelling "efficiency" interest in their defense: While judicial efficiency may not be served by delaying Class Plaintiffs' motion, a broader efficiency is advanced by the court deciding Issue X just once, rather than issuing two separate orders in response to two separate motions.

**Relevance.** While "relevance" is the watchword of federal discovery practice, its application to the concurrent resolution scenario raises a question-begging proposition. Individual Plaintiffs may plausibly claim to have dispositive legal or factual insights on the relevance of Issue X that Class Plaintiffs lack – insights the court should consider before reaching definitive conclusions, via Class Plaintiffs' motion, about whether Issue X is relevant to the entire simultaneous action. The only way the court can determine if Individual Plaintiffs have such delay-worthy insights to offer, however, is by granting a delay that allows the Individual Plaintiffs' to flesh out this argument. At the same time, the Defendant(s) may fairly object that any concern the court might have about delay-worthy insights on relevance is more than offset by the broad view of "relevance" that already exists under federal discovery rules. *See Oppenheimer Fund, Inc. v. Sanders*, 437 U.S. 340, 351 n.12 (1978) ("[T]he court should and ordinarily does interpret 'relevant' very broadly to mean matter that is relevant to anything that is or may become an issue in the litigation." (internal quotation marks omitted) (citation omitted)).

**Fairness.** Putting aside concerns about expense and delay phrased in terms of what is "fair" to the parties involved, the concurrent resolution scenario raises a further fairness-based dilemma for the court to consider: the risk of inconsistent adjudication. Simply put, if the court rules on Class Plaintiffs' motion now, the court must gamble that it will reach the same conclusion with respect to Individual Plaintiffs' later motion. But what if the Individual Plaintiffs – or the Defendant(s), for that matter – demonstrate the court's ruling on Class Plaintiffs' motion was incorrect? Certainly, the odds of this happening are enhanced if the court rules on Class Plaintiffs' motion now and thereby informs Individual Plaintiffs and Defendants as to what judicial conclusions they must rebut. This reality in turn may also foster an even greater impression of unfairness among the parties. Indeed, if the court denies Class Plaintiffs' motion, the Individual Plaintiffs may deem it "unfair" to be stuck with the task of "changing the court's mind" (versus getting a blank slate), since the court is bound to defend its prior ruling.

## EXAMINING THE INTERESTS: THE "CONCURRENT PRODUCTION" SCENARIO

Should a court coordinate discovery in a simultaneous action so as to enable Individual Plaintiffs to obtain the fruits of Class Plaintiffs discovery requests – or does such "piggy-backing" impermissibly burden the Defendant(s) and let Individual Plaintiffs

unfairly exploit discovery-based advantages that belong to Class Plaintiffs alone? The interests of the relevant parties – the Class Plaintiffs, the Individual Plaintiffs, the Defendant(s), and the court itself – are ultimately best examined via the efficiency/relevance/fairness rubric that inherently pervades all discovery practice.

**Efficiency.** When it comes to efficiency, both Individual and Class Plaintiffs have a relatively easy argument to make: It should not cost much (at least in theory) for the Defendant(s) to produce the same set of documents to Individual and Class Plaintiffs, and such production will ensure a level playing field between all the parties involved. But the Defendant(s) may also plausibly maintain that “efficiency” in simultaneous action discovery cannot be maintained unless all parties involved are encouraged to avoid duplicative efforts. In other words, if the Individual Plaintiffs can simply “piggy-back” on whatever discovery requests are filed by the Class Plaintiffs, then the Individual Plaintiffs are stripped of sufficient incentive to avoid unnecessary duplication and think carefully about what independent discovery requests they decide to serve. Nevertheless, Individual Plaintiffs may be permitted to supplement their specific discovery needs without undue burden to Defendants.

**Relevance.** If the value of “efficiency” tends to favor Individual Plaintiffs in the concurrent production scenario, the value of “relevance” likely favors the Defendant(s). After all, a simultaneous action would not exist but for Individual Plaintiffs that have refused to raise class action claims themselves or be consolidated into Class Plaintiffs’ lawsuits. It thus seems inappropriate to presume that all discovery “relevant” to the interests of the Class Plaintiffs as a “class” – interests the Individual Plaintiffs neither seek to represent nor to join – must be equally “relevant” to the Individual Plaintiffs’ claims, thereby warranting a concurrent production order. This is especially true when one considers that many of the discovery requests that Class Plaintiffs are liable to serve on the Defendant(s) will be “relevant” to an issue that Individual Plaintiffs cannot claim to share: the achievement of class certification. Yet, the final word on this issue may belong to the liberal nature of the discovery rules themselves and a refusal to accept the idea that “each litigant who wishes to ride a taxi to court must undertake the expense of inventing the wheel.” *Ward v. Ford Motor Co.*, 93 F.R.D 579, 580 (D. Colo. 1982). However, Individual Plaintiffs will likely have many overlapping issues for which class discovery will be relevant. Thus, courts can and do encourage Individual Plaintiffs to tailor any separate discovery requests so that they are relevant to any specific claims Individual Plaintiffs claim but are not duplicative of class’ claims. A new wrinkle to this problem has arisen as a result of several federal courts of appeal raising the bar for class certification. *See e.g., In re Initial Public Offering Sec. Litig.*, 471 F.3d 24 (2d Cir. 2006); *In re Hydrogen Peroxide Antitrust Litig.*, 552 F.3d 305 (3d Cir. 2008); *Luskin v. Intervoice-Brite, Inc.*, 261 Fed. Appx. 697 (5th Cir. 2008); *Ellis v. Costco Wholesale Corp.*, 657 F.3d 970 (9th Cir. 2011); *Vallario v. Vandehy*, 554 F.3d 1259 (10th Cir. 2009); *but see also, Gooch v. Life Investors Ins. Co.*, \_\_\_ F.3d \_\_\_, 2012 U.S. App. LEXIS 2643 (6th Cir. 2012) (holding that district court’s failure to resolve factual issues on class certification was harmless error). These appellate courts have now said that, in deciding motions for class certification, district courts not only *may*, but *must* make any factual findings that are necessary to support class certification. These might include findings on the merits of certain claims. This means that individual, non-class plaintiffs are at risk of having the court make findings that would be adverse to, or even dispositive of, their claims, but with no procedural vehicle to protect their interests. So the “class” versus “merits” distinction that federal courts have wrestled with for the last 40 years under Fed. R. Civ. P. Rule 23, may no longer have much meaning, at least for discovery purposes.

**Fairness.** Whether a concurrent production order would serve the interests of efficiency or relevance appears to hinge on how closely Individual Plaintiffs' discovery interests align with those of Class Plaintiffs. "Fairness," however, prompts a different concern: What about the explicit limits that federal discovery rules place on how much discovery can be sought by each party? Rule 33, for example, states that "[u]nless otherwise stipulated or ordered by the court, a party may serve on any other party no more than 25 written interrogatories." The Defendant(s) may thus argue that a concurrent production order really means giving each Individual Plaintiff the unfair benefit of 50 interrogatories – the 25 provided under Rule 33 and the 25 already served by Class Plaintiffs. And if "fairness" in discovery is largely the product of negotiation between the parties, the Defendant(s) may be less willing to enter into such negotiations, since the chance of "piggy-backing" is liable to undercut any compromises they might make.

### WEIGHING POSSIBLE SOLUTIONS

Both the concurrent resolution and concurrent production scenarios reflect the difficult problems that courts must face when coordinating the discovery process in simultaneous actions. Efficiency, relevance and fairness may illuminate the dimensions of these problems, but they do not afford any easy answers in terms of how courts should solve them. Instead, these values only further reveal that any feasible solution to these problems will likely entail the prioritization of one of these values above the other two (all the while recognizing that long-term achievement of all three values depends on this). With this in mind, the following possible "solutions" either have been or could be implemented by courts in simultaneous actions to address the kinds of difficulties reflected by the concurrent resolution and concurrent production scenarios.

**Command-and-Control (Efficiency).** One way to deal with the problems posed by the concurrent resolution and production scenarios is through a Case Management Order requiring coordination as a way to prevent such problems from arising in the first place. Under this "efficiency-driven" model, the court vests the right to serve and argue discovery entirely with Class Plaintiffs, who in turn must coordinate with Individual Plaintiffs. Whatever the Defendant(s) produce, in turn, may be equally used by Class and Individual Plaintiffs. This is the model that Judge Denise Cote adopted in the *Worldcom* fraud litigation, wherein Judge Cote held that: "There shall be no separate discovery conducted in any of the Individual Actions unless issues unique to one or more Individual Actions are identified to the Court and permission is obtained to conduct such separate discovery." *In re Worldcom, Inc. Sec. Litig.*, No. 02 Civ. 3288 (DLC), slip op. at 13 (S.D.N.Y. May 22, 2003).

**Intermediate Coordination (Relevance).** In contrast to Judge Cote's top-down efficiency-driven approach to discovery in simultaneous actions, a "relevance-driven" model aims to preserve the liberal character of federal discovery practice. Under this model, the concurrent resolution scenario reduces to the view that Individual Plaintiffs should be heard – even if in a small way (*e.g.*, a letter) – on why Issue X is "relevant" before deciding Class Plaintiffs' motion. As for concurrent production, a relevance-based model weighs in favor of letting Individual Plaintiffs "piggy-back" on Class Plaintiffs requests so long as these requests are relevant to Individual Plaintiffs' claims (*i.e.*, Defendants do not have to share documents that relate only to class certification issues). *Cf. Sauer v. Exelon Generation Co.*, 2011 U.S. Dist. LEXIS 90511, at \*15 (N.D. Ill. Aug. 15, 2011) (ordering defendants to produce documents from three related cases because the documents likely contained information relevant to plaintiffs' case).

**Situational Pragmatism (Fairness).** Despite its lofty title, a fairness-driven model for coordinating discovery in simultaneous actions requires courts to do what they normally do outside the simultaneous action context: consider every issue on the merits and afford each party's interests the *separate* respect they deserve. Such a model thus makes it easy to resolve the concurrent resolution scenario: the court should rule on Class Plaintiffs' motion now (*i.e.*, even if efficiency is not served by doing so) because Class Plaintiffs filed their motion first and in a manner seeking review apart from the Individual Plaintiffs. As for concurrent production, fairness tends to militate against letting Individual Plaintiffs piggy-back on Class Plaintiffs' discovery, if only because the opposite result seemingly risks eliminating the limits on discovery prescribed by the Rules.

## CONCLUSION

None of the three models identified above constitutes a perfect approach to resolving the wide variety of issues that courts must face when coordinating discovery in simultaneous actions. Courts may have to choose between various models in dealing with different discovery issues – for example, using a efficiency-based model to handle discovery requests, while using a fairness-based model to resolve discovery disputes. Courts may also end up adopting certain models early in the litigation only to later reject such models as infeasible or unmanageable in the face of novel factual or legal circumstances. Regardless of how this whole process unfolds, however, courts should take care to memorialize their decision-making through carefully considered Case Management Order, formal opinions, and motion practice that are ultimately accessible not just to the immediate parties involved, but the next set of litigants who happen to get caught up in a simultaneous action. Yet, such advice admittedly tends to contravene the Manual for Complex Litigation, which indirectly suggests that when it comes to managing complex litigation in general, courts should be in the practice of “[a]voiding formal motions in discovery disputes.”<sup>3</sup>

Formal motion practice is neither cheap nor fast. Nevertheless, its overriding virtue is that it lets courts articulate both to the parties and to the world a reasoned basis for decision that can make a difference in future disputes in the instant litigation, as well as in future cases. In short, no simultaneous action is an island – and courts that recognize this through formal motion practice will set the standard for how future courts pursue the values of efficiency, relevance, and fairness in such actions. Such judicial guidance is certainly to be preferred to mere gut-based assumptions about what is or is not possible when it comes to simultaneous action discovery. Thus, while every case is different and comes with its own unique set of issues to consider, courts should not shy away from issuing formal opinions (despite the potential delay and expense involved) when doing so can help put to rest questions like: Do courts often hear separate discovery motions on the same issue from Class and Individual Plaintiffs? Is it common for Individual Plaintiffs to serve discovery requests that piggy-back on the discovery requests filed by Class Plaintiffs? When production of such requests has been ordered, is the scope of discovery limited in any way?

The Honorable Pamela Rymer has observed that:

[T]o give reasoned decisions is part of what judging is all about. The heart of judging, after all, is judgment . . . Even if the Federal Rules do not require a statement of reasons, fairness does. Simply to ‘grant’ or

<sup>3</sup> *Manual for Complex Litigation* § 11.424 (4th ed. 2004).



'deny' looks arbitrary; so does ignoring or overlooking a point that was argued by the loser. Instead, to touch all the bases with at least a summary reason not only looks reasonable, but leaves lawyers and litigants alike with the feeling they've had their due: their day in court. Coincidentally, it avoids error: forcing yourself to articulate reasons makes it less likely that you will miss a critical link. Finally, in my experience, to spell out grounds for a ruling reduces both the incidence of appeal and the risk of reversal. It is therefore a benefit to the system as well.<sup>4</sup>

Hence, while meet-and-confers and informal dispute resolution may be cost-effective methods for simultaneous action litigants to resolve their discovery disputes, courts should not rely on these mechanisms as ways to avoid declaring what the law requires of these litigants – especially when the litigants want such a ruling, and the long-term interests of efficiency, relevance, and fairness cannot be served by anything less.

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4 Hon. Pamela Ann Rymer, *The Trials of Judging*, 4 GREEN BAG 57, 58-59 (2000).



# ADMINISTRATIVE HOUSEKEEPING AND ETHICAL MATTERS IN MASS TORT MDLS AND CLASS ACTIONS

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## I. INTRODUCTION AND OVERVIEW OF MDLS

Multidistrict Litigation (MDL) was created by federal legislation in 1968 after an onslaught of electrical equipment price-fixing cases were filed in numerous federal district courts. An MDL is a procedural device that allows for the transfer of federal cases from multiple districts to any single district for coordinated or consolidated pretrial proceedings.

Under 28 U.S.C. § 1407, an MDL proceeding is created by a decision of the U.S. Judicial Panel on Multidistrict Litigation (“JPML”). The JPML consists of seven sitting federal judges appointed by the Chief Justice of the United States. The multidistrict litigation statute provides that no two Panel members may be from the same federal judicial circuit.

The job of the JPML is to (1) determine whether civil actions pending in different federal districts involve one or more common questions of fact such that the actions should be transferred to one federal district for coordinated or consolidated pretrial proceedings<sup>1</sup>; and (2) select the judge or judges and court assigned to conduct such proceedings.

The purpose of this transfer or “centralization” process is to resolve consolidated pretrial discovery and pretrial motions, so as to avoid duplication of discovery, to prevent inconsistent pretrial rulings, to conserve the resources of the parties, their counsel and the judiciary, and to further the convenience of the parties and promote the just and efficient conduct of the litigation.

Transferred actions not terminated in the transferee district are remanded to their originating transferor districts by the JPML at or before the conclusion of centralized pretrial proceedings.

A party whose case has been removed from state court to a federal district court and made part of an MDL proceeding may file, on jurisdictional grounds, a motion to remand the case back to the original state trial court from where it was removed.

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1 28 U.S.C. § 1407.

Since its creation, the JPML has considered motions for centralization in over 2,200 dockets involving more than 350,000 cases and millions of claims therein. These dockets encompass litigation categories as diverse as airplane crashes; other single accidents, such as train wrecks or hotel fires; mass torts, such as those involving asbestos, drugs and other products liability cases; patent validity and infringement; antitrust price fixing; securities fraud; and employment practices.

## II. GENERAL OBLIGATIONS OF TRANSFEREE JUDGES UPON ASSIGNMENT OF A MASS TORT MDL

The obligations of an MDL Mass Tort transferee judge are numerous. They include coordinating with the court clerk's office to ensure a smooth processing of cases, the prompt scheduling of a conference with counsel, the entering of a case management order, ruling promptly on motions, holding regular telephone conferences, coordinating with parallel state court cases, encouraging an early mediation process, anticipating *Lexecon* issues,<sup>2</sup> and exercising good management techniques (decide pretrial issues, settle or try all claims when possible, remand cases to transferor courts where appropriate, and informing transferor court what the transferee court did).

## III. SELECTION OF LEAD/LIAISON COUNSEL AND COMMITTEES AND RELATED ADMINISTRATIVE ISSUES

### A. Mass Tort MDL Proceedings

The first important decision that a Mass Tort MDL judge must make is the appointment of counsel. It is usually necessary in complex MDLs to select lead, liaison, and/or administrative counsel. *The Manual for Complex Litigation* (Fourth) (2004) sets forth the criteria to consider in selecting counsel.<sup>3</sup> Many judges request lawyers' resumes, descriptions of prior experience in other complex litigation, and their proposed fee arrangements. Special consideration should be given to the method or amount of fees that a lawyer will charge. The court should explain and enforce record-keeping requirements (very important). It should also identify and appoint counsel who are vigorous advocates, constructive problem solvers, and are civil with their adversaries and each other. Moreover, in Mass Tort MDLs involving state-court litigation, lead counsel ought to include other attorneys in the committee structure and delegate significant responsibilities to them. The political and economic dynamics, unless monitored, can disrupt the MDL and related state court proceedings.

A Mass Tort MDL judge will ordinarily appoint lead and/or liaison counsel for both parties or one side. Whether both lead and liaison counsel are appointed will depend upon complexity and amount of interests at stake. Typically a local lawyer or firm will be appointed as liaison counsel. A liaison counsel plays an important role in coordinating matters in product liability MDLs that concern numerous parties. They handle administrative matters, including communications between counsel and the court and apprising parties of developments.

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2 In *Lexecon Inc. v. Milberg Weiss Bershad Hynes & Lenach*, 523 U.S. 26, 28 (1998), the Supreme Court held that a transferee court in an MDL proceeding does not have power to transfer a case to itself and must remand the case to the transferor district court upon the conclusion of the coordinated pretrial proceedings. *Id.* at 39-40 (holding that plain language of 28 U.S.C. § 1407(f) imposes responsibility to remand, which "bars recognizing any self-assignment power in a transferee court").

3 See *id.* §§ 10.224, 14.211, 22.62.

Lead counsel and committees of counsel for plaintiffs in Mass Tort MDLs carry out many functions. Lead counsel usually act for the group and formulate substantive and procedural approaches during the litigation.

Committees of counsel, including steering committees, coordinating committees, management committees, executive committees, discovery committees, trial teams, and state liaison committees, are usually appointed when the interests or positions of the members of the group are dissimilar such that they should have some representation in the decision making.<sup>4</sup> Committees may prepare briefs or conduct portions of the discovery if a single lawyer cannot do so adequately. Also, a plaintiffs' steering committee ("PSC") may wish to form subcommittees to perform specific sub-benefit tasks. The PSCs' responsibilities can include initiating, coordinating, and conducting all pretrial discovery on behalf of plaintiffs; acting as a spokesperson for plaintiffs during pretrial proceedings; negotiating and entering into stipulations with defendant; developing and pursuing settlement options with defendant; creating a method for reimbursement for costs and fees for services; and dealing with liens on a national basis.<sup>5</sup>

### Mass Tort MDLs and Class Actions Generally

In addition, in class action litigation and generally in Mass Tort MDLs, courts have the opportunity and obligation to appoint counsel who will represent beneficiaries of any common fund.<sup>6</sup> Judges have used four distinct approaches to selection of counsel in this regard: (1) reviewing recommendations of lawyers who have filed related actions and appointing the recommended lawyers if they are adequate to represent the interests of the class; (2) selecting among counsel who have filed related actions but are unable to reach an agreement and who compete for the appointment; (3) inviting bids from counsel who may or may not have filed a related action; and (4) allowing the most adequate plaintiff to select counsel, subject to review by the court.

### B. Staffing

A major issue of concern in determining fees is the appropriate level of staffing for the litigation. The *Manual* encourages courts to set guidelines at the outset of the litigation, which can reduce the potential for later problems and facilitate judicial review of fee applications.<sup>7</sup> For instance, guidelines can cover the number of attorneys who may charge for time spent attending depositions, court hearings, office and court conferences, and trial, and may caution against using senior attorneys on projects suitable to less senior (and less costly) attorneys. The setting, and observance, of such guidelines can assist attorneys for both sides in avoiding overstaffing particular parts of the litigation and therefore avoid complaints of overcharging or overbilling.

### C. Maintenance of Time Records

When fees in large scale litigation are based on the lodestar method, or when the lodestar method serves as a cross-check on the percentage-of-fund method, the maintenance of complete time records is critical to the determination of fees. As such, counsel should maintain contemporaneous and accurate time records throughout the course of an MDL or

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<sup>4</sup> See, e.g., *In re Vioxx Prods. Liab. Litig.*, No. 05-md-1657, Dkt. Nos. 245-46 (E.D. La. Apr. 8, 2005) (orders appointing Plaintiffs' and Defendants' Steering Committees (copies annexed hereto as Exhibits A & B)).

<sup>5</sup> See *In re Zyprexa Prods. Liab. Litig.*, No. 04-MD-01596, 2004 WL 3520245 (E.D.N.Y. June 17, 2004).

<sup>6</sup> See Fed. R. Civ. P. 23(g).

<sup>7</sup> *Id.* § 14.212.

class action. Courts can also (and do) require the periodic submission of time records during the litigation. This practice encourages attorneys to maintain adequate and contemporaneous records, and allows the court an opportunity to detect any problems reflected in the records. Because these records are often too voluminous for effective judicial review, courts also employ methods that will facilitate their review, such as the appointment or approval of a certified public accountant firm to review the records and to periodically provide records to the court, or the delegation of this task to a special master.<sup>8</sup>

#### IV. ALLOCATION AND DETERMINATION OF ATTORNEY FEES IN THE SETTLEMENT CONTEXT IN MASS TORT MDLS AND CLASS ACTIONS

Attorney fees are not awarded unless there is a settlement. Generally, attorney fees should be linked to services provided and a reasonable share of the value of the settlement benefits actually received by plaintiffs.

A major difference between mass torts and other class actions is that members of a mass tort litigation have affirmatively opted in to the litigation and are often represented by individually retained plaintiffs' attorneys. By contrast, in a class action, the absent class members have no individually retained lawyers and must rely upon counsel for the class representative and the court to look out for their interests. In a class action or Mass Tort MDL, the transferee judge usually appoints counsel to litigate common issues and prepare the case for trial or settlement. In these settings, the courts will have to allocate fees among attorneys. Some courts have even limited the amount of contingent fees awarded for pursuing individual claims in a common-fund settlement.<sup>9</sup> The capping of contingent fees in Mass Tort MDLs, however, has not been without criticism.<sup>10</sup>

If there is a combination of individual settlements and a global settlement, the judge sometimes orders individual plaintiffs' lawyers to pay a certain percentage of the fees they receive into a common fund to contribute to the fees of the class counsel (or, in an MDL, to the fees of the lawyers appointed by the court to perform the work for the common benefit of the MDL members), whose work in discovery and trial preparation contributed to the settlement of the individual cases as well. "A necessary corollary to court appointment of lead and liaison counsel and appropriate management committees is the power to assure that these attorneys receive reasonable compensation for their work."<sup>11</sup> In a consolidated national mass litigation, it is a standard practice for courts to compensate attorneys who work for the common benefit of all plaintiffs by setting aside a fixed percentage of settlement proceeds.<sup>12</sup> "In a complex multi-party litigation, attorneys designated with responsibilities for actions beyond those in which they are retained may be compensated for their work not only by their own clients, but also by those other parties on whose behalf the work is performed and on whom a benefit has been conferred."<sup>13</sup>

8 See, e.g., *In re Vioxx Prods. Liab. Litig.*, No. 05-md-1657, Dkt. No. 245, at 4 (order approving retention of certified public accounting firm to review time and expense submissions) (copy annexed hereto as Exhibit A).

9 See, e.g., *In re Vioxx Prods Liab. Litig.*, 574 F. Supp.2d 606 (E.D. La. 2008) (capping plaintiffs' counsels' contingent fees at 32%); *In re Zyprexa Prods. Liab. Litig.*, 424 F. Supp.2d 488, 496 (E.D.N.Y. 2006) (capping plaintiffs' counsels' contingent fees at 35%).

10 See Aimee Lewis, Note, *Limiting Justice: The Problem of Judicially Imposed Caps on Contingent Fees in Mass Actions*, 31 Rev. Litig. 209 (2012).

11 *In re Linerboard Antitrust Litig.*, 292 F. Supp. 2d 644, 653 (E.D. Pa. 2003); see also *Smiley v. Sincoff*, 958 F.2d 498, 501 (2d Cir. 1992) ("District courts have exercised this power to establish fee structures designed to compensate committee members for their work on behalf of all plaintiffs involved in consolidated litigation.").

12 See MANUAL § 20.312 ("MDL judges generally issue orders directing that defendants who settle MDL-related cases contribute a fixed percentage of the settlement to a general fund to pay national counsel.").

13 *In re Worldcom, Inc. Sec. Litig.*, No. 02-CIV-3288, 2004 WL 2549682, at \*2 (S.D.N.Y. Nov. 10, 2004); see also *Smiley*, 958 F.2d at 501.

A transferee court in a federal multidistrict litigation has the power to determine the compensation for appointed lead counsel and to impose its fee calculation on all federal plaintiffs, even if their cases are 1) before other federal courts rather than the transferee court, or 2) not yet in a federal court, but ultimately will be in such a court.<sup>14</sup> Courts have thus sanctioned a common benefit fund derived from a fixed percentage of fees earned by individual attorneys.<sup>15</sup>

As a result of this authority, MDL transferee judges often issue orders that direct a fixed percentage of any settlement be contributed to a general fund to pay such national counsel. Courts may direct that contributions be made by defendants or by plaintiffs' counsel from individual settlement payments received.

Most courts use the percentage basis to determine the appropriate fees. In instances involving large settlements, the common range is 4% to 18%. Some courts use the lodestar approach, applying a detailed analysis of the reasonable amount of hours worked and multiplying that amount by an adjusted reasonable hourly rate. And some courts use a combination approach involving both methods, where the percentage method is used and the lodestar method is used as a cross-check on the reasonableness of the fee.<sup>16</sup>

With respect to attorneys who provide a common benefit to a group of litigants, such attorneys may receive compensation from a common fund. Courts have authority to protect members of a class from excessive fees by limiting the amount of contingent fees awarded for pursuing individual claims in a common-fund settlement. If there is a combination of individual settlements and a class-wide settlement, the court can order individual plaintiffs' lawyers to pay a certain percentage of fees they received into a common fund to contribute to the fees of lead or class counsel, whose work in discovery and trial preparation contributed to the settlement of the individual cases as well.

## V. ETHICAL ISSUES IN THE CONTEXT OF MASS TORT MDLS AND CLASS ACTIONS

Ethical rules were drafted many years ago before the arrival of mass tort situations, where attorneys may represent not just one or a few clients but many. As such, the ethical rules were not created with the intent that they cover the mass tort settlement situation.

Plaintiffs lawyers nonetheless face many ethical issues in the context of multiple party actions: They have to represent their individual clients zealously within the bounds of the law; if appointed to a leadership position or a committee in an MDL proceeding, they must exercise care and consideration for the concerns of the court, co-counsel and their clients; they must deal with the desire of defendants to obtain full closure of the litigation, often on a national scale; they must deal with overworked courts interested in global, efficient, and expeditious resolutions to the litigation; and they must face the concerns of a society that desires a fair and economic resolution to the litigation.

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14 See *Walitalo v. Chrysler Corp.*, 968 F.2d 741, 747 (8th Cir. 1992) ("the district court did not err in specifying how the originating trial courts should calculate the amount of lead and liaison counsel's fees in those cases remanded for trial . . . the district court appointed lead and liaison counsel and thus had authority to determine the amount of their compensation"); *In re Air Crash Disaster at Florida Everglades*, 549 F.2d 1006, 1019 (5th Cir. 1977) (stating that transferee district court, which appointed lead counsel, "was the only tribunal that could effectively handle the fee matter"); *In re Zyprexa*, 424 F. Supp. 2d at 491 (setting caps on attorneys' fees in settled Zyprexa cases).

15 See *Smiley*, 958 F.2d at 500 ("The order provided that any committee fee was to be paid by all attorneys on behalf of their clients. Plaintiffs were not to pay fees to the committee out of their own recoveries."); see also *In re Air Crash Disaster*, 549 F.2d at 1016 ("We hold that the district court had the power to direct that the Committee and its counsel be compensated and that requiring the payment come from other attorneys was permissible").

16 See, e.g., *In re AT&T Corp.*, 455 F.3d 160, 164 (3d Cir. 2006).

**A. Whether There is an Absence of the Adversarial Process in the Mass Tort Settlement Context and Whether this Can Adversely Impact or Jeopardize Settlements and Attorneys Fees**

The consolidation of tort claims, whether by class action or MDL, radically changes the dynamics of settlement. Some commentators have opined that the interests of attorneys can be pitted against those of their clients, and that the interests of plaintiffs can sometimes be pitted against other plaintiffs. In these situations, some commentators believe that the focus on a mass settlement can sweep aside the concerns of individual claimants. But while these tensions can work to replace the intended adversarial relationship of plaintiff and defendant with a struggle between monied, connected interests and lone class members, for attorneys that follow the ethical rules, this should not happen.

Much criticism of settlement in the mass tort context has been focused on the theory that early settlement circumvents the traditional adversarial process, through which the facts and evidence would be unearthed and the true value of the case discerned. Absent discovery conducted in the adversarial process, the theory goes, facts and evidence usually unearthed during the discovery process remain buried. The adversary system that is traditionally at play in litigation also breaks down in the attorney fee context in a mass tort settlement because defense counsel generally does not have an interest in the amount or percentage of attorney's fees allotted to plaintiffs' counsel, since it is coming out of a percentage of the settlement figure (out of plaintiffs' pockets) or is being allotted between common benefit attorneys and non-common benefit attorneys.

Although the foregoing concerns might have some validity in some situations, the recent settlements in the *Baycol*, *Vioxx*, and *World Trade Center Disaster Site*<sup>17</sup> mass tort litigations were reached after much pretrial discovery and litigation activity, conducted by both sides in an adversarial setting, unearthed substantial facts and evidence. In addition, in the *Baycol* and *Vioxx* litigations the settlements were reached after multiple bellwether jury trials. By deciding controlling legal issues expeditiously and adopting bellwether trial plans, these cases seem to suggest that courts can ensure that the complex settlement formulas and matrices used in private mass tort settlements are informed by, and account for, the legal and factual issues impacting individual plaintiffs' claims (*i.e.*, issues that are at play in the traditional adversarial setting). And these measures further allow for a public airing of mass tort disputes, thus providing a transparency that is likewise in place in the traditional adversarial setting. Indeed, the courts in these cases made public the measures they instituted at each step of the way. All told, these measures go far in removing much of the concern about the purported absence of an adversarial process in the mass tort settlement context.

The *Vioxx* litigation provides an example of where the full-fledged discovery necessary to prepare for bellwether trials will often reveal many of the factual circumstances relevant to the ultimate success or failure of individual plaintiffs' claims (circumstances that are another indicator that suggests the adversary process is in play). Judge Fallon explained the institutional benefits of his use of bellwether jury trials in the *Vioxx* litigation as follows:

[B]y injecting juries and fact-finding into multidistrict litigation, bellwether trials assist in the maturation of disputes by providing an opportunity for coordinating counsel to organize the products of pretrial

<sup>17</sup> *In re Vioxx Prods. Liab. Litig.*, No. 05-md-1657 (E.D. La.); *In re World Trade Center Disaster Site Litig.*, Dkt No. 21-mc-00100 (AKH) (S.D.N.Y. filed Feb. 13, 2003); *In re Baycol Prod. Liab. Litig.*, MDL No. 1431 (D. Minn.).



common discovery, evaluate the strengths and weaknesses of their arguments and evidence, and understand the risks and costs associated with the litigation. . . . [T]he knowledge and experience gained during the bellwether process can precipitate global settlement negotiations and ensure that such negotiations do not occur in a vacuum, but rather in light of real-world evaluations of the litigation by multiple juries.<sup>18</sup>

Even if parties settle before bellwether jury trials are held, as in the *World Trade Center Disaster Site Litigation*, the discovery conducted in preparation for such trials can nevertheless provide the requisite knowledge to inform the relative valuations reflected in the structure of the settlement formulas and matrices. Moreover, authoritative pretrial rulings on significant legal issues (that are customary to an adversarial setting) can also assist in the maturation of mass tort disputes and supply useful information to be factored into settlement negotiations.

On the other hand, the notion of judicial approval of a settlement in a mass action has, in certain instances, led some commentators to observe that such approval can detract from the adversarial nature of the judicial system. In *Zyprexa*, *Vioxx*, and the *World Trade Center Disaster Site Litigation* case, the courts seemed to espouse the notion that the settlements were in the best interests of the claimants. Commentators have stated that the idea that a judge should determine what is in the claimant's best interest is inconsistent with the adversarial system. Counsel, not the judge, should act in the client's best interests. This observation, however, might be somewhat tempered by the fact that each claimant in a mass action can review the settlement terms with his attorney and decide for themselves whether to consent to the settlement offer. But where the judge declines to approve a settlement, the claimant's input is essentially nonexistent.

## **B. Potential Conflicts of Interest Arising From Simultaneous Representation of Parties in Multiple Class Actions Against the Same Defendant in Different Jurisdictions**

The issue of conflicts of interest that may arise when counsel simultaneously represents two parties in two class actions in different jurisdictions against the same defendant has not received much attention. But the issue certainly exists.

Counsel has an ethical duty of loyalty to his client. The bedrock of the attorney-client relationship is loyalty – “the lawyer’s virtually total loyalty to the client and the client’s interests.”<sup>19</sup> This duty bars an attorney from representing two clients that have inconsistent interests. Rule 1.7 of the MODEL RULES OF PROF’L CONDUCT provides that a lawyer shall not represent a client if the representation of the client will be directly adverse to another client, unless (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and (2) each client consents after consultation.

Rule 23(a)(4) of the Federal Rules of Civil Procedure requires that a representative of members of a class must “fairly and adequately” protect the interests of the class. Furthermore, Rule 23(g)(1)(B) provides that in appointing class counsel, a court may consider any other matters pertinent to counsel’s ability to “fairly and adequately” represent the interests of the class.

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18 Eldon E. Fallon, Jeremy T. Grabill, Robert Pitard Wynne, *Bellwether Trials in Multidistrict Litigation*, 82 Tul. L. Rev. 2323, 2325 (2008).

19 G. Wolgram, *Modern Legal Ethics* § 4.1, at 146 (1986).

Adequacy of representation is crucial to a binding judgment on absent class members. In the absence of adequate representation, the binding judgment is subject to attack under the Due Process Clause.<sup>20</sup>

In situations where counsel is simultaneously representing classes in multiple class actions against the same defendant or defendants in different jurisdiction, the question arises whether his loyalties may be so divided that a conflict of interest arises.

Where counsel's duty of loyalty to a client may be compromised, he arguably cannot fairly and adequately protect the interests of the class for purposes of Rule 23. The Supreme Court in two cases involving intra-class conflicts of interest found that, under Rule 23's adequacy prong, conflicts of interest existed where the representation of the class members would result in conflicting interests between the class members, requiring a determination that representation was inadequate and the rejection of the class settlements.<sup>21</sup>

Courts have ruled along similar lines in cases involving inter-class action conflicts. In *Fiandaca v. Cunningham*, the First Circuit ruled that the failure to disqualify the class counsel from representation was an abuse of discretion where counsel's simultaneous representation in two separate class actions created a conflict of interest between the classes in terms of the settlement.<sup>22</sup> The terms of the proposed settlement in one class action were inconsistent with the interests of class members in the other class action. The court cited New Hampshire's ethical rule that tracked Model Rule 1.7(a) and the ABA's comment to that Rule, which provides that "[l]oyalty to a client is also impaired when a lawyer cannot consider, recommend or carry out an appropriate course of action for the client because of the lawyer's other responsibilities or interests. The conflict in effect forecloses alternatives that would otherwise be available to the client."<sup>23</sup>

Other courts have similarly held that a disqualifying conflict of interest arose in the context of simultaneous representation in multiple class actions where it would be difficult to award the whole sum of damages to both classes, or where the defendants' assets would not be sufficient to satisfy the judgments in the two class actions.<sup>24</sup>

In another case, the court held that a disqualifying conflict arose where the named plaintiffs were the same in both class actions, and thus the fact that they would be indifferent to whether one case or the other succeeded posed a risk of harm to the absent class members in both cases.<sup>25</sup>

On the other hand, courts have declined to find a disqualifying conflict of interest at least in respect to a liability phase of a class action involving simultaneous representation in multiple class actions.<sup>26</sup>

20 *Hansberry v. Lee*, 311 U.S. 32, 42-43 (1940).

21 *Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 864-65 (1999); *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 625-29 (1997).

22 827 F.2d 825, 829 (1st Cir. 1987)

23 MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 4 (2011).

24 *Moore v. Margiotta*, 581 F. Supp. 649, 650-53 (E.D.N.Y. 1984); *Sullivan v. Chase Investment Servs. of Boston, Inc.*, 79 F.R.D. 246, 258 (N.D. Cal. 1978); *Jackshaw Pontiac, Inc. v. Cleveland Press Publish'g Co.*, 102 F.R.D. 183, 192 (N.D. Ohio 1984); *Kuper v. Quantum Chem. Corp.*, 145 F.R.D. 80, 83 (S.D. Ohio 1992); *In re Cardinal Health Inc. ERISA Litig.*, 225 F.R.D. 552, 556-57 (S.D. Ohio 2005); cf. *Dietrich v. Bauer*, 192 F.R.D. 119, 126 (S.D.N.Y. 2000) (rejecting argument that counsel was improperly conflicted because "the Court is not presented with a situation in which counsel simultaneously represents classes in parallel litigations seeking to tap the same pool of finite assets").

25 *Kurcz v. Eli Lilly & Co.*, 160 F.R.D. 667, 671, 679 (N.D. Ohio 1995).

26 See *Seijas v. Republic of Argentina*, 606 F.3d 53, 57 (2d Cir. 2010) (district court did not abuse discretion in certifying class where potential conflicts of interest that arose because lead counsel represented all eight classes, as well as individual plaintiffs in non-class actions, and all plaintiffs theoretically were in competition with one another to recover on their judgments, would threaten damages phase of the proceedings, not the liability phase, and district court promised to revisit conflict issue in damages phase if necessary).

Thus, simultaneous representation in class actions against the same defendant in different jurisdictions may result in a settlement or judgment that restricts or adversely impacts the damages or rights sought by the class members in the respective class actions. Counsel should be aware of the potential for conflicts of interest that may arise in these situations.

The enactment of the Class Action Fairness Act of 2005 arguably reduces the prospect of simultaneous representation in multiple class actions in different courts against the same defendant by pushing state court class actions into the federal courts. But the issue will not disappear because class actions against the same defendant can still be filed in multiple federal courts. MDLs, though, should result in a reduction of this problem, because the interests of the classes in an MDL, or the outcomes sought, are generally the same.



# THE CONSEQUENCES OF CAFA: CHALLENGES AND OPPORTUNITIES FOR THE JUST, SPEEDY, AND INEXPENSIVE DETERMINATION OF CLASS AND MASS ACTIONS

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## I. INTRODUCTION

Seven years after the enactment of the Class Action Fairness Act of 2005 (“CAFA”), the federal courts to which a myriad of formerly state court class actions have been removed under CAFA’s exponential expansion of diversity jurisdiction for class and mass actions have begun to move past their threshold struggles with interpreting and implying the statute. These focused on whether CAFA was retroactive (the prevailing answer is “no”); whether and how to apply the statute’s detailed, yet partially undefined and seemingly inconsistent exceptions for local controversies and largely intra-state disputes; and the challenge of comprehending what Congress had in mind with the “mass action” invented by the statute itself. The federal courts have now progressed to the real work of meeting the challenge of managing putative multistate and nationwide class actions, brought under one or a variety of state substantive laws, guided by the Federal Rules (in particular, Rule 23), but without a unifying body of federal substantive law, or a federal choice-of-law statute.

Rule 23, and its most recent amendments, predated the enactment of CAFA, and was designed and applied in an era in which the class actions adjudicated in the federal courts were there by virtue of federal subject matter jurisdiction: these cases arose under the securities and antitrust laws, the employment laws, and the civil rights statutes. Occasionally, the federal courts would face a class action involving only state law. Most often, if such an action were framed as a nationwide or multistate class action, the court’s choice of law analysis would begin and end with the observation that a number of states had interests in the matter; the class was thus unmanageable as a nationwide class action (since it would involve the application of many states’ laws); and the case should preferably proceed, in statewide components, in the underlying state courts.<sup>1</sup>

CAFA shifted the field of class action battle from state to federal court.<sup>2</sup> Swept away was the presumption that class actions asserting state claims could and would be adjudicated in state courts; now, such cases were frequently filed in, and more frequently removed to, the federal courts. The cynical view, among CAFA opponents, was that this was not merely a change of scene; it was designed to remove state law class actions to less favorable, more hostile federal courtrooms, where the cases would be denied certification,<sup>3</sup> or simply ignored. Certain aspects of the CAFA legislative history can be read to bear this out. Most obvious is the hostility to state courts’ management of class actions. In this view, the purpose of CAFA was to transfer class actions from favorable or at least feasible state court environments to the alien world of federal court, where class action life was impossible.

The battle over CAFA enactment, which began with the first introduction of the bill in 2001 and ended with the enactment of CAFA in 2005, was bitter, partisan, and fueled by anecdotes which did not always have a firm foundation in fact. The bitter taste of the CAFA enactment process has lingered, and has tinged the litigation and commentary on what the statute meant to do, whether such a purpose was good, bad, or indifferent and how (depending upon one’s viewpoint) CAFA could be promoted, resisted, subverted, or ignored in actual class action litigation in actual federal courts.

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1 The Seventh Circuit’s *Bridgestone/Firestone* decision, 288 F.3d 1012 (7th Cir. 2002) exemplifies this approach. See also *In re Propulsid Prods. Liability Litig.*, 208 F.R.D. 133 (E.D.La. 2002).

2 For the view that state courts and nationwide marketing were inherent mismatch, see John H. Beisner & Jessica Davidson Miller, “They’re Making a Federal Case Out of It . . . In State Court,” 25 Harv. J.L. & Pub. Pol’y 143 (2001).

3 See Nicole Ochi, *Are Consumer Class and Mass Actions Dead? Complex Litigation Strategies After CAFA & MMTJA*, 41 Loy. L.A. L. Rev. 965, 1033 (2008).

Seven years, particularly in the world of litigation, is not an especially long period of time, and CAFA-related resentments are still fresh in the minds of many. It may modestly be proposed, however, that it is time to move on to address the task at hand: to work together, as advocates and jurists, to fulfill the command of the Federal Rules that applies to every case, under every claim for relief, that comes before the federal courts by any route: to secure its “just, speedy and inexpensive determination.” Fed. R. Civ. P. 1. There is no Rule 1 exemption for Rule 23 class actions. Emergence from the weeds of contentious CAFA legislative history (which itself is controversial and inconsistent) to the clearer path of focus on the Act’s express purposes themselves may illuminate the inquiry into CAFA’s legitimate intent and guide us in effectuating its purposes.

## II. TO REVIEW: A CAFA PRIMER

The United States has had, since its founding, a dual court system. As every law student learns, the state courts are considered courts of general jurisdiction, while the federal courts’ jurisdiction is limited to actions arising under federal statutes (such as federal securities, employment, and antitrust laws) and actions raising “federal questions,” *e.g.*, Constitutional issues. The one historical exception has been the federal courts’ “diversity jurisdiction” over disputes between citizens of different states, involving a jurisdictional minimum in controversy: currently, \$75,000, exclusive of interest and costs. Diversity jurisdiction was seen as an antidote to the bias an outsider might suffer in a “foreign” state court.

Many class actions do not arise under federal statutes or raise federal questions. Consumer fraud and tort actions are typically prosecuted under state common law or state consumer statutes. Diversity jurisdiction looks to the citizenship of the named parties, *e.g.*, the defendant and the class representatives. As a result, severe injury/unlawful death tort class actions could be brought in the federal courts, or “removed” by defendants from state to federal court. But “small claims” consumer class actions have typically proceeded in the state courts, because each class member did not have the requisite \$75,000 in damages to trigger federal jurisdiction.

With the rise of nationwide marketing and distribution of standardized consumer goods and services, ranging from prescription drugs to debit cards, come an increase in tort and consumer class actions, arising (of necessity) under state law (outside the maritime realm since there is no federal substantive law of tort or common fund with a private right of action).

As a result of the increase in nationwide class actions asserting state law claims initiated in state courts, defendants complained of being peppered with multiple state court class suits over the same product or service. The federal court system can “centralize” such cases in a single court for consolidated treatment under 28 U.S.C. § 1407, the “multidistrict litigation” statute, but the state courts have no similar mechanism that allows transfer and centralization across state lines. Each state is, in many respects, a sovereign entity. Moreover, state courts have long been acknowledged to have the power to certify multistate or nationwide class actions, so long as a proper choice-of-law analysis is conducted, and class members are afforded due process, such as notice and the right to “opt-out” of the class. *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797 (1985). The situation in state courts, with overlapping or competing class actions. Thus, a defendant might face multiple state class actions asserting claims arising from the same product or cause of conduct, and claims arising from the nationwide marketing of a standard product had no sure means of being centralized in a single federal court.



This *status quo* was profoundly altered in February 2005, when Congress, in enacting the “Class Action Fairness Act Of 2005” (hereinafter known as “CAFA”) in one fell swoop mandated a mass exodus of class action litigation from the states to the federal court system. CAFA’s legislative version of a geographical cure for perceived abuses (a scourge on they system, in defendants’ view, while largely mythical, in plaintiffs’ view) was effected without any express change in substantive law, or any increased staffing or funding for the federal court system that is now charged with presiding over the vast majority of United States class action suits. This shift alone was predicted to have a profound impact on the speed and efficiency with which class action litigation is conducted in the United States. It was also anticipated (or feared), over time, to result in a commanding federal role in articulating, as well as applying, the state substantive law of torts and consumer rights, which as heretofore lacked a true federal common law.

In addition to these hopes or fears, CAFA was predicted to have unintended consequences on the nature of class action litigation in United States courts.

On February 18, 2005, the “Class Action Fairness Act of 2005” (CAFA) became law. CAFA was effective immediately, and greatly expanded federal diversity jurisdiction over class action cases. The Act’s stated purpose is to “restore the intent of the framers of the United States Constitution by providing for Federal court consideration of interstate cases of national importance under diversity jurisdiction.” P.L. 109 2, § 2(b)(2). CAFA’s new minimal diversity standards promise gradual and substantial growth of federal courts’ responsibility over consumer class actions.

CAFA has two main sets of provisions. One set greatly expands original federal jurisdiction, as well as removal standards. The second set applies to class action settlements and requires, for the first time, notifications to state and federal governmental authorities within ten days of filing of a proposed settlement and restricts attorney fee components and other features of class action “coupon” settlements.

CAFA’s minimal diversity provisions vest the federal courts with virtually plenary, though discretionary, diversity jurisdiction over most class actions, except for purely intrastate, local matters. As a practical matter, CAFA operates to vest the federal courts with diversity jurisdiction over most class actions, except for purely intrastate, local matters. As 28 U.S.C. § 1332(d) now provides:

- (2) The district courts shall have original jurisdiction of any civil action in which the matter in controversy exceeds the sum or value of \$5,000,000, exclusive of interest and costs, and is a class action in which—
  - (A) any member of a class of plaintiffs is a citizen of a State different from any defendants;
  - (B) any member of a class of plaintiffs is a foreign state or a citizen or subject of a foreign state and any defendant is a citizen of a State; or
  - (C) any member of a class of plaintiffs is a citizen of a State and any defendant is a foreign state or a citizen or subject of a foreign state.

28 U.S.C. § 1332(d), with several narrow exceptions, now gives district courts diversity jurisdiction over class actions in which any class member and any defendant are citizens of different states. CAFA also aggregates the claims of all class members to meet the new jurisdictional threshold of \$5 million.

As courts, counsel and affected litigants continue to apply CAFA, profound judicial challenges and opportunities will emerge. CAFA's embrace of minimal diversity imposes on the federal courts vast responsibility for consumer and business tort class action claims against corporate defendants. This is a significant change from long-standing dependence upon state laws, state regulations and state courts to regulate and police corporate conduct and remedy consumers fraud, deceptive conduct, and unfair business practices. Will the federal courts do better, or worse, than their state court predecessor in enforcing the letter and spirit of these state laws?

Since CAFA provided for no new judgeships, no additional staffing, and no new resources for the federal judiciary, CAFA was predicted to further increase the federal courts' already heavy burdens. As former Chief Justice Rehnquist explained in his State of the Judiciary Report, released January 1, 2005, at 2, "The continuing uncertainties and delays in the funding process, along with rising fixed costs that outpace any increased funding from Congress, have required many courts to impose hiring freezes, furloughs, and reductions in force."

### ***Effective Date of CAFA and Effect on Pending Actions***

For practitioners, an initial vexing question was CAFA's applicability to particular cases. It is now clear that the statute is not retroactive and applies instead only to cases filed, or very substantially amended, on or after February 18, 2005. Controversy over these issues arose from Section 9 of the statute which states: "The amendments made by this Act shall apply to any civil action commenced on or after the date of enactment of this Act." In *Pritchett v. Office Depot*, 360 F. Supp. 2d 1176 (D. Colo. 2005), Office Depot had removed a Colorado certified wage and hour class action two weeks before trial, arguing that the removal itself "commenced" the action under CAFA. The trial court rejected Office Depot's construction and held that the term "commenced" referred to the original commencement of the action in a court of proper jurisdiction, whether that was in state or federal court.

### ***Legislative Findings of CAFA Reaffirm and the Propriety of Class Actions While Enumerating Abuses Justifying Reform***

Sections 2(a) and 2(b) of CAFA include Congressional findings and elucidated statutory purposes which reaffirm the importance and value of consumer class action claims, while citing a history of abuses justifying CAFA's substantial reforms. CAFA Section 2(a)(2)(4) specifically cautions judges to be alert to stop class action abuses and subsequent subsections enumerate them. The perceived abuses are many, and include unjustified awards made to certain plaintiffs at the expense of other class members. CAFA is intended to ensure that incentive payments are appropriate and should also protect against "buy-offs" where plaintiffs seek to obstruct legitimate class actions and/or selling class members' interests short, for example, with a reverse action. Section 2(a)(3)(C) states that "confusing notices are published that prevent class members from being able to fully understand and effectively exercise their rights."

While no provision of CAFA specifically addressed the content of class notices, the act fundamentally expanded notice by requiring notifications of proposed class action settlement to state and federal governmental officials. (Discussed below.) CAFA does not amend Rule 23 because 2003 amendments to Federal Rule of Civil Procedure 23 had already done so by, for example, specifically requiring notices to be clear, concise and easily understood.

Section 2(a)(4)(A) identified “keeping cases of national importance out of Federal court” as an abuse and CAFA reformed this area by eliminating the requirement of complete diversity, embracing minimal diversity and relaxing amount in controversy requirements. Section 2(a)(f)(B) identifies as an abuse “sometimes acting in ways that demonstrate bias against out-of-State defendants,” and Section 2(a)(f)(C) identifies as an abuse “making judgments that impose their view of the law on other States and bind the rights of the residents of those States.”

### ***Dramatic Expansion of Diversity Jurisdiction of Federal Courts***

Section 4 of CAFA amended 28 U.S.C. § 1332 and broadly expanded federal diversity jurisdiction. CAFA establishes federal diversity jurisdiction, with a few exceptions, over any action in which any one member of the class (whether a named plaintiff or an “absent” [unnamed] class member) has diverse citizenship from any one defendant, and where the aggregate amount in controversy exceeds \$5 million. 28 U.S.C. § 1332(d)(2).

28 U.S.C. § 1332(d)(3) provides a discretionary single-state CAFA exception over a class action in which greater than one-third but less than two-thirds of the members of all proposed plaintiff classes in the aggregate and the primary defendants are citizens of the State in which the action was originally filed or at least one significant defendant is a forum state resident if “principal injuries” were also suffered in the forum state and no other “similar” class action has been filed within the past three years. In determining whether to accept or declare jurisdiction over these cases, the courts are directed to consider: whether the claims implicate matters of national origin; involve application of the laws of states outside the forum; the existence of “distinct nexus” in the state; residency of the class; “interests of justice”; and totality of circumstances.

The term “primary defendant” is not defined in the statute.<sup>4</sup> The statute also does not allocate the burden of persuasion on the issue of federal-court jurisdiction, an important omission. Ordinarily, the party asserting federal jurisdiction has the burden of establishing the facts necessary to jurisdiction though 2003 Senate committee report indicates that the reverse may be true under CAFA.<sup>5</sup>

Under new 28 U.S.C. § 1332(d)(4), federal courts “shall decline to exercise jurisdiction,” however, over a class action where greater than two-thirds of the class are citizens of the forum state.

§ 1332(d)(5)(A) exempts from CAFA any class action in which the primary defendants are States, State officials, or other governmental entities against whom the district court may be foreclosed from ordering relief; or the number of members of all

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<sup>4</sup> The Senate committee report (S.Rep. No. 108-123 (108th Cong., 1st Sess. July 31, 2003)) state, “[T]he Committee intends that the only parties that should be considered “primary defendants” are those defendants who are the real “targets” of the lawsuit – i.e., the defendants that would be expected to incur most of the loss if liability is found.”

<sup>5</sup> *Id.* at p. 44.

proposed plaintiff classes in the aggregate is less than 100. The governmental exception sensibly respects the Eleventh Amendment which bars suits in federal court for monetary relief, cases for the enforcement of state laws against state government agencies, and cases involving such intensely local interests that federal courts normally abstain.<sup>6</sup> Subsection 5(B)'s narrow exception for plaintiff classes less than 100 is undefined. The statute does not specify whether "the number of all proposed plaintiff classes in the aggregate" refers to a single lawsuit, or multiple lawsuits.

28 U.S.C. § 1332(d)(9) also excepts from CAFA all class action cases solely involving securities claims, as well as analogous claims, such as breach of fiduciary duty, which arise in the securities context. The purpose of this provision is to preserve the federal versus state court jurisdictional lines already drawn in the securities litigation class action context by the enactment of the Securities Litigation Uniform Standards Act of 1998.<sup>7</sup>

These exceptions ensure continuing vitality of state court class actions involving local injuries and defendants. Those states with many resident corporations are likely to see the continuing feasibility of state court class action claims, which are consciously protected by this section. An important feature of the "single-state exception" is that a class seeking more than \$5 million can be composed exclusively of residents of a state, and all but one of the primary defendants may be both headquartered and incorporated within the state; however, federal court original (and removal) jurisdiction still exists if even one "primary defendant" (however future jurisprudence may define that term) is out-of-state.

### ***"Mass Actions"***

CAFA also treats certain "mass actions" as CAFA class actions for expanded federal diversity of jurisdiction purposes but limits MDL transfer and consolidation of such claims. "Mass action" is restrictively defined as "any civil action (except a civil action within the scope of section 1711(2)) in which monetary relief claims of 100 or more persons are proposed to be tried jointly on the ground that the plaintiffs' claims involve common questions of law or fact..." except that jurisdiction shall exist only over those plaintiffs whose claims in a mass action satisfy the jurisdictional amount requirements under subsection (a).

Exempted from the definition of 'mass action' are situations where all of the claims in the action arise from an event or occurrence in the State where the action was filed, and that allegedly resulted in injuries in that State or in States contiguous to that State. Any mass action removed to Federal court pursuant to this subsection cannot thereafter be transferred to any other court pursuant to the MDL procedures, unless a majority of the plaintiffs in the action request such transfer.

A CAFA "mass action" is thus both a broader and narrower concept than a "mass tort," although the two could overlap. Most mass torts will not become removable "mass actions," because plaintiffs in mass torts are rarely intentionally joined (and can easily now avoid being joined) in groups of 100 or more.

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6 See *Pennhurst State School & Hospital v. Halderman* (1964) 465 U.S. 89, 104 S. Ct. 900, 79 L. Ed. 2d 67 ("[I]t is difficult to think of a greater intrusion on state sovereignty than when a federal court instructs state officials on how to conform their conduct to state law. Such a result conflicts directly with the principles of federalism that underlie the Eleventh Amendment.")

7 S. Rep. No. 108-123 (108th Cong., 1st Sess., July 31, 2003) at 45.

There are important differences between the treatment of mass actions and class actions under the statute. Even if the aggregate \$5 million jurisdictional requirement is met, no individual plaintiff's claim will stay in federal court unless more than \$75,000 is at stake for that plaintiff. Subsection 11 does not apply to cases in which all of the claims arise from "an event or occurrence" in the forum state, resulting in injuries in that state or contiguous states. For example, if a local grocery sold locally produced bacteria-contaminated juice that sickened or killed consumers, a consolidated case would remain in state court if the plaintiffs were limited to residents of that state and adjoining states. Other cases could be filed for residents of non-contiguous states. If the defendant then moved to consolidate the cases, subsection 11 would not apply.

Notably, subsection 11 also does not apply to cases in which "all of the claims in the action are asserted on behalf of the general public (and not on behalf of individual claimants or members of a purported class) pursuant to a state statute specifically authorizing such action." For example, this provision protects California Business and Professions Code Section 17200 et seq. claims, unless they are also plead as class claims.

Subsection 11 also does not apply to cases in which the claims are consolidated for pretrial proceedings only, and does not apply to cases in which the defendant moves to join the claims. Plaintiffs should therefore be able to keep "mass actions" in state court if they adhere to current practices, which typically avoid the filing of complaints seeking the joint trial of plaintiffs in numbers even remotely approaching 100.<sup>8</sup>

### ***Expanded Removal, and New Rules of Appeal on Remand Orders***

28 U.S.C. § 1453 now provides for removal rights coextensive with the expanded diversity jurisdiction rules, waives the former rules requiring consensus of defendants to remove and cancels the former one year limit on removal. Now, "A class action may be removed to a district court of the United States in accordance with section 1446 (except that the 1-year limitation under section 1446(b) shall not apply), without regard to whether any defendant is a citizen of the State in which the action is brought, except that such action may be removed by any defendant without the consent of all defendants."

The removal of the one-year "safe harbor" in 28 U.S.C. § 1446(b) is an important change. If a complaint not meeting the requirements of CAFA is substantially amended at any time in a manner that then meets the requirements of CAFA, the defendant will have an opportunity to remove it.

The ability of any defendant to remove the case against the wishes of other defendants protects defendants with the most at stake, but also places disruptive power in the hands of any defendant, even one with little to lose.

28 U.S.C. § 1453(c) on Review of Remand Orders is an extraordinary provision significantly expanding appellate jurisdiction and reviewability of remand orders. Federal court orders remanding cases to state court are traditionally not subject to federal appellate review, because federal jurisdiction is lost upon grant of removal. CAFA reverses this. While CAFA eliminates interlocutory review of an order denying remand to the state court,

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<sup>8</sup> See *Tanoh v. Dow Chemical Co.*, 561 F.3d 945 (9th Cir. 2009). The court affirmed the remand to state court of seven actions, each naming fewer than 100 plaintiffs, that similarly alleged exposure to toxic chemicals (manufactured by defendant) while working on banana and pineapple plantations on the Ivory Coast, strictly construing CAFA's mass action language.

it expands the notion of situational federal jurisdiction by providing discretionary interlocutory review of a remand order, if the petition is filed within seven days after entry of the order.<sup>9</sup> There were early concerns that the filing of the petition – not the grant of review, or the filing of briefs – appeared to start a new 60-day period for decision. This narrow appellate window has consequences. If the court of appeals is untimely, “the appeal shall be denied.” This reading was rejected by the Second Circuit in *DiTolla v. Doral Dental IPA of N.Y.*, 469 F.3d 271, 272 (2nd Cir. 2006).<sup>10</sup>

28 U.S.C. § 1453(d) again recognizes exceptions for securities claims; claims relating to the internal affairs or governance of a corporation or other form of business enterprise; or a claim that relates to the rights, duties (including fiduciary duties), and obligations relating to or created by or pursuant to any security.

### ***“Consumer Class Action Bill of Rights”: New Class Action Coupon Settlement Rules***

Section 3 of CAFA entitled, “Consumer Class Action Bill of Rights” adds a new chapter of statutes on class actions to Title 28 of the United States Code. 28 U.S.C. § 1711 broadly defines basic class action terms, new Section 1712 closely controls attorney fee availability in coupon settlements, and § 1715 requires broad governmental notice of proposed settlements.

The statute uses the term “coupon” in its ordinary sense (although the term is not defined) and includes substantive new limits on attorney fee calculations in coupon settlements. The courts are encouraged, upon motion by any party, to receive expert testimony of actual value of the coupons actually redeemed. This section also explicitly empowers the Court to make cy pres distributions, to charitable or governmental organizations of remainder funds, none of which may be factored into attorney fee calculations. In Section 1712(b)(2), Congress expressly recognizes multipliers on lodestars as a means of providing a reasonable attorney’s fee.

### ***Settlement Rules Requiring Notification to Appropriate Federal and State Officials***

In another major change, new 28 U.S.C. § 1715 requires notifications to appropriate Federal and State officials of any settlement of a class action. The “appropriate Federal official” means the Attorney General of the United States; or in any case involving depository institutions, the person with primary regulatory or supervisory responsibility. The “appropriate State official” means the person in the State with “primary regulatory or supervisory responsibility with respect to the defendant, or who licenses or otherwise authorizes the defendant to conduct business in the State...”

Not later than 10 days after a proposed settlement of a class action is filed in court, each defendant participating in the proposed settlement shall serve upon the appropriate Federal and State official – for each State in which class members reside – a notice of the proposed settlement consisting of the complaint; hearing notices; class notices; judgment and even, if feasible, “the names of class members who reside in each State and the estimated proportionate share of the claims of such members to the entire settlement to

<sup>9</sup> Fed. R. Civ. P. 6(a) may apply to this time period, excluding intermediate weekdays and holidays, but the safest course until this provision is definitively construed is to file the petition within seven calendar days.

<sup>10</sup> The *DiTolla* court addressed this issue “*nostra sponte*,” 469 F.3d at 274, and decided “...under the provision of CAFA requiring courts of appeals to ‘complete all action’ on appeals ‘not later than 60 days after the date on which such appeal was filed...’ 28 U.S.C. § 1453(c)(2), we are not required to deny the appeal despite the fact that it was docketed more than 60 days prior to the time that a panel of this Court granted the petition to allow it.” *Id.* At 272.

that State's appropriate State official; or if not feasible, a reasonable estimate of the number of class members residing in each State and the estimated proportionate share of the claims of such members to the entire settlement."

The "10 days after a proposed settlement of a class action is filed in court" is clear language, but has caused some confusion, as it does not mesh precisely with standard practices in initiating the Rule 23(e) judicial approval process in class action settlements. This process starts with "preliminary approval," which may be sought informally, with the documentation of the proposed settlement submitted to, but not filed in, the Court. Under this procedure, the first settlement-related document filed in court may be the Order granting preliminary approval, which typically attaches the settlement agreement and forms of class notice.<sup>11</sup> Settlement proponents have learned to assure CAFA compliance by sending the available documentation – even if preliminary approval has not yet been granted – to attorneys general within ten days of the first filing of a settlement-related document in court.

Defendants bear the burden of complying with CAFA's government notification provisions. Defendants are required to identify the appropriate officials, gather the necessary papers and other information, determine the residence of class members, perform state-by-state calculations of the relief for class members, and make (duplicative) reports to the officials. Defendants also suffer the penalty for any mistakes in providing such notice: "opt outs" by any or all class members long after the time for normal "opt outs" has expired. Section 1712(e) does not impose any outer time limit on such "opt outs," and does not expressly require the class member "opting out" to return the member's share of the settlement proceeds.

The required calculations by Section 1714(b)(7)(A) or (B) may be difficult to perform in advance of the filing of proof-of-claim forms. Mailed notices to class members are frequently returned undelivered, and their current addresses then must be researched and identified.

Section 1714(b)(5) requires that all contemporaneous side agreements between class counsel and defense counsel be included in the notice. Section 1714(d) delays the grant of final approval until 90 days after the required notices have been given.

Section 1714 does not state what the notified officials are to do with this information. It creates no express statutory right of standing, objection, or intervention, but governmental officials will undoubtedly feel entitled and/or obligated to act or speak up, and may in some cases wield substantial influence on class settlements and proceedings.

As a practical matter, several strategies have already emerged from notice experts working to comply with CAFA's Attorney General/Regulator notice requirements. Todd B. Hilsee and Shannon R. Wheatman PhD, President and Notice Director respectively of Hilsoft Notifications in Souderton, Pennsylvania, describes their approach as follows:

- As a general rule in large, nationwide or particularly significant class action settlements, all state Attorney Generals as well as the United States

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<sup>11</sup> What is often termed "preliminary approval" is more properly described as "preliminary fairness review," see *Manual for Complex Litigation, Fourth* (Federal Judicial Center 2004), § 21.632, and may occur informally in chambers, or in connection with a "first fairness hearing". For a comprehensive contemporary treatment of the procedures and standards for settlement-purposes class certification and approval of a proposed class action settlement under Rule 23(e), see *In re Hearland Payment Sys.*, 2012 U.S. Dist. LEXIS 37326 (S.D. Tex. 2012).

Attorney General can be sent notice packages. Otherwise, a settlement may face risks or challenges stemming from omission of notification of some states, a problem easy to avoid with nationwide notification.

- Defendants, who stand to lose res judicata effect with a failure to notify governmental officials, have the responsibility for determining which state regulators should receive notification.
- While seeking preliminary approval, Courts can be asked to “bless” or approve the CAFA notice issuance plan, to give the parties additional peace of mind.
- The required notice documents can all be burned onto CDs for each Attorney General and Regulator, which keeps production and distribution costs to a minimum and avoids burdening recipients with mountains of paper too vast to review. A concise cover letter accompanying the CDs can eloquently describe the notification purpose and contents and everything should be mailed registered mail, return receipt requested.

In addition to helping ensure satisfactory performance of the new governmental notification requirements, notice experts may also become helpful for providing evidence to courts on geographic and audience data to help courts resolve the “1/3 - 2/3” issues under removal provisions, particularly for classes where class member names and addresses are unavailable.

### ***Judicial Conference Study of, and Report on, Class Action Settlements***

CAFA Section 6 provides that within a year of CAFA’s enactment, the Judicial Conference of the United States, with the assistance of the Director of the Federal Judicial Center and the Director of the Administrative Office of the United States Courts, shall prepare and transmit to the Committees on the Judiciary of the Senate and the House of Representatives a report on class action settlements, with particular focus on best judicial practices regarding fairness to class members and appropriateness of fees given risks and results.

### ***Early Appearance of CAFA in Federal Decisions***

Other early decisions invoking CAFA include the following:

- *Holland v. Cole National Corp.*, 2005 U.S. Dist. LEXIS 9862 (W.D. Va. May 24, 2005). Amount in controversy diversity threshold not met under CAFA (plaintiff failed to allege that more than \$5 million was in controversy).
- *Lander & Berkowitz, PC v. Transfirst Health Services*, 2005 U.S. Dist. LEXIS 9604 (E.D. Mo. May 19, 2005). Remand to state court granted. Court found that the date of enactment of CAFA (February 18, 2005, the day it was signed into law by the President, not passage on February 17, 2005) governs its application. Case filed in state court on February 17, 2005 was not therefore subject to CAFA jurisdictional expansion.



- In *re Lupron Marketing and Sales Practices Litigation* (MDL No. 1430), 2005 U.S. Dist. LEXIS 9027 (D. Mass. May 12, 2005). Dictum in the context of court approval of federal MDL class action settlement: “The Act essentially consolidates all class actions with multi-state constituencies in the federal courts.” *Id.* at \*13.
- *Fears v. Wilhelmina Model Agency, Inc.*, 2005 U.S. Dist. LEXIS 7961 (S.D.N.Y. May 5, 2005). CAFA invoked in context of attorney fee application to “provide clarity into congressional intent with respect to the way in which attorneys’ fee should be awarded in class actions, and that insight is that attorneys’ fees in class actions are to be crafted so as to be related to the claims filed.” *Id.* at \*\*31-32.

*Holland v. Cole National Corp.* is noteworthy because it involved plaintiffs who sought to retain, rather than escape, federal jurisdiction over their consumer fraud claims. *Holland* involved a proposed plaintiff consumer class alleging fraud in connection with purported 50% off sales of prescription eyeglasses. Much of the *Holland* decision is taken up with a substantive analysis, and ultimate dismissal, of plaintiffs’ civil RICO claims. In short, the court found that, although plaintiffs’ claims that they were unwittingly induced into buying a \$35 extended warranty and lens care kit, which in turn rendered the total purchase price of the eyeglasses to be greater than the “50% Off” promotion promised, may have constituted consumer fraud, but “otherwise is a square peg in RICO’s round statutory hole. Holland’s hidden charge claim . . . is not of the criminal dimension and degree necessary to invoke RICO’s stark remedies.” 2005 U.S. Dist. LEXIS 9862, \*2. Once dismissal of the RICO claims was established, the remaining counts failed as well. Plaintiff did not meet the threshold jurisdictional requirement for bringing a Magnusson-Moss Warranty Act claim in federal court, nor did it appear from the complaint that the amount in controversy had “the potential of exceeding \$75,000.00.” *Id.* at \*3-5. The *Holland* case was filed prior to CAFA’s enactment date, and was therefore governed by the “old” provisions of § 1332. Nonetheless, the *Holland* court took note of CAFA, observing that, under CAFA’s expanded jurisdictional provision, “diversity of citizenship exists.” *Id.* at 43. Named plaintiffs listed in the complaint included residents of Virginia, Texas, and Georgia. The defendants were Delaware corporations with their principal places of business in Ohio. *Id.*

However, plaintiffs flunked the amount in controversy threshold for federal diversity jurisdiction under both the old and new provisions of § 1332. “Although *Holland* meets the diversity requirements contained in the Act, it does not provide a basis for subject matter jurisdiction because *Holland* has failed to allege that more than \$5 million is in controversy.” As the *Holland* court noted, while CAFA “expands the subject matter jurisdiction to federal courts over class actions in which at least one plaintiff class member is diverse in citizenship from defendant and where the amount in controversy exceeds \$5 million . . . .” *Id.* at \*45-46, “although *Holland*’s allegations meet the requirement of diversity of citizenship, plaintiff fails to allege that more than \$5 million is in controversy regarding her common law fraud claims.” *Id.* at \*46. The *Holland* plaintiffs indeed alleged that there were “many thousands of class members located throughout the United States,” and that defendants generated revenues of “more than \$50 million per fiscal year through the sale of extended warranties. . . .” *Id.* However, the named plaintiff “fails to allege that she, or other members of her putative class, have injuries resulting from defendant’s fraud totaling more than \$5 million. Neither the amount of revenue nor the recitation of the possibility of ‘many thousands’ of plaintiffs is enough to meet the jurisdictional amount.”

*Id.* As the *Holland* court concluded “as the sum claimed by plaintiff in her complaint determines the jurisdictional amount, and plaintiff has not alleged enough damages to meet the standards included in the recent amendments to 28 U.S.C. § 1332(d), plaintiff cannot subject matter jurisdiction under it.” *Id.*

Accordingly, the United States Magistrate Judge writing in *Holland* concluded and recommended that the complaint be dismissed. *Holland* is thus an early and ironic example of plaintiffs who wished to bring and keep their claims in federal court, rebuffed for failure to plead jurisdiction, even under CAFA’s greatly expanded federal jurisdictional opportunities.

The issue in *Lander and Berkowitz, P.C. v. Transfirst Healthservices, Inc.*, was the CAFA “gate” issue: Was CAFA’s enactment date February 17, 2005, when the Act was passed by Congress, or was it February 18, 2005, when the President signed the Act into law? The issue is critical, because CAFA’s Section 9 states that amendments made by the Act apply to any civil action commenced on or after the date of enactment of the Act. Defendant Transfirst Healthservices argued that it was Congress that enacted a law, not the President. Plaintiffs’ response: Enactment is the process of making an act into a law, which can occur only when the President signs an act into law, or when Congress enacts a law over a Presidential veto. The *Lander* court, in a succinct opinion, held that “the date of enactment of the Act is February 18, 2005, the day when it was signed into law by the President.” 2005 U.S. Dist. LEXIS 9604 at \*2. The *Lander* court cited the Tenth Circuit’s *Pritchett* decision in support, not surprisingly, but also added, to its otherwise terse and businesslike decision, the following musical authority:

Although it is certainly not binding precedent, the parties may recall a popular episode of the television series “Schoolhouse Rock” titled I’m Just a Bill. In that episode, Bill sang, “I’m just a bill/Yes, I’m only a bill/And if they vote for me on Capitol Hill/Well, then I’m off to the White House/Where I’ll wait in a line/With a lot of other bills/For the president to sign/And if he signs me, then I’ll be a law/How I hope and pray that he will/But today I am still just a bill.” (Emphasis added.) 2005 U.S. Dist. LEXIS 9604, \*2, n. 1.

The *Lupron* decision was a thorough analysis of a proposed class action settlement in a prescription drug retail price inflation action. The *Lupron* decision’s single reference to CAFA is nonetheless important, although it appears in a footnote. The *Lupron* litigation was apparently enlivened by strategic multi-jurisdictional filings, and a resulting competition between plaintiffs’ counsel electing, respectively, to pursue their clients’ claims in state versus federal court. State/federal competition has been a recurring challenge to our dual court system in complex antitrust, consumer, and mass tort litigation, since these cases frequently involve primarily or solely state law-based claims, federal jurisdiction (at least in the non-antitrust consumer, and personal injury contexts) is diversity jurisdiction, and state courts are sometimes seen as more favorable fora within which plaintiffs may proceed to trial more quickly, and with perhaps more favorable results. Such a complication was apparently a feature of the *Lupron* case, and was remarked upon by the court in response to mutual critiques by federal and state court attorneys of each others’ performance and bona fides. As the *Lupron* court remarked:

Bringing an end to unseemly attempts to exact advantage over class action defendants or lawyers representing competing plaintiffs’ claims by exploiting the potential for conflict inherent in a federal system of

coordinate sovereigns was a principal argument advanced by advocates of the Class Action Fairness Act of 2005. The Act essentially consolidates all class actions with multi-state constituencies in the federal courts. 2005 U.S. Dist. LEXIS 9027, \*2, n. 10.

The decision in *Fears v. Wilhelmina Model Agency* also involved judicial approval of a class action settlement, and an attorneys' fees and costs application, in an action brought on behalf of a class of fashion models against their agencies, to resolve a price-fixing scheme. In evaluating the fee request, the court invoked CAFA as the new fashion in attorneys' fees principles, specifically, the provision of CAFA (which itself did not apply to the *Fears* case, which was commenced prior to its enactment) to limit the attorneys' fees to a reasonable percentage of the amount of the settlement actually claimed by class members. In referring to CAFA, the court incorporated the Congressional intent by the bill into its attorneys' fees gestalt, specifically citing to the Congressional Record:

Congressional intent is also pretty clear in the more recent Class Action Fairness Act ("CAFA"). See Class Action Fairness Act of 2005, Pub. L. 109-2 (Feb. 18, 2005). There, the language used urges the calculation of attorneys' fees based on a percentage of the class claims. The legislation evidenced congressional desire to reform the tort system and limit exorbitant attorneys' fees. Congressional action was unequivocal; it expanded federal diversity jurisdiction, addressed unfair class settlements, inflated attorneys' fees, and state court class action abuses:

Class actions were originally created to efficiently address a large number of similar claims by people suffering small harms. Today they are too often used to efficiently transfer the large fees to a small number of trial lawyers, with little benefit to the plaintiffs.

151 Cong. Rec. H723, H725 (2005) (statement of Rep. Sensenbrenner (Rep.-R.), Chair., H.R. Comm. on the Jud.). Members of both political parties shared this sentiment. See 151 Cong. Rec. H723, H727 (2005) (statement of Rep. Boucher (Rep.-D.), H.R. Comm. on the Jud.). Consequently an award of attorneys' fees in excess of the claims made by the class could contradict the clear public policy of awarding settlement funds to claimants and not attorneys. 2005 U.S. Dist. LEXIS 7961, \*\*15-16.

The *Fears* total common fund was nearly \$22 million, but the claims total was less than half that, approximately \$9.34 million. 2005 U.S. Dist. LEXIS 7961, \*15. The court, taking its cue from CAFA and other recent attorneys' fee awards decisions (see 2005 U.S. Dist. LEXIS 7961 at \*\*30-31) decided to utilize the smaller, claims made number, in setting an attorneys' fee award of 40%. Mathematically, that award approximated 17% of the total common benefit. And the court's CAFA-derived rationale is clearly stated:

As already discussed . . . public policy is easily constructed from an analysis of the PSLRA and the Class Action Fairness Act of 2005, along with much case law. Taken together, they provide clarity into congressional intent with respect to the way in which attorneys' fees should be awarded in class actions, and that insight is that attorneys' fees in class actions are to be crafted so as to be related to the claims filed. It is in this fashion that I have awarded attorneys' fees and believe it to be fair to all concerned. *Id.* at \*\*31-32.

We thus see CAFA's early impact upon the federal judiciary: A not-unexpected mix of skepticism and support. The early flurry of litigation over the enactment date issue has come to pass as predicted, and that issue, courtesy of the Tenth Circuit, is now settled. The impact of CAFA on moderating attorneys' fees also displays early adherents. Also noteworthy is the *Holland* example of plaintiffs who will attempt to utilize CAFA, supposedly an anti-plaintiff initiative, to facilitate the prosecution of state law-based claims in the federal fora of their choosing.

In *In re Relafen Antitrust Litigation*, 2005 U.S. Dist. LEXIS 21630 (D. Mass. 9/28/05), Judge Young observed, in the context of a lengthy decision granting approval to application for a \$75 million nationwide class action settlement and attorneys' fees in a litigation involving brand name prescription price manipulation, the impact of CAFA on the traditionally dual-jurisdictional nature of antitrust litigation. The federal antitrust statutes enable "direct purchasers" (e.g., wholesalers) to sue under federal anti-competition and price fixing statutes. "Indirect purchasers," e.g., consumers, have been relegated to the state courts. CAFA changes this landscape. As Judge Young observed: "The effect of this recent legislation, however, may not be quite what the drafters intended [causing] antitrust cases to...flood back into the federal court..." 2005 U.S. Dist. Lexis 21530 at \*101, n.25.

### *Exodus and Prophecies*

Early analysis of available state and federal data by Public Citizen<sup>12</sup> indicated, in light of CAFA, that much the time-consuming and complex class action work now spread nationwide over 9,200 state trial judges would slowly shift to 678 sitting federal trial judges. In California alone, class action cases formerly spread over 1,498 California trial judges were projected to slowly shift to the 62 federal trial judges in California. More recent attempts to quantify the class action shift to federal courts confirm the view that the federal courts are where the class action action is.<sup>13</sup>

The optimistic view of CAFA was that it could lead to new levels of cooperation and discourse among federal and state governmental authorities and state courts. The governmental notification provisions give the United States and affected states, which in many cases may include most or all states, unprecedented opportunities to speak up and work to improve class action settlements. Similarly, it was suggested that, as federal courts increasingly became arbiters of the state substantive laws which apply to most consumer class actions, they would ask and rely upon state judges to serve as a special masters in the federal class actions, pursuant to Federal Rule of Civil Procedure 53, overseeing pre-trial issues, particularly those dependant on understanding and development of substantive state consumer and tort law. This author went so far as to express the hope, in an early CAFA article written for the Canadian bar, that "perhaps the best of the broad and rich state statutory and jurisprudential law of consumer protection and fair business practice that has been developed by State legislatures and courts will be adopted in an emerging federal common law of consumer protection." Cabraser, Vincent & doAmaral, "The Class action Fairness Act of 2005: The Federalization of U.S. Class Action Litigation" (2005). Much of the text of this section is adapted from that article.

12 National Center for State Courts, State Court Caseload Statistics 2003, State Court Structure Charts. 2003 Judicial Business, Annual Report of the Director of the Administrative Office of the U.S. Courts, Table X-1A.

13 See, e.g., Howard M. Erichson, *CAFA's Impact on Class Action Lawyers*, 156 U. Pa. L. Rev. 1593, 1610 (2008) ("CAFA has increased not only the number of class action removals to federal court, but also the number of class action original filings in federal court; Emery G. Lee III & Thomas E. Willging, *The Impact of the Class Action Fairness Act on the Federal Courts: An Empirical Analysis of Filings and Removals*, 156 U. Pa. L. Rev. 1723, 1754 (2008) (analysis of class actions in federal courts "provides support for the conclusion that the federal courts have seen an increase in diversity removals and, especially, original proceedings in the post-CAFA period as a result of the expansion of the federal courts' diversity of citizenship jurisdiction"); BNA Class Action Litig. Rep. Feb. 24, 2012, at 225 (after CAFA's enactment, "[C]onsumer class action filings increased 577% in the district courts in the Ninth Circuit!").

Other optimistic predictions were that CAFA would largely amplify existing jurisprudential trends. Meritorious class action consumer and business tort claims would continue to be certified in the federal courts for litigation and settlement purposes, though increased scrutiny of class actions would likely have a culling effect, particularly upon claims at the margin. The point was made that, historically, federal and state courts have been equally likely – or unlikely – to certify litigation classes, only one in four of which is certified:

Our data, however, lend little support to the view that state and federal courts differ greatly in how they resolve class actions. For example, state and federal courts were equally unlikely to certify cases filed as class actions. Both state and federal courts certified classes in fewer than one in four cases filed as class actions. Although state courts approved settlements awarding more money to the class than did federal courts, that difference was a product of the size of the class; individual class members on average were awarded more from settlements in federal courts than in state courts.

*An Empirical Examination of Attorneys' Choice of Forum in Class Action Litigation*, by Thomas E. Willging and Shannon R. Wheatman, Federal Judicial Center 2005; pp. 4-5.

The author spoke with (now subdued) anticipation that: “Those who look to the litigation process to enforce and protect consumers’ rights to safe products, fair pricing, and honest business practices can only hope that the federal courts will respond with major new class action rulings and solutions required to federally adjudicate significant, nationwide consumer harms and both inter- and intra-state business torts formerly handled in the states’ court systems.” Supreme Court decisions on points of law under other rules and statutes – Rule 23 in *Dukes*<sup>14</sup> and the Federal Arbitration Act in *Concepcion*<sup>15</sup> – not directly linked to CAFA have temporarily dampened such hopes.

Yet the challenge of CAFA, embodied in its express purposes, remains: to federalize class actions not to eliminate them, but to utilize them as national vehicles to vindicate national rights and interests held by the makers, marketers, and users, of the goods and services that constitute our national economy. The dual goals of CAFA: to protect and promote competition and innovation by makers, and to preserve consumers’ active roles in protecting themselves and each other to ensure the resulting services and products are honest and safe (by prompt adjudication of legitimate claims), are meant to be reconciled, not nullified, by CAFA. Those who declare, in victory or defeat, that CAFA was a decisive partisan battle that corporations won and consumers lost, must be proven wrong. Lawmaking can be a fraught and partisan process, but one side’s bill, when enacted, becomes a law for all the people.

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14 *Wal-Mart Stores, Inc. v. Dukes*, \_\_\_ U.S. \_\_\_, 131 S. Ct. 2541 (2011).

15 *AT&T Mobility LLC v. Concepcion*, \_\_\_, U.S. \_\_\_, 131 S. Ct. 1740 (2011).

### III. RECONCILING LEGISLATED INTENT, EXPRESS STATUTORY PURPOSE, AND FEDERAL RULES PRINCIPLES

As *Tanoh v. Dow Chemical Co.*, 561 F.3d 945, 952 (9th Circuit 2009), observed,

Congress enacted CAFA in 2005 to “assure fair and prompt recoveries for class members with legitimate claims; [2] restore the intent of the framers . . . by providing for Federal court consideration of interstate cases of national importance under diversity jurisdiction; and [2] benefit society by encouraging innovation and lowering consumer prices.”

CAFA § 2,119 stat. at 5.

Other appellate courts have similarly noted these express statutory aims.<sup>16</sup>

The enactment of CAFA has sometimes been perceived, by plaintiffs’ advocates, as a victory for defendants because it moves the class action playing field to a venue that both plaintiffs and defendants frequently (mis)perceive as inherently tilted against plaintiffs. Thus, the transfer of a case to federal court may be misapprehended, by both sides, as a defendant’s victory. The federal courts have disabused litigants of this notion, and of the corollary that Congress, in enacting CAFA, has somehow conferred upon defendants a right to favorable (anti-class) treatment that operates upon removal to federal court.

As the Eighth Circuit tartly noted in *Plubell v. Merck*, 434 F.3d at 1073, in remanding a Missouri statewide consumer class action, brought to assert Missouri’s statutory consumer fraud claims:

Merck claims that it is prejudiced because CAFA confers a right to be in federal court. However, nothing in CAFA grants such a right. According to CAFA, its purposes are to: “(1) assure fair and prompt recoveries for class members with legitimate claims; (2) restore the intent of the framers of the United States Constitution by providing for Federal court jurisdiction of interstate cases of national importance under diversity jurisdiction; and (3) benefit society by encouraging innovation and lowering consumer prices.” . . . The first purpose relates only to plaintiffs, while the second and third purposes speak to society-at-large’s benefits, not to defendants’. While some defendants may benefit by having their cases in federal instead of state court, this is not a stated purpose of the Act.

This principle bears repeating, because internalizing it enables litigants and courts to maintain a correct and balanced view of the statute and its goals, and, more importantly, to act accordingly: The express statutory purpose of CAFA is not to benefit defendants per se. It is to enable litigation to reflect the contemporary economic and social realities of the nationwide marketing, promotion and sale of goods and services, to speed recoveries by

<sup>16</sup> “Section 2(b) of CAFA states that ‘[t]he purposes of this Act are to (1) assure fair and prompt recoveries for class members with legitimate claims; (2) restore the intent of the framers of the United States Constitution by providing for federal court consideration of interstate cases of national importance under diversity jurisdiction; and (3) benefits society by encouraging innovation and lowering consumer prices.’ 28 U.S.C. § 1711 note.” *Morgan v. Gay*, 471 F.3d 469, 473 (3rd Circuit 2006); accord, *Miedema v. Maytag Corp.*, 450 F.3d 1322, 1330 (11th Circuit 2006). *Plubell v. Merck & Co.*, 434 F.3d 1070, 1073 (8th Circuit 2006).

those with legitimate claims arising from wrongdoing or defect in such goods and services, and to benefit society-at-large in the process. CAFA's stated purposes harmonize to a remarkable degree, with the overarching principles of the federal rules, as laid down in Fed. R. Civ. P. 1. These purposes also recognize the underlying truth of our free market system, founded on our social contract: Everyone benefits from the innovation and lower prices the proper operation of our free market system is intended and expected to deliver, and federal court management and adjudication of the "interstate cases of national importance" that arise when freely marketed products and services are alleged to cause injury or damage best promotes the shared societal interest in better, newer, safer, and more honestly marketed products and services, at lower prices. It recognizes that producers and consumers are not natural enemies, struggling in the Hobbesian stateless wilderness of each against all.

#### IV. NECESSITY AS THE MOTHER OF A CHOICE OF LAW REVIVAL

As technology advances, and corporate ability to mass-produce and distribute products nationally increases, the legal framework of state laws governing these companies is becoming increasingly obsolete and inadequate, in the absence of the predictable power to apply them nationwide through the predictable operation of choice-of-law rules. Corporations are creatures of state law, but now operate far beyond the provincial bounds our framers could have envisioned for them. As a practical matter, in the absence of a substantive federal law to regulate corporate marketing behavior, and given the reluctance of courts to apply an appropriate state's law to the nationwide harm a product defect or dishonest marketing has inflicted, major corporations may now effectively operate both beyond the reach of the states historically charged with regulating them, in a free zone devoid of systematic federal regulation.

CAFA brings such suits into federal court, to promote a nationwide solution, but provides no ready-made substantive legal framework. CAFA is a procedural statute, but lacks what would seem to be an elementary procedural predicate: a standard choice-of-law doctrine. "Because most products are mass produced and mass distributed, without any clear sense of where in the national market they might end up, the need for federal uniformity would seem especially pressing."<sup>17</sup> The question of choice of law inevitably arises when these products prove defective across multiple states. The basic choices have been to choose one state's law to apply to the entire class, or, in the alternative, to apply the laws of every state with an interest in the litigation. The former approach has the *imprimatur* of the United States Supreme Court as a Constitutionally permissible solution.<sup>18</sup>

In *Phillips Petroleum Co. v. Shutts*, the Supreme Court defined the constitutional minimum choice-of-law analysis that must be conducted before a court may apply the law of its own forum state (or that of any other single state) to a nationwide class: the presence of "a significant contact or significant aggregation of contacts, creating state interests, such that choice of its law is neither arbitrary nor fundamentally unfair."<sup>19</sup> In essence, the *Shutts* rule provides that the choice of a default law – that is, a forum's own law – is constitutionally acceptable so long as it meets its minimum contacts test. Notwithstanding permission from our highest court, in the nationwide class action context, federal courts have been reluctant to take advantage of the *Shutts* rule, and have frequently denied class certification, as inherently unmanageable, upon recognizing that multiple states might have

17 Samuel Issacharoff and Catherine M. Sharkey, "Backdoor Federalization," 53 UCLA L. Rev. 1353, 1385 (2006). Instead of designing different products according to the laws of the destination state, manufacturers tend to design uniform products that conform to the laws of the state with the most stringent requirements. *Id.*

18 *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797 (1985).

19 472 U.S. at 818.

an interest in the controversy. This identification of multiple interests is, of course, only the first step in a multi-phase choice of law analysis, but many courts have been reluctant to go farther. Prior to CAFA's enactment, this reluctance made some sense: The state court system was always available to entertain statewide class actions, and state courts were, presumably, both more familiar and more comfortable with their own native laws. The high-water marks of this dispersive attitude was the Seventh Circuit's decision in *In re Bridgestone/Firestone*.<sup>20</sup> In *Bridgestone/Firestone*, the Seventh Circuit condemned nationwide classes as excrescences of "central planning," and declared what was interpreted as a one-law, one-class rule, "no class action is proper unless all litigants are governed by the same legal rules. Otherwise the class cannot satisfy the commonality and superiority requirements of [Rule] 23(a), (b)(3)."<sup>21</sup> The alternative preferred by the Seventh Circuit in *Bridgestone/Firestone* was a series of decentralized, single-state classes (or individual cases), through which the litigation would eventually mature, as a process of multiple trials in multiple places gradually revealed the merits and value of the case.

One would think that CAFA spelled the end of the *Bridgestone/Firestone* regime: it was designed to eliminate the proliferation of statewide or nationwide classes in the state courts themselves. But CAFA lacked a uniform choice-of-law provision that would have armed the federal courts in choosing an appropriate state law to govern the new cases before them.<sup>22</sup> One solution would have been to articulate the *Phillips Petroleum v. Shutts* Constitutional choice-of-law standard in the CAFA statute itself.<sup>23</sup> A more specific amendment was actually proposed as an amendment to CAFA, by Senators Dianne Feinstein and Jeff Bingaman. They proposed an amendment to CAFA that attempted to resolve the conflict-of-law problem, which "if left uncorrected, could leave many properly filed multistate consumer class actions without a forum."<sup>24</sup> The amendment would have given courts two options: (1) to apply the substantive law of one state to all class members; or (2) to make a concerted effort to utilize subclasses.<sup>25</sup> By providing federal judges with this framework, the proposed amendment would have provided a feasible alternative to the denial of class certification altogether in the mere presence of complex choice-of-law issues. This amendment, and many others fell victim to the CAFA "no amendment" rule. CAFA became law without a choice-of-law provision.

Not all courts have avoided the responsibility to make a principled and complete choice-of-law analysis in the context of considering the certification of a nationwide class proceeding under state law. The complexity of the choice-of-law analysis, however, is most complex where it is most needed, and frequently called for: in multidistrict litigation. The Judicial Panel sends cases to a single forum to facilitate the consistency determination of class issues. In doing so, however, it places transferee courts in the position of conducting not one, but two layered choice-of-law analyses.

It is a matter of long-settled law that a federal court hearing a case solely on diversity must apply the choice-of-law rule of the state in which it sits.<sup>26</sup> So far, so good. However, when multiple cases are transferred from district courts in multiple states to a single MDL transferee court, that court must frequently consider not only the choice-of-law

20 *In re Bridgestone/Firestone, Inc.*, 288 F.3d 1012 (7th Cir. 2002).

21 288 F.3d at 1015.

22 Timothy Kerr "Cleaning Up One Mess To Create Another: Duplicative Class Actions, Federal Courts' Injunctive Power, and the Class Action Fairness Act of 2005," 29 Hamline L. Rev. 218, 223 (2006).

23 See Elizabeth J. Cabraser "The Manageable Nationwide Class: A Choice-of-Law Legacy of *Phillips Petroleum Co. v. Shutts*," 74 U.N.K.C.L. Rev. 543 (2006).

24 151 Cong. Rec. S1157-02, S1167 (Daily ed. Feb. 9, 2005) (Statement of Sen. Bingaman).

25 *Id.* at 1166.

26 *Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487, 496 (1941).



rule of the state in which it is situated, but the choice-of-law rules of the transferor courts' forum states, as well. Frequently, these choice-of-law rules themselves differ. The exercise of conducting and completing a choice-of-law analysis in such circumstances is possible, and has been accomplished, but is demanding and results in such extended decisions as *In re Mercedes-Benz Tele Aid Contract Litigation* (MDL No. 1914), 267 F.R.D. 46 (D.N.J. 2009) (choice-of-law analysis and resulting nationwide class certification under New Jersey law); 267 F.R.D. 113 (D.N.J. 2010) (motion for decertification denied).

In the *Mercedes-Benz* litigation, the MDL transferee court was required to apply the choice-of-law rules of six different states, in managing a motion for class certification that would have affected the ten separate actions transferred to it. The court thus was required to attain and apply a familiarity not only with New Jersey's choice-of-law doctrine, but those of California, Illinois, Missouri, New Jersey, New York and Washington.<sup>27</sup> Four of these states followed the "most significant relationship" test laid out in the Restatement (Second) of Conflicts of Laws. California had a somewhat different test.

Arguably, prior to CAFA, the *Mercedes-Benz* transferee court may have been tempted to do what other MDL courts did in pre-CAFA days: stop the process at the point at which it realized that multiple states' choice-of-law doctrines, or at least multiple states' interests in seeing their respective laws applied – would be involved in the analysis.<sup>28</sup>

That the *Mercedes-Benz* court did not shrink from this task, particularly when faced with serial attacks on class certification opposition, a 23(f) appellate petition, and multiple motions for decertification, is to its credit. However, this does not change the fact that this task was far more difficult, or at least tedious, than it should be. There should be some mechanism, by statute or rule, that could assist courts in making the choice that the Constitution permits them to do: to select a law or laws to govern multistate or nationwide disputes so as to decide common questions of fact in a consistent, non-repetitive and conclusive manner.

Choice-of-law is a perennial least-favorite law school subject, and one that engenders confusion, resistance, and resentment among practitioners and jurists alike. In the absence of a federal substantive law of consumer fraud or product liability, the choice from among multiple states' laws cannot be avoided. It is certainly not avoided in non-class disputes which come before the federal courts on the basis of diversity. To avoid the exercise because an action is a class action rather than an individual case suggests that the procedural, and perhaps the substantive, rights of the parties are being abridged because of a choice or an effort by one side to proceed under a particular Federal Rule. There is thus, on the part of courts, a necessity to grapple with the choice-of-law labyrinth that exists under the present law, and to develop, by virtue of increased experience in conducting choice-of-law analyses, a dependable jurisprudence of choice-of-law in the nationwide state-law-based class action context. The *Mercedes-Benz* decisions of Judge Debevoise are one example, but more are needed.

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<sup>27</sup> 267 F.R.D. at 119.

<sup>28</sup> See e.g., *In re Propulsid*.

## V. CAFA AND *ERIE*: THE CHALLENGE OF PRESERVING STATE SUBSTANTIVE LAW IN THE FEDERAL REALM

Cases over which the federal courts have diversity jurisdiction have engendered a long established culture of deference by federal courts to state substantive law. The federal common law is constrained by reference to federal statutes. Federal courts are not free to alter or enhance the state statutory and common law that governs the state law claims that come before them. State substantive law is intended to govern state claims in federal courtrooms. *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938).

This is frequently a difficult task. The development of the common law is an ongoing process, and is not equally advanced or detailed in every substantive area in every state. Federal courts are thus often called upon to make an “*Erie* guess” – to discern how the highest court of a state would rule on a matter it has not yet decided. An *Erie* guess cannot be a wild guess, nor do federal courts have an unfettered license to create. “When making an *Erie* guess, our task is to attempt to predict state law, not to create or modify it.” *SMI Owen Steel Co. v. Marsh USA, Inc.*, 520 F.3d 432, 445 (5th Cir. 2008).<sup>29</sup>

Federal courts frequently confront a gap in the substantive state law – or at least the absence of a definitive articulation of a specific legal point by a state’s highest court. They have accordingly developed a hierarchy of deference, but with built in discretion. Federal courts “defer to intermediate state appellate court decisions unless convinced by other persuasive data that the highest court of the state would decide otherwise.” *First Nat’l Bank of Durant v. Trans Terra Corp.*, 142 F.3d 802, 809 (5th Cir. 1998).

Prior to the enactment of CAFA, federal courts often voiced reluctance to certify classes that were dependent on state law, on grounds of *Erie* deference – or at least concern over making an *Erie* guess with broad ramifications – explicitly leaving to state courts responsibility for both the class certification decisions, and the articulation of the appropriate substantive law. A prominent example of this stance is the Fifth Circuit’s decision reversing nationwide class certification in *Castano v. American Tobacco Co.*, 84 F.3d 734 (5th Cir. 1996). Among the array of reasons articulated by the *Castano* court for its rejection of the class are the following “manageability problems” invoked to defeat Rule 23(b)(3) certification:

[D]ifficult choice of law determinations, subclassing of eight claims with variations in state law, *Erie* guesses, notice to millions of class members, further subclassing to take account of transient plaintiffs . . . .<sup>30</sup>

The *Castano* court’s deference to state substantive law extended to an express prescription for the maturation of the mass tort claims: utilization of the decentralized state court system for multiple adjudications (and perhaps statewide classes), a theme consistent with the decentralized preference expressed by the Seventh Circuit in *Bridgestone/Firestone* and *Rhone-Poulenc*.<sup>31</sup>

Through individual adjudication, the plaintiffs can winnow their claims to the strongest causes of action. The result will be an easier choice of

<sup>29</sup> This oft-cited formula was coined in *United Parcel Service, Inc. v. Weben Indus., Inc.*, 794 F.2d 1005, 1008 (5th Cir. 1986).

<sup>30</sup> 84 F.3d at 747.

<sup>31</sup> *In re Rhone-Poulenc Rorer*, 51 F.3d 1293 (7th Cir. 1995).

law inquiry and a less complicated predominance inquiry. State courts can address the more novel of the plaintiffs' claims, making the federal court's *Erie* guesses less complicated. It is far more desirable to allow state courts to apply and develop their own law than to have a federal court apply a kind of Esperanto [jury] instruction.<sup>32</sup>

The passage of CAFA largely extinguished the opportunity for state courts to do what *Castano* deemed more desirable: to develop their own law in the mass action/class action context. This opportunity is gone because the class action (and purported "mass action") cases are now in federal court – the very court that *cannot* innovate and extend the substantive law governing the claims themselves. The state courts, as laboratories of innovation, have been closed in the very cases most needful of such an approach.

Federal courts, long reluctant to make "difficult choice of law determinations" must now do so. Federal courts can no longer punt on "complicated" *Erie* guesses. These uncomfortable tasks can no longer be avoided, except by the expedient of simply denying class certification in every case that may involve multiple states' laws – the precise population of mass actions that CAFA redirects to federal courts for a national solution.

The challenge of fidelity to state substantive law will only become more difficult as time passes, as the state court systems that formerly developed substantive law in the context of the class actions they handled will no longer be doing so. Gaps will widen, and *Erie* guesses will have fewer appellate decisions, and few state jurisprudential data, to guide them.

CAFA has placed a two-layered task in the care of the federal courts:

1. To engage in difficult choice-of-law determinations and decide which state or states' laws will govern the substantive issues in the class actions that come before them, in order to decide whether to certify such classes, on which issues, and whether to cast them as statewide or nationwide classes; and
2. To faithfully apply the substantive law of the state whose law they have chosen.

In short, federal courts, post-CAFA, must do more and more of the state courts' most important and challenging work – the management of state law class and mass actions – with less and less guidance from state substantive law, which will have fewer and fewer opportunities to develop in the class action/complex litigation context.

## VI. THE MDL EFFECT

By some accounts, we are living in a post-class action world of aggregate litigation, a realm of Rule 23 alternatives: quasi-class actions, consolidations, aggregations and MDLs. It is a complex litigation landscape in which experimentation with anything but class actions appears to be case management fair game. There is some truth to this, at least from the practitioners' eye view, but it may be that we are litigating through a transitional period, as courts attempt to adjust to the new paradigm of state law cases in the federal courts, of

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32 84 F.3d at 750, quoting *Rhone-Poulenc*, 51 F.3d at 1300.

defendants' antipathy toward class certification (unless and until it is time to settle the case), and of uncertainty as to the appellate viability of classes certified for purposes of trial.

One thing is especially certain: More cases are coming into federal courts as components of "MDLs" (multidistrict litigation centralized in one federal district under 28 U.S.C. § 1407) than by any other means. Increasingly these MDLs are comprised of state law personal injury tort claims (not likely candidates for class treatment under current trends) and state law consumer claims (routine candidates for class treatment under many states' consumer fraud acts). The latter category of MDL aggregate, termed "Sales and Marketing Practices Litigation" in the nomenclature of the Judicial Panel on Multidistrict Litigation, makes up an increasing part of the Panel's docket. In the January 2012 MDL hearing docket, for example, 4 out of 17 total cases were "Sales and Marketing Practices" litigation. That is, the Panel transferred and centralized to a single federal forum multiple class actions asserting non-personal injury consumer fraud claims for economic loss, in which individual damages are usually small, and claims are brought under statutes designed to facilitate consumer redress and deter unfair business practices. There is no exact federal statutory corollary, although sometimes such claims intersect with federal Civil RICO claims, or even antitrust violations.

Despite the fairly recent use of the Rule 23 mechanism to resolve some large scale personal injury mass torts, such as the *Diet Drugs* litigation, which was certified, in part, for litigation purposes under Rule 23(b)(2)/(b)(3) and settlement under Rule 23(b)(3),<sup>33</sup> "The *Zyprexa* and *Ephedra* settlements, as well as the more recent *Guidant* and *Vioxx* settlements, suggest that the MDL process was supplemented and perhaps displaced by the class action device as a procedural mechanism for large settlements." Thomas E. Willging & Emery G. Lee III, "From Class Actions to Multidistrict Consolidations: Aggregate Mass Tort Litigation After *Ortiz*," 58 *U. Kan. L. Rev.* 775, 801 (2010). This is one aspect of the "MDL effect."

MDLs and class actions retain a symbiotic relationship in many complex litigation settings. MDL transfer does not itself vest a Transferee Court with trial jurisdiction over transferred cases; MDL centralization is limited by statute to pretrial proceedings. One such pretrial proceeding is the class certification process, and the Panel regularly invokes the need to "prevent inconsistent pretrial rulings on class certification" as a basis for transfer and centralization." (See, e.g., recent Transfer Orders on the Judicial Panel's website, [jpm1.uscourts.gov](http://jpm1.uscourts.gov), including March 7, 2012 Transfer Order in *In re: Colgate-Palmolive Softsoap Antibacterial Hand Soap Marketing and Sales Practices Litigation*, MDL No. 2320.) A court to whom "suits were transferred under MDL for pretrial management" may still dispose of all transferred cases via a comprehensive nationwide class action settlement of claims arising under many states' laws, eliminating the need for multiple transferor courts to deal with statewide class cases or individual suits. See *In re: Heartland Payment Systems, Inc. Consumer Data Security Breach Litigation (MDL No. 2046)*, 2012 U.S. Dist LEXIS 37326, \*30 (S.D. Tex 2012).

A more thorough exploration of class actions in MDL proceedings is beyond the purview of this article. For analyses of the options facing MDL courts in the class certification context, see John Beisner, "Class Action in MDL Proceedings: When is the Court's Job Done?" (The Sedona Conference® 2012). A recent (April 16, 2012) *Remand Order* by the Judicial Panel on Multidistrict Litigation in *In re Light Cigarettes Marketing*

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33 See *In re Diet Drugs Prods. Liab. Litig.*, 582 F.3d 524 (3d Cir. 2009) (for an account of the litigation and settlement of class claims).

and *Sales Practices Litigation* (MDL No. 2068) illustrates circumstances in which the MDL transferee court may not complete the class certification process in all the cases transferred to it, deferring to the transferor courts who will try such cases: when separate, non-overlapping, statewide classes (the type of cases most likely to stay in state courts prior to CAFA) are MDL components. In *Light Cigarettes*, the Court utilized a “bellwether” class certification process to rule on, and deny, class certification for four states. It appearing unlikely there would be bellwether classes certified or tried in the MDL, plaintiffs in four remaining statewide putative class actions moved for and obtained remand back to their respective transferor courts. See *In re Light Cigarette Marking and Sales Practices Litigation*, 2012 U.S. Dist. LEXIS 55458 (JPML 2012).

Whatever the fate of the individual mass tort actions or centralized class actions after they are transferred to a single federal judge for coordinated case management, the fact of MDL centralization has cast them as an aggregate. Hence the growing judicial recognition that, whether Rule 23 has ever expressly invoked, such aggregates, in terms of the judicial supervising role at least, are “quasi class actions,”<sup>34</sup> in function if not in name. The phenomenon is so widespread that the American Law Institute’s *Principles of the Law of Aggregate Litigation* (2010) devotes much of what was originally considered as a guide to class actions to the ethical and managerial uses of other aggregate litigation forms.

Just as class actions began, long before the enactment of modern Rule 23, as creatures of equity,<sup>35</sup> contemporary MDLs, as quasi class actions, are considered to be “subject to the general equitable power of the court” merge them through completion. *Zyprexa*, 467 F. Supp. 2d at 262. One concern is that this power is exercised without the framework of a clear-cut rule, such as Rule 23, which has clearly defined roles for named plaintiffs, absent class members, defendants, counsel, and the court. There is some indication that, in the context of class certification for settlement purposes at least, this traditional procedural framework, with its robust jurisprudential resources, may yet be superior, within the meaning of Rule 23(b)(3), to other emerging or experimental alternatives for fairly and efficiently adjudicating the controversy.<sup>36</sup>

The refusal of some courts to certify settlement classes has led a number of recent mass actions to settle outside of the class action process. The highly publicized multidistrict Vioxx and Zyprexa settlements are examples of non-class mass settlement.<sup>37</sup> The concurring opinion of Judge Scirica in *Sullivan v. DB Investments, Inc.* relates this phenomenon to the *Amchem* decision, opining that the Supreme Court’s opinion has led “some practitioners to avoid the class action device,” and noting that “some observers believe there has been a shift in mass personal injury claims to aggregate non-class settlements.”<sup>38</sup> Judge Scirica seems to view this avoidance as a problem – perhaps one that a return to formal class action settlements would solve.

[The increase in large non-class settlements] is significant, for outside the federal rules governing class actions, there is no prescribed independent review of the structural and substantive fairness of a settlement including

34 See *In re Zyprexa Prods. Liability Litig.* (MDL No. 1596), 451 F. Supp. 2d 458, 477 (E.D.N.Y. 2006); 671 F. Supp. 2d 397 (E.D.N.Y. 2009) (the sine qua non of a quasi class action is enforced judicial control of counsel conduct and attorney fees).

35 See Geoffrey C. Hazard, “An Historical Analysis of the Binding Effect of Class Suits,” 146 U. Pa. L. Rev. 1849, 1861-65 (1998).

36 See, e.g., *Sullivan v DB Invs., Inc.*, 667 F.3d 273, 334 (3d Cir. 2011) (Scirica, J. concurring).

37 See, e.g., Elizabeth Chamblee Burch, *Group Consensus, Individual Consent*, 79 Geo. Wash. L. Rev. 506 & n.5, 513 (2011) (describing settlements).

38 *Sullivan*, 667 F.3d 273, 333 (3d Cir. 2011) (Scirica, J., concurring).

evaluation of attorneys' fees, potential conflicts of interest, and counsel's allocation of settlement funds among class members.<sup>39</sup>

The increasing tendency of MDL courts to label the assembly of cases before them as "quasi class actions" invoke the Rule 23 infrastructure to fill a perceived gap in judicial equitable or supervising power may signal a move back to Rule 23 for mass tort settlement purposes. There have been renewed calls for the addition of a settlement class pursuant to Rule 23, to more clearly enable the class settlement of cases that could not be tried as class actions.<sup>40</sup> Indeed, there is a growing feeling that application of the procedural advantages, protections and certainties of formal class settlement to cases that are problematic or controversial as trial-purposes class actions would be facilitated by adding an express "settlement class" category to Rule 23.<sup>41</sup>

## VII. CONCLUSION

The task of delivering upon CAFA's stated promises is a profound challenge. The CAFA statute itself did not supply many of the tools some would consider necessary, or at least useful, for its implementation. There is no uniform choice of law provision; there is no federal common law of consumer fraud or fair marketing practices; and there is no express provision that facilitates collaboration between the federal and state court systems as federal courts struggle to find, to know, and to apply state common and statutory law, with deference and fidelity to the states themselves. We can continue to view CAFA with cynicism and sarcasm, and thus enable it to fulfill what some had hoped or feared were its short term partisan, polarized purposes. Or we can take the statute at its words, and work to develop case management techniques with the tools at hand (the federal rules and available choice-of-law doctrines) to recognize the express and legitimate purposes of the statute itself, and to realize them in our federal courts. To do so will work a truly transformational reform, and will achieve in truth what some have lampooned CAFA for invoking with irony: class action fairness.

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<sup>39</sup> 667 F.3d at 304.

<sup>40</sup> *Amchem Prods, Inc. v. Windsor*, 521 U.S. 591, 620 (1997), provided a partial solution, stating, "Whether trial would present intractable management problems . . . is not a consideration when settlement-only certification is requested, for the proposal is that there be no trial." While more recent decisions have built upon *Amchem* to increase the potential for class settlements in cases that might resist practicable class trials, *see, e.g., Sullivan v. D.B. Indus., Inc.*, 667 F.3d 273 (3d Cir. 2011), *Amchem* has been perceived by others as a barrier to mass tort class settlements.

<sup>41</sup> In 1996 the Advisory Committee proposed a fourth type of class under Rule 23(b), essentially a Rule 23(b)(4) "settlement class." The proposed rule provided that "the parties to a settlement [may] request certification under subdivision (b)(3) for purposes of settlement, even though the requirements of subdivision b(3) might not be met for purposes of trial. As noted in Brian T. Fitzpatrick, *An Empirical Study of Class Action Settlements and Their Fee Awards*, 7 J. Empirical L. Stud. 811, 819 (2010), the majority of contemporary certified class actions have been certified expressly for settlement purposes: "68% of the federal [class action] settlements in 2006 and 2007 were settlement classes."

# CONCEPCION AND THE FUTURE OF PRE-DISPUTE ARBITRATION AGREEMENTS

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On April 27, 2011, in *AT&T Mobility v. Concepcion*,<sup>1</sup> a 5 to 4 majority of the U.S. Supreme Court “overturned the entire landscape” of consumer class action.<sup>2</sup> Until *Concepcion*, courts in California and elsewhere routinely found class action waivers in the arbitration clauses of consumer agreements categorically unconscionable.<sup>3</sup> Left to pursue individual claims, as Justice Breyer noted in his dissent in *Concepcion*, “only a lunatic or a fanatic sues for \$30.”<sup>4</sup> Nevertheless, the majority of the Supreme Court held that the refusal to enforce arbitration clauses with class action waivers “stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress” in Section 2 of the Federal Arbitration Act (FAA),<sup>5</sup> which makes agreements to arbitrate “valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”<sup>6</sup>

As we explore below, *Concepcion* threatens to slam the courthouse doors not only on the consumer false advertising class action at issue in that case, but a vast swath of litigation. The majority opinion in *Concepcion* leaves little room to avoid arbitration of consumer claims. The opinion explicitly endorses arbitration clauses that not only bar class claims, but also restrict discovery and require that the proceedings be confidential. While the decision involved false advertising claims, nothing in it would prevent its application to product liability claims involving personal injury and even death.

## I. THE *CONCEPCION* STORY

The case had humble beginnings. AT&T offered free cell phones for new wireless customers. Vincent and Liza Concepcion signed a two-year contract and received their two phones. They were surprised, however, when they got their first bill. While there was no charge for the phones themselves, AT&T had charged them \$30.22 in sales tax on their “free” phones. The Concepcions felt cheated and, believing that other new AT&T wireless customers felt the same way, they sued on behalf of all AT&T customers who were charged sales tax on their “free” phones. When the Concepcions got to court, however, AT&T surprised them again. Buried somewhere in the terms and conditions of the cell phone contract, AT&T’s lawyers had inserted a clause requiring arbitration of any dispute and requiring that the arbitration be in an “individual capacity, and not as a plaintiff or class

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1 131 S. Ct. 1740 (2011)

2 *Grabowski v. C.H. Robinson Co.*, Case No. 10cv1658 (S.D. Cal. Sept. 19, 2011)

3 California’s “Discover Bank Rule” was set forth in *Discover Bank v. Superior Court*, 36 Cal. 4th 148, 162 (2005).

4 131 S. Ct. at 1761 quoting *Carnegie v. Household Int’l, Inc.*, 376 F.3d 656, 661 (7th Cir. 2004).

5 9 U.S.C. §§1-16.

6 131 S. Ct. at 1744 quoting 9 U.S.C. § 2.

member in any purported class or representative proceeding.” AT&T moved to compel an *individual* arbitration. The Concepcions argued that the class action waiver was unconscionable – both procedurally because it was part of a contract of adhesion, and substantively because the costs of an individual arbitration effectively prevented them from pursuing their claims. The trial court rejected the Concepcions’ argument, but the Ninth Circuit reversed. Applying California law, it held that the class action waiver was unconscionable.<sup>7</sup> The U.S. Supreme Court granted review to consider whether state law rules prohibiting enforcement of class action waivers in arbitration clauses conflicted with the Federal Arbitration Act.

The majority opinion, authored by Justice Scalia, explained that “the principal purpose of the FAA is to ensure that private arbitration agreements are enforced according to their terms.”<sup>8</sup> It would conflict with the FAA for a state to prohibit arbitrations outright or even to have rules that “disfavored” arbitration. The first example given of such a discriminatory rule was a prohibition on contracts that did not allow for judicially supervised discovery. Restrictions on discovery are a fundamental part of why parties choose arbitration: to reduce cost and increase the speed of dispute resolution. Finding a contract unconscionable because it restricts discovery conflicts with one of the principal purposes of arbitration. Similarly, keeping arbitrations confidential facilitates an efficient, streamlined procedure. Finding a contract unconscionable because it requires confidentiality conflicts with the FAA’s policy favoring arbitration.

The majority was unimpressed with the fact that the Concepcions had no opportunity to negotiate the terms of the contract: “the times in which consumer contracts were anything other than adhesive are long past.”<sup>9</sup> For support, the opinion cites *Hill v. Gateway 2000, Inc.*, 105 F.3d 1147, 1149 (7<sup>th</sup> Cir. 1997), where the terms and conditions were stuffed into the box with the Hill’s new computer. The terms provided that the customer could reject the terms by returning the computer within 30 days. After that, the terms were binding. That was good enough for the Seventh Circuit and good enough for Justice Scalia and his four conservative brethren on the Court.

The majority also brushed aside the argument that class proceedings are necessary to prosecute small-dollar claims that might otherwise slip through the legal system. “States cannot require a procedure that is inconsistent with the FAA, even if it is desirable for unrelated reasons.”<sup>10</sup> Nevertheless, the Court went on to say that the claim in *Concepcion* “was most unlikely to go unresolved.”<sup>11</sup> AT&T had agreed that if it lost the arbitration, the arbitrator could award the winning consumer his or her costs and attorneys’ fees *and*, if the arbitrator awarded more than AT&T’s last written offer, AT&T would pay a minimum recovery of \$7,500 plus double the consumer’s attorneys’ fees. Of course, AT&T expected to make written offers for the \$30 sales tax to the Concepcions long before an arbitrator was even selected.

The Court concluded that “requiring the availability of classwide arbitration interferes with fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA.”<sup>12</sup>

7 In light of *Concepcion*, the Ninth Circuit recently held that a similar Washington state judicial rule (*Scott v. Cingular Wireless*, 161 P.3d 1100 (2007)) was preempted by the FAA and remanded for more individualized analyses of procedural unconscionability. *Coneff v. AT&T Corp.*, No. 09-35563 (9th Cir. March 16, 2012).

8 131 S.Ct. at 1748 (internal quotes omitted).

9 131 S. Ct. at 1750.

10 131 S.Ct. at 1753.

11 131 S.Ct. at 1753.

12 131 S. Ct. at 1748.



## II. JUDICIAL ACTIONS IN THE WAKE OF *CONCEPCION*

In the short time since it decided *Concepcion*, the Supreme Court has twice overturned state supreme court decisions upholding arbitration clauses as preempted by the FAA, in contexts well beyond those considered in *Concepcion*. In *Marmet Health Care Center v. Brown*, 132 S. Ct. 1201 (Feb. 21, 2012), the Court held that states could not prevent arbitration merely because the claims involved personal injury or wrongful death. The West Virginia Supreme Court held that arbitration agreements in nursing home contracts were unconscionable as a matter of public policy and Congress did not intend the FAA to apply “to personal injury or wrongful death suits.”<sup>13</sup> The U.S. Supreme Court resoundingly rejected the ruling, calling it “contrary to the terms and coverage of the FAA.”<sup>14</sup>

In *Sonic-Calabasas A, Inc. v. Moreno*,<sup>15</sup> the U.S. Supreme Court held that the FAA can preempt efforts to limit arbitration in the employment context. The California Supreme Court had decided that an arbitration clause may not require an employee to waive California’s optional wage and hour administrative hearing procedures, which are “statutory advantages accorded to employees designed to make that process fairer and more efficient.”<sup>16</sup> The U.S. Supreme Court instructed the California Supreme Court to reconsider the matter in light of *Concepcion*.

Many lower courts have dutifully applied *Concepcion*, sending to individual arbitration numerous claims that had been filed as class actions.<sup>17</sup> The Third, Eighth, Ninth and Eleventh Circuits have applied *Concepcion* to class actions against banks, health insurance companies and employers, and the Ninth Circuit recently invalidated a California judicial rule barring the arbitration of claims for broad public injunctive relief.<sup>18</sup>

A handful of courts have sought to avoid *Concepcion*’s broad scope. The most promising are cases involving federal claims where the FAA’s “mandate has been overridden by a contrary congressional command.”<sup>19</sup> For example, the Fair Labor Standards Act (“FLSA”) expressly permits representative actions.<sup>20</sup> Accordingly, Judge Sweet of the Southern District of New York held that “a waiver of the right to proceed collectively under the FLSA is unenforceable as a matter of law,” because “an otherwise enforceable arbitration agreement should not become the vehicle to invalidate the particular Congressional

13 *Brown v. Genesis Healthcare Corp.*, (W. Va. June 29, 2011).

14 *Marmet Health Care Center v. Brown*, 132 S. Ct. 1201 (Feb. 21, 2012).

15 132 S. Ct. 496 (2011).

16 51 Cal. 4th 659, 686 (2011).

17 See e.g. *Coneff v. AT&T Corp.*, No. 09-35563, 2012 BL 61851 (9th Cir. Mar. 16, 2012) (FAA preempts Washington common law on substantive unconscionability of class action waiver, but permits further proceedings as to whether contract formation was procedurally unconscionable); *Quilloin v. Tenet HealthSystem Philadelphia, Inc.*, No. 11-1393, 2012 BL 62060 (3d Cir. Mar. 14, 2012), (FAA preempts Pennsylvania law the held that class action waiver was unconscionable where it “is the only effective remedy” given the high cost of arbitration and the minimal value of individual claim); *Kilgore v. KeyBank, N.A.*, No. Nos. 09-16703, 10-15934, 2012 BL 53654 (9th Cir. Mar. 07, 2012) (FAA preempts California rule against arbitration of public injunctive relief claims (Consumer Legal Remedies Act)); *In re Checking Account Overdraft Litigation*, No. 11-14317, 2012 BL 51577 (11th Cir. Mar. 05, 2012) (FAA preempts Georgia law that found arbitration clause was unconscionable because bank had unilateral right to recover its expenses from arbitration); *Antkowiak v. TaxMasters*, No. 11-1882, 2011 BL 324525 (3d Cir. Dec. 22, 2011), Court Opinion (remands to consider whether FAA preempts Pennsylvania law from finding arbitration provision substantively unconscionable where customer must be all costs of arbitration and whether that provision can be severed); *Green v. SuperShuttle Intl., Inc.*, 653 F.3d 766 (8th Cir. 2011), Court Opinion (FAA preempts Minnesota law challenge to enforceability of class action waiver in shuttle driver’s contract); *Litman v. Celco Partn.*, 655 F.3d 225 (3d Cir. 2011) (FAA preempted New Jersey law that made class action waivers unconscionable, even though waiver applied if the case was litigated rather than arbitrated); *Cruz v. Cingular Wireless, LLC*, 648 F.3d 1205 (11th Cir. 2011) (FAA preempts Florida law that class action waiver could be unconscionable despite evidence that plaintiffs could not cost-effectively pursue individual claims in arbitration).

18 *Kilgore v. KeyBank, Nat’l. Assoc.*, Case No. 09-16703 (9th Cir. March 7, 2012) (invalidating the rule of *Broughton v. Cigna Healthplans of California*, 988 P.2d 67 (1999) as FAA preempted for the same reasons as the *Discover Bank* rule).

19 *Compucredit Corp. v. Greenwood*, 132 S.Ct. 665, 669 (2011) citing *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 226 (1987).

20 The FLSA is the Fair Labor Standards Act, 29 U.S.C. § 201 et seq.

purposes of the collective action provision and the policies on which that provision is based.”<sup>21</sup> An appeal based in part on *Concepcion* is pending.<sup>22</sup> Many other courts have disagreed, finding waivers of FLSA collective actions enforceable.<sup>23</sup>

Another New York district judge ruled that class action waivers were unenforceable in a federal employment civil rights case under Title VII because the Second Circuit had previously held that cases alleging a pattern or practice of discrimination may only be brought as class actions. A class action waiver would “prevent the plaintiff from vindicating her statutory cause of action.”<sup>24</sup> The defendant has appealed to the Second Circuit.<sup>25</sup>

Separately, the Second Circuit has held that arbitration class action waivers may not be enforced where “the practical effect of enforcement would be to preclude [the] ability to vindicate [] federal statutory rights.”<sup>26</sup> Relying on testimony from plaintiffs’ economic expert that it was not economically rational to pursue an individual action, the Second Circuit concluded that “forcing plaintiffs to bring their claims individually here would make it impossible to enforce their rights under the Sherman Act and thus conflict with congressional purposes manifested in the provision of a private right of action in the statute.”<sup>27</sup> This contrasts with the facts of *Concepcion*, where the Supreme Court observed in dicta that AT&T’s arbitration policy likely would have provided the *Conceptions* a full recovery.<sup>28</sup>

However, when the Ninth Circuit held that the Credit Repair Organizations Act (“CROA”)<sup>29</sup> prohibited arbitration of claims made under the statute, the Supreme Court reversed, finding that CROA was “silent” about arbitration, so it could not override the FAA’s policy in favor of arbitration.<sup>30</sup>

A different *Concepcion* “work around” involves California’s private attorney general actions (“PAGA”) to enforce certain employment laws. A California Court of Appeal described a PAGA as a “law enforcement action” distinct from class actions<sup>31</sup> and found *Concepcion* inapplicable.<sup>32</sup> Other courts have disagreed, ruling that *Concepcion* and the FAA compel enforcement of arbitration agreements even when the agreements bar representative PAGA claims.<sup>33</sup>

21 *Raniere v. Citigroup, Inc.*, CV11-2448 (S.D.N.Y. Nov 22, 2011)

22 Second Circuit Case Number 11-5213.

23 Citigroup’s appellate brief lists: *Adkins v. Labor Ready, Inc.*, 303 F.3d 496 (4th Cir. 2002); *Vilches v. Travelers Cos.*, 413 F. App’x. 487 (3d Cir. 2011); *Horenstein v. Mortgage Mkt., Inc.*, 9 Fed. App’x. 618 (9th Cir. 2001); *Carter v. Countrywide Credit Indus. Inc.*, 362 F.3d 294 (5th Cir. 2004); and *Caley v. Gulfstream Aerospace Corp.*, 428 F.3d 1359.

24 *Chen-Oster v. Goldman, Sachs & Co.*, 785 F. Supp. 2d 394, 406-410 (S.D.N.Y. Apr. 28, 2011) and 1:10-cv-06940 Dkt. 59 (S.D.N.Y. July 7, 2011) (order holding that *Concepcion* does not alter the court’s prior ruling). The court noted that “plaintiffs ability to vindicate her statutory rights appears even more threatened in this case than was the ability of the plaintiffs in the American Express cases, for whom the class action waiver had the ‘practical effect’ of ensuring they would not bring claims against the defendant. Given the case law in this district indicating the plaintiff may not bring a pattern or practice claim as an individual, she would have absolutely no recourse for proving her claim.” 785 F. Supp. 2d 410 n.7.

25 Second Circuit Case No. 11-5229.

26 *In re American Express Merchants’ Litigation* (2d. Cir. Feb. 1, 2012) citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 632 (1985) for the proposition that “Arbitration is also recognized as an effective vehicle for vindicating statutory rights but only so long as the prospective litigant may effectively vindicate its statutory cause of action in the arbitral forum.”

27 *In re American Express Merchants’ Litigation* n. 5 (2d. Cir. Feb. 1, 2012).

28 See 131 S.Ct. at 1753 (noting that the claim “was most unlikely to go unresolved.”)

29 CROA is the Credit Repair Organizations Act, 15 U.S.C. § 1679 et seq.

30 *Compucredit Corp. v. Greenwood*, 132 S.Ct. 665 (2011).

31 Under California’s PAGA (Cal. Labor Code § 2698 et seq.), 75% of penalties collected go to the state and only 25% to the aggrieved employees.

32 197 Cal. App. 4th 489, 500 (2011); see also *Plows v. Rockwell Collins, Inc.*, 2011 U.S. Dist. LEXIS 88781 (C.D. Cal. Aug. 9, 2011) (denying motion to compel arbitration of PAGA claims based on *Brown*).

33 E.g. *Quevedo v. Macy’s, Inc.*, 798 F. Supp. 2d 1122 (C.D. Cal. 2011); *Grabowski v. C.H. Robinson Co.*, No. 10cv1658 (S.D. Cal. Sept. 19, 2011).

We can expect that pro-consumer and pro-employee judges will continue to look for exceptions to *Concepcion*. We can expect that pro-business judges, including a majority of the U.S. Supreme Court, will continue to stretch the logic of *Concepcion* as far as it can go.

#### IV. OTHER REACTIONS TO *CONCEPCION*

Shortly after *Concepcion* came down, Senators Al Franken (D-MN), Richard Blumenthal (D-CT) and Representative Hank Johnson (D-GA) introduced the Arbitration Fairness Act of 2011, which would make pre-dispute arbitration agreements unenforceable in employment, consumer and civil rights cases.<sup>34</sup> Similar legislation has been introduced unsuccessfully in the past and the present bill is not expected to advance.<sup>35</sup> Senator Blumenthal also introduced the Consumer Mobile Fairness Act,<sup>36</sup> which would invalidate pre-dispute arbitration agreements in cell phone contracts. Enactment of this legislation is also not expected.

On the regulatory front, FINRA,<sup>37</sup> an agency charged with regulating securities markets and broker dealers, recently informed Charles Schwab & Co. that it would seek disciplinary sanctions for Schwab's post-*Concepcion* insertion of class action waivers in its customer agreements.<sup>38</sup> FINRA has interpreted an existing rule as barring class action waivers despite *Concepcion*.<sup>39</sup> Schwab sought injunctive relief in District Court but the court dismissed its complaint for failure to exhaust administrative remedies through FINRA and the SEC.<sup>40</sup>

The Consumer Financial Protection Bureau, recently formed as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, has an express mandate to "prohibit or impose conditions or limitations on the use of an agreement . . . for a consumer financial product or service providing for arbitration of any future dispute if the Bureau finds that such a prohibition or imposition of conditions or limitations is in the public interest and for the protection of consumers."<sup>41</sup> Thus far, no steps have been taken to promulgate regulations on the issue.

State legislatures would appear to have some ability to limit *Concepcion*, although to date none of them has taken advantage of that ability. In *Concepcion*, the Supreme Court recognized that "states remain free to take steps addressing the concerns that attend contracts of adhesion – for example, requiring class-action waiver provisions in adhesive arbitration agreements to be highlighted."<sup>42</sup> Thus, states may seek to protect consumers and employees by developing stricter standards for the enforceability of arbitration agreements so long as they do not "conflict with the FAA or frustrate its purpose to ensure that private arbitration agreements are enforced according to their terms."<sup>43</sup> The contours of what a majority of the Supreme Court believes "does not conflict with the FAA" remain to be defined and, in the wake of *Concepcion*, courts have turned to an individualized analysis of

<sup>34</sup> Senate Bill 987 and House Resolution 1873.

<sup>35</sup> Arbitration Fairness Acts were introduced in Congress in 2007 and 2009.

<sup>36</sup> Senate Bill 1652.

<sup>37</sup> Financial Industry Regulatory Authority, Inc.

<sup>38</sup> Complaint for Declaratory and Injunctive Relief in *Charles Schwab & Co., Inc. v. Financial Industry Regulatory Authority, Inc.*, Case No. CV12-0518 (N.D. Cal. Feb. 1, 2012).

<sup>39</sup> National Association of Securities Dealers Rule 3110(f)(4)(C).

<sup>40</sup> Complaint for Declaratory and Injunctive Relief in *Charles Schwab & Co., Inc. v. Financial Industry Regulatory Authority, Inc.*, Case No. 3:12-cv-00518-EDL (N.D. Cal. Feb. 1, 2012) (Dkt. 1) and Order of Dismissal (May 11, 2012) (Dkt. 38).

<sup>41</sup> Dodd-Frank Act, Pub. Law 11-203 § 1028.

<sup>42</sup> 131 S. Ct. at 1750 n. 6.

<sup>43</sup> *Id.*

unconscionability for each disputed arbitration clause. If states were to pass legislation banning pre-dispute arbitration agreements in consumer or employment contracts outright, along the lines of the pending federal legislation, or seek to ban pre-dispute class action waivers, as was attempted in Maryland,<sup>44</sup> it is unlikely that such laws would survive a FAA preemption challenge.

In another approach, states may also attempt to respond to *Concepcion* by expanding private attorney general actions. Given the severe budget crises many states face, such an approach may be doubly attractive by saving money the state would have spent on its attorney general's office while protecting its citizens. It is still unclear, however, whether PAGAs will be preempted by the FAA.

*Concepcion* does not preclude states from adopting changes in arbitration procedures that may make the arbitrations themselves more consumer friendly. The most obvious concern is that arbitrators will favor parties from whom they hope to get future work. That will almost always be the business in a consumer-business dispute. State could require that consumer representatives be included in the pool of potential arbitrators. The final selection of arbitrators may be left to chance, permitting the parties only challenges for cause.

On the flip side, *Concepcion* could open a door for entrepreneurial states to attempt to attract business by developing laws narrowing unconscionability and expanding the enforceability of pre-dispute arbitration agreements. Much as South Dakota and Delaware attracted credit card business by passing lender-friendly legislation, states could pass arbitration-friendly legislation, prompting businesses to select that state's choice of law to govern their consumer agreements. For the choice of law provisions to be enforceable, business would have to establish a presence in the arbitration friendly state, generating jobs in that state.

#### IV. POST-*CONCEPCION* OPPORTUNITIES FOR BUSINESSES

*Concepcion* opens up enormous opportunities for businesses to expand the use of arbitrations for resolution of disputes. It also allows businesses to shape those arbitrations further to their advantage and to the disadvantage of consumers and employees.

There is a wide array of reasons that businesses prefer arbitration for consumer and employment disputes. Arbitration can be more efficient, resulting in faster and lower cost resolution of disputes, particularly when discovery is limited and motion practice is almost non-existent. Businesses want to avoid the uncertainty of an unknown judge or jurors by having a hand in selecting the arbitrator. And arbitrators are less likely than juries to be driven by passion to make substantial awards for minimal injuries or to impose punitive damages.

*Concepcion* allows businesses to shape arbitrations even further to their liking. The majority directly addressed using individual arbitrations to avoid class actions. They also endorsed other restrictions on arbitration, restrictions that will tend to favor businesses. Most importantly, the Court found that restrictions on discovery were a fundamental characteristic of arbitration. State law efforts to overcome restrictions in the parties'

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<sup>44</sup> A recent Maryland House of Delegates Bill (#729) was sweeping, stating that "a written agreement made before a dispute arises may not waive or have the practical effect of waiving the rights of a party to the agreement to resolve the dispute by obtaining relief as a representative of or as a member of a class of similarly situated persons." It was defeated in the Maryland Senate.

agreement would be preempted by the FAA. Will courts and arbitrators enforce arbitration agreements that prohibited all discovery?

In *Concepcion*, the Court also found that confidentiality was a central feature of arbitration. The Court will almost certainly strike down any efforts by states to require that arbitrations be open to the public. Thus, businesses will have the advantage of using the information that they develop in multiple arbitrations while consumers or employees have to reinvent the wheel for every case.

Being too creative with an agreement may lead to costly, protracted and public litigation on the enforceability of the arbitration clause. This could leave the business with the same uncertainty, delay and cost that it hoped to avoid through arbitration.

The FAA preempts state laws that interfere with arbitration, but that same protection does not extend to other parts of an agreement containing an arbitration clause. Businesses must be careful not to overreach in other parts of their agreements with consumers and employees. An agreement that caps compensatory damages, waives punitive damages or only gives the business the right to appeal, may be deemed substantively unconscionable. Such efforts to gain advantage in other portions of the agreement could result in a finding of unconscionability that would invalidate the agreement entirely, including the right to compel individual arbitration.

To avoid charges of procedural unconscionability, businesses should keep their consumer agreements clear and concise. In the online context, websites should be configured to make an unambiguous record of the customers' consent. Courts distinguish between "click-wrap" agreements, which are enforceable, and "browse wrap" agreements, which often are not.<sup>45</sup> A browse-wrap agreement only has the terms available on the site, but does not require affirmative action to accept them. A click-wrap requires the consumer to click on a separate button explicitly accepting the terms and conditions. To further document consent, customers should not be allowed to complete a purchase without first scrolling through the terms and conditions and clicking on a separate screen or pop-up box to explicitly indicate acceptance.

When returning customers are able to skip the page accepting the terms and conditions, they should be alerted to substantive changes since they last purchased and be given the opportunity to review the new terms.

Getting consent to terms and conditions from consumers should not be a problem for businesses that have a direct relationship with their ultimate customers, such as car dealers, banks, insurance companies, doctors and hospitals. The challenge is: How do manufacturers that rely upon a retail distribution network create enforceable arbitration agreements with their consumers? This is particularly an issue for manufacturers who frequently face product liability claims and would like to move those claims into confidential, individual arbitrations with limited discovery. Increasingly, manufacturers are creating direct relationships with their ultimate customers through loyalty programs, which offer customers incentives to purchase the manufacturer's product or provide advance notice of new products. The loyalty program agreement could include an arbitration clause covering disputes of any kind that involve the manufacturer's products.

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<sup>45</sup> See *U.S. v. Drew*, 259 F.R.D. 449, 462 n.22 (C.D. Cal. 2009) (collecting cases and stating that click wrap agreements are routinely upheld whereas the enforceability of browse wrap agreements will depend on whether a website user has actual or constructive knowledge of a site's terms and conditions)

Business could also attempt to turn to intermediaries to procure the arbitration agreements. For example, branded drug companies currently pay rebates to health insurers for including the manufacturer's products on the insurer's formulary. Drug companies could provide an additional rebate to insurance companies that require their insureds to arbitrate all claims arising from goods or services purchased with the insurance, however the burden would be on the drug company to establish that it is an intended third party beneficiary to the insurance agreement.<sup>46</sup>

Credit card companies could earn similar rebates from manufacturers if they make their customers agree to arbitrate any disputes arising from products purchased with that credit card. Presumably, the credit card company would make such arbitration agreements enforceable only by manufacturers who pay a rebate to the credit card company. Not only will it earn money for the credit card company, it will also create the mutuality needed for an enforceable agreement.

Relying upon intermediaries may create confusion over what claims are covered by the arbitration agreement. Toyota sought to invoke arbitration clauses in its dealer's contracts with Toyota customers in its unintended acceleration multi-district litigation.<sup>47</sup> The court refused to impose the arbitration provision on the customers, finding that the dealer agreements dealt with "the mundane details of purchasing or leasing a new or used motor vehicle . . . [and the agreements] are utterly devoid of any guarantees or representations regarding the performance, operation, or maintenance of the vehicles."<sup>48</sup>

Another possible means of manufacturers binding customers with whom they have no direct relationship is to adopt a variation of the shrink-wrap licenses used by software manufacturers. The packaging conspicuously discloses to consumers that opening the package means that the consumer has adopted the manufacturer's terms. The terms could be made available online at a web address disclosed on the box. Or the terms could be inside the packaging and the consumer could reject the terms by returning the product. Such a "stuff wrap" agreement was upheld in *Hill v. Gateway*,<sup>49</sup> the case cited by Justice Scalia when dismissing the notion that California's policy against class action waivers should be upheld because it relates to adhesion contracts.<sup>50</sup>

Even with assent established, procedural unconscionability remains a problem if the arbitration clause is not sufficiently prominent. Courts tend to scrutinize arbitration provisions in adhesive contracts more closely – a practice which itself may be suspect as conflicting with the FAA.<sup>51</sup> Courts may find procedural unconscionability when the clauses are buried in lengthy agreement terms, printed in a small font, printed on the back of a physical agreement or at the end of an online agreement or not otherwise made sufficiently distinctive.<sup>52</sup> While standards vary somewhat by jurisdiction, California has defined

46 See e.g. *Jones v. Jacobson*, 125 Cal. Rptr. 3d 522, 534 (4th Dist. 2011); *City of Hope v. Bryan Cave, L.L.P.*, 102 Cal. App. 4th 1356, 1371 (2d Dist.).

47 Central District of California Case No. 8:10ML 02151 JVS, Dkt. #2312 at p. 49. Equitable estoppel is "designed to ensure fairness by forcing a party who reaps the benefits of an agreement to accept the agreement's accompanying burdens."

48 *Id.* at pp. 52-53.

49 105 F.3d 1147 (7th Cir. 1997).

50 131 S. Ct. at 1750.

51 The following question is currently pending before the California Supreme Court: Does the FAA as interpreted in *Concepcion* "preempt state law rules invalidating mandatory arbitration provisions in a consumer contract as procedurally and substantively unconscionable." California Supreme Court Case No. S199119 granting review of *Sanchez v. Valencia Holding Co.*, 201 Cal. App. 4th 90-93 (2d Dist. 2011).

52 See discussion and collection of cases in *Sanchez v. Valencia Holding Co.*, 201 Cal. App. 4th 90-93 (2d Dist. 2011) (post *Concepcion* case finding an automotive sales contract procedurally unconscionable where the arbitration clause was located at the bottom of the back page of the sale contract and plaintiff averred that he was not afforded time to read the agreement). The case was recently appealed to the California Supreme Court (Case No. S199119).

'conspicuousness' for the purpose of waiver of warranties as including (1) a heading in capitals equal to or greater in size than the surrounding text, or in contrasting type, font, or color to the surrounding text of the same or lesser size; and (2) language in the body of a record or display in larger type than the surrounding text, or in contrasting type, font, or color to the surrounding text of the same size, or set off from surrounding text of the same size by symbols or other marks that call attention to the language.<sup>53</sup> The *Concepcion* court suggested highlighting.<sup>54</sup> If contract terms must be lengthy, there should be a table of contents that describes each paragraph, as well as upfront language indicating that the agreement contains an arbitration clause.

## V. CONCLUSION

With *Concepcion*, businesses that want to move their litigation out of court and into arbitration, avoiding class actions, reducing the burden of discovery and improving the confidentiality of their disputes, will have a favorable environment for some time. No one can guarantee, however, that the pendulum will not swing back, whether through legislative or regulatory action or by the appointment of new justices with views more in line with the dissenters in *Concepcion*.

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<sup>53</sup> California Commercial Code § 1201(b)(1). See also *Harustak v. Wilkins*, 84 Cal. App. 4th 208, 215 (5th Dist. 2000).

<sup>54</sup> 131 S. Ct. at 1750 n. 6.





# “DEFENSIBLE” BY WHAT STANDARD?

*Hon. Craig B. Shaffer<sup>1</sup>  
United States Magistrate Judge  
for the District of Colorado  
Denver, CO*

## OVERVIEW

“E-discovery” can be described as the process of identifying, collecting, reviewing and producing electronically stored information (“ESI”) in connection with pending or reasonably foreseeable litigation. There is a growing body of literature suggesting that e-discovery processes that rely upon automated tools to prioritize and select materials for review and production may be more cost-effective and result in document production that is superior to traditional “linear” or manual review.<sup>2</sup> A technology-assisted review process may incorporate a variety of approaches, including keywords, Boolean or conceptual search techniques, as well as “clustering,” machine learning, relevance ranking, “predictive coding,” or sampling.<sup>3</sup> Each of these procedures, when applied individually or in combination, present the parties and the court with “complicated question[s] involving the interplay, at least, of the sciences of computer technology, statistics and linguistics.”<sup>4</sup>

The process of designing and managing a complex e-discovery project presents obvious challenges, “whether it involves ‘simple’ human review or application of automated tools and more sophisticated techniques.”<sup>5</sup>

Technologically advanced tools, however “cutting edge” they may be, will not yield a successful outcome unless their use is driven by people who understand the circumstances and requirements of the case, as guided by thoughtful and well-defined methods, and unless their results are measured for accuracy. The first step, then, is the development of a well thought-out process in which the applicable review method can be applied.<sup>6</sup>

<sup>1</sup> United States Magistrate Judge for the District of Colorado.

<sup>2</sup> See, e.g., Maura R. Grossman & Gordon V. Cormack, *Technology-Assisted Review in E-Discovery Can Be More Effective and More Efficient Than Exhaustive Manual Review*, XVII Rich. J.L. & Tech. 11, 55 (2011) (citing study results that “support the conclusion that technology-assisted review can achieve at least as high recall as manual review, and higher precision, at a fraction of the review effort, and hence, a fraction of the cost”); Herbert L. Roitblat, Anne Kershaw & Patrick Oot, *Document Categorization in Legal E-Discovery. Computer Classification vs. Manual Review*, 61 J. Am. Soc’y For Info. Sci. & Tech. 70, 72-72 (2010) (finding that computer-aided information retrieval techniques were no less accurate in identifying relevant and responsive documents than traditional human review). Technology-assisted review in the preservation context, however, may be limited at this time. See Thomas Y. Allman, Jason R. Baron & Maura R. Grossman, *Preservation, Search Technology & Rulemaking*, Civil Rules Mini-Conference (Dallas) (September 2011), at 4-5 (describing limitations of centralized searches of multiple sources of enterprise ESI subject to preservation), copy at [http://www.uscourts.gov/uscourts/RulesandPolicies/rules/DallasMiniConf\\_Comments/Thomas%20Allman,%20Janson%20Baron,%20and%20Maura%Grossman.pdf](http://www.uscourts.gov/uscourts/RulesandPolicies/rules/DallasMiniConf_Comments/Thomas%20Allman,%20Janson%20Baron,%20and%20Maura%Grossman.pdf).

<sup>3</sup> For definitions or descriptions of many of these terms, see *The Sedona Conference® Glossary: E-Discovery & Digital Information Management (Third Edition)* (September 2010) available at [www.thesedonaconference.org](http://www.thesedonaconference.org).

<sup>4</sup> *United States v. O’Keefe*, 537 F. Supp. 2d 14, 24 (D.D.C. 2008).

<sup>5</sup> See *The Sedona Conference® Commentary on Achieving Quality in the E-Discovery Process*, 10 Sedona Conf. J. 299, 306 (Fall 2009).

<sup>6</sup> *Id.*

Confronted with pending or the reasonably foreseeable prospect of litigation, clients are asked to make e-discovery decisions in a technological realm that provides an array of options, but no single “correct” solution.<sup>7</sup> At the outset of litigation, and often even before a lawsuit commences, the goal is to implement a discovery plan that identifies, collects and produces relevant and responsive non-privileged materials from a larger universe of ESI using reliable methodologies that provide a quality result at costs that are reasonable and proportionate to the particular circumstances of the client and the litigation. That would be a defensible e-discovery protocol.

Designing and implementing a defensible discovery process, however, is complicated by the *post hoc* nature of most discovery motions challenging the results. Typically, the court is asked to evaluate the results and legal sufficiency of a particular discovery process only after a party has made critical technological decisions, spent considerable time and money, and progressed through most (if not all) of the pretrial process, despite the increased emphasis on early development of a discovery plan.<sup>8</sup> While implementation of an effective e-discovery process requires an iterative approach from the outset of the litigation, the true measure of a defensible e-discovery process is the ability to withstand an after-the-fact challenge by the opposing party.

Search protocols may produce varying results, and the parties (as well as the court) should expect that methodologies will be refined or adjusted to reflect the evolving discovery needs of a given case. A technology-assisted e-discovery process cannot be held to a standard of perfection, but should produce discovery results that are defensible in terms of the producing party’s discovery obligations and reasonable from the standpoint of cost and efficiency.<sup>9</sup> Ultimately, a technology-assisted review process must comport with the requirements of the Federal Rules of Civil Procedure, be proportionate to the claims, defenses and circumstances of the particular case, and be reasonably transparent to the court and opposing parties.<sup>10</sup>

In 2007, The Sedona Conference<sup>®</sup> noted that litigants and their counsel must be prepared to explain to the opposing party and/or the court how the selected search methodology can be or was used to produce responsive documents.

[A] unilateral choice of search methodology may be challenged due to a lack of scientific showing that the results are accurate, complete and reliable. Since all automated search tools rely on some level of science, the challenging party may argue that the process used by the responding party is essentially an expert technology which has not been validated by

7 See Athena Johns, *Computer Science and the Reference Manual for Scientific Evidence: Defining the Judge’s Role as a Firewall*, 14 Intellectual Property Law Bulletin 23, 28 (2009). See also *The Sedona Conference® Commentary on Achieving Quality in the E-Discovery Process*, 10 Sedona Conf. J. 299, 315 (Fall 2009) (“The question for the producing party is how best to capture and properly produce [non-privileged documents and ESI responsive to non-objectionable discovery requests], and how and what resources need to be allocated to this project.”).

8 As discussed in more detail below, Rule 26(f) and Rule 16(b) contemplate development of a discovery plan marked by cooperation in “front loading” an understanding and discussion of the sources of ESI. See Steven S. Gensler, *Some Thoughts on the Lawyer’s E-Valuing Duties in Discovery*, 36 N. Ky. L. Rev. 521, 535-539 (2009). See also *Home Design Services, Inc. v. Trumble*, 2010 WL 1435382, at \*5 (D. Colo. Apr. 9, 2010) (Shaffer, M.J.).

9 Cf. *Moore v. Publicis Groupe*, 2012 WL 607412, at \*12 (S.D.N.Y. Feb. 24, 2012) (Peck, M.J.) (hereinafter “*Moore I*”) (“[c]ounsel must design an appropriate process, including use of available technology, with appropriate quality control testing, to review and produce relevant ESI while adhering to [Fed. R. Civ. P.] 1 and [Fed. R. Civ. P.] 26(b)(2)(C) proportionality”).

10 See *The Sedona Conference® Commentary on Achieving Quality in the E-Discovery Process*, 10 Sedona Conf. J. 299, 307 (Fall 2009) (suggesting that the effective application of technology in the e-discovery process should include “the selection, design, implementation and measurement of a process” that can be “explained in a clear and comprehensive way to the relevant fact-finder, decision-maker, tribunal or regulator, as well as to opposing party as may be appropriate”). Cf. *Equity Analytics, LLC v. Lundin*, 248 F.R.D. 331, 333 (D.D.C. 2008) (requiring defendant’s computer forensic expert to submit an affidavit describing in detail how the search of plaintiff’s computer will be conducted in order to make the best possible judgment as to how to balance the competing interests of the parties).

subjecting it to peer review, and unbiased empirical testing or analysis. . . . A requesting party may demand the responding party to ‘prove up’ the use of such search technology. This could set the stage for a difficult and expensive battle of experts.<sup>11</sup>

Recent judicial proceedings may portend discovery battles to come as litigants and their vendor surrogates debate the efficacy of competing search methodologies. In *Da Silva Moore*, the plaintiffs brought a putative collective/class action on behalf of “all current, former, and future female PR employees” of Publicis Groupe and its subsidiary, MSL Group.<sup>12</sup> The parties agreed in the abstract to use predictive coding to distill and review “approximately three million electronic documents from the agreed-upon custodians.” After Magistrate Judge Peck accepted a search protocol proposed by Defendant MSL Group, the plaintiffs filed objections challenging whether the protocol adopted by the court would reliably result in the production of ESI that satisfied the defendants’ discovery obligations. More specifically, the plaintiffs argued “that the predictive coding method contemplated in the ESI protocol lacks generally accepted reliability standards, that the use of such method violates Fed. R. Civ. P. 26 and Federal Rules of Evidence 702, that Judge Peck improperly relied on outside documentary evidence . . . , that [Defendant’s] expert is biased because the use of the predicative coding method will reap financial benefits for the company, that Judge Peck failed to hold an evidentiary hearing, and that he adopted [Defendant’s] version of the ESI protocol on an insufficient record.”<sup>13</sup>

In upholding the ESI protocol appended to Magistrate Judge Peck’s February 24, 2012 Opinion and Order,<sup>14</sup> District Judge Carter acknowledged that no review tool “guarantees perfection” and “there are risks inherent in any method of reviewing electronic documents.”<sup>15</sup> After noting that the ESI protocol adopted by Magistrate Judge Peck “contains standards for measuring the reliability of the process,” “builds in levels of participation by Plaintiffs,” and “provides that the search methods will be carefully crafted and tested for quality assurance,” Judge Carter concluded that the plaintiffs’ challenge to the reliability of the selected predictive coding software was premature.<sup>16</sup>

Conversely, in *Kleen Products, LLC v. Packaging Corporation of America*,<sup>17</sup> a putative class action brought under section 1 of the Sherman Act, 15 U.S.C. § 1, the plaintiffs challenged the adequacy of the defendants’ search methodology only after the defendants had incurred considerable expense and identified for production more than a million documents using conventional keyword-based search procedures. The *Kleen Products* plaintiffs reportedly contend, in part, that the defendants’ search protocol is flawed because it does not include methods for validating effectiveness, potentially fails to include key custodians, and does not capture variations of key concepts and terms. The plaintiffs in *Kleen Products* would have the defendants re-visit the production of ESI using “content-based advanced analytics.” In an effort to clarify the parties’ competing positions, Magistrate Judge Nolan of the Northern District of Illinois considered expert testimony and legal arguments in a hearing that extended over two days and generated more than 600 pages of transcript.

11 *The Sedona Conference® Best Practices Commentary on the Use of Search and Information Retrieval Methods in E-Discovery*, 8 Sedona Conf. J. 189, 204 (Fall 2007).

12 *Moore I*, 2012 WL 607412, at \*1.

13 *Da Silva Moore v. Publicis Groupe SA*, 2012 WL 1446534, at \*1 (S.D.N.Y. Apr. 26, 2012) (hereinafter “*Moore II*”).

14 *Moore I*, 2012 WL 607412, at \*13-23.

15 *Moore II*, 2012 WL 1446534, at \*3.

16 *Id.* at \*2 (noting that “Judge Peck has ruled that if the . . . Plaintiffs are not receiving the types of documents that should be produced, the parties are allowed to reconsider their methods and raise their concerns with the Magistrate Judge”).

17 No. 10 C 5771 (N.D. Illinois).

One state court also has weighed into the battle on technology-assisted review. In *Global Aerospace Inc. v. Landow Aviation, LP*, the plaintiffs objected to the defendants’ proposed use of predictive coding to retrieve potentially relevant materials from an estimated 250 gigabytes of reviewable ESI. In moving for a protective order approving the use of predictive coding, the *Global Aerospace* defendants argued that

At average cost and rates of review and effectiveness, linear first-pass review would take 20,000 man hours, cost two million dollars, and locate only sixty percent of the potentially relevant documents. As one alternative, keyword searching might be more cost-effective but likely would retrieve only twenty percent of the potentially relevant documents and would require [defendants] to incur substantial unnecessary costs for document review. Predictive coding, on the other hand, is capable of locating upwards of seventy-five percent of the potentially relevant documents and can be effectively implemented at a fraction of the costs and in a fraction of the time of linear review and keyword searching.<sup>18</sup>

In the absence of any “judicial or other legal mandate requiring, or even advocating, the use of one method of document retrieval over another,” the *Global Aerospace* defendants insisted that predictive coding will identify the relevant ESI with “reasonable accuracy” and fully satisfy the “reasonable inquiry” obligation imposed by applicable Virginia Supreme Court Rules.

The plaintiffs’ opposition brief argued there are “no grounds justifying [a] departure” from the traditional approach to document production which the plaintiffs described as

talk[ing] to the client[;] locat[ing] the files that might reasonably contain responsive documents[;] look[ing] at the documents[;] select[ing] the ones that are responsive and non-privileged[;] [and] produc[ing] them.<sup>19</sup>

Plaintiffs were quick to concede that computer technologies can make the ESI review process more efficient, and should be used to “supplement” the more traditional linear review process and “ensure a complete response.” However, in the absence of any reported “cases in which a court has compelled a party to accept a document production selected by a ‘predictive coding’ computer program,” the *Global Aerospace* plaintiffs concluded that Virginia law does not “permit such a radical departure from the standard practice of human review of documents as a necessary step in responding to a request for production.”<sup>20</sup> This argument would effectively create a presumption in favor of traditional linear review.

On April 23, 2012, in a very short Order and without any substantive discussion, the court in *Global Aerospace* approved the use of predictive coding “for the purposes of the processing and production of electronically stored information.”<sup>21</sup> The court acknowledged, however, that its Order was entered “without prejudice to a receiving party raising with the Court an issue as to completeness or the contents of the production or the ongoing use of predictive coding.”<sup>22</sup>

18 Memorandum in Support of Motion for Protective Order Approving the Use of Predictive Coding, *Global Aerospace Inc. v. Landow Aviation, L.P.*, Consolidated Case No. CL 61040, (Circuit Court for Loudoun County, Virginia, Apr. 9, 2012).

19 Opposition of Plaintiffs to the Landow Defendants’ Motion for Protective Order Regarding Electronic Documents and Predictive Coding, *Global Aerospace Inc. v. Landow Aviation, L.P.*, Consolidated Case No. CL 61040, (Circuit Court for Loudoun County, Virginia, Apr. 16, 2012).

20 *Id.*

21 Order Approving the Use of Predictive Coding for Discovery, *Global Aerospace Inc. v. Landow Aviation, L.P.*, Consolidated Case No. CL 61040, (Circuit Court for Loudoun County, Virginia, Apr. 23, 2012).

22 *Id.*

The discovery disputes in *De Silva Moore*, *Kleen Products* and *Global Aerospace* raise important procedural considerations concerning the identification, collection, review and production of ESI. More specifically, the issue of defensibility will require a court to determine the appropriate legal standard for evaluating a technology-assisted search protocol and the factual showing that should be required to trigger judicial intervention.

### THE STANDARD FOR MEASURING DEFENSIBILITY

Rule 26(b)(1) of the Federal Rules of Civil Procedure provides a logical starting point for addressing the legal defensibility of any discovery process. A party may obtain discovery of any nonprivileged matter that is relevant to a claim or defense, “including the existence, description, nature, custody, condition and location of any documents or other tangible things.”<sup>23</sup> The scope of permissible discovery is not defined by the Federal Rules of Evidence, as Rule 26(b)(1) expressly states that “relevant information need not be admissible at the trial if the discovery appears *reasonably calculated* to lead to the discovery of admissible evidence.”<sup>24</sup> But the right to obtain discovery is not absolute.<sup>25</sup>

While a defensible e-discovery plan is not held to a standard of perfection,<sup>26</sup> Rule 34 of the Federal Rules of Civil Procedure does require a party to undertake reasonable efforts to identify and produce responsive, non-privileged material in its possession, custody or control.<sup>27</sup>

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- 23 Fed. R. Civ. P. 26(b)(1). See also *Basaldu v. Goodrich Corp.*, 2009 WL 1160915, at \*2 (E.D. Tenn. Apr. 29, 2009) (“The purpose of the modern civil discovery rules is to get all of the proverbial cards on the table in advance of trial.”); *Board of Regents of University of Nebraska v. BASF Corp.*, 2007 WL 3342423, at \*5 (D. Neb. Nov. 5, 2007) (“The overriding theme of recent amendments to the discovery rules has been open and forthright sharing of information by all parties to a case with the aim of expediting case progress, minimizing burden and expense and removing contentiousness as much as practicable. . . . If counsel fail in this responsibility – willfully or not – these principles of an open discovery process are undermined, coextensively inhibiting the courts’ ability to objectively resolve their clients’ disputes and the credibility of its resolution.”) (internal citations omitted).
- 24 *Johnson v. Kraft Foods North America, Inc.*, 238 F.R.D. 648, 653 (D. Kan. 2006) (“A request for discovery should be allowed ‘unless it is clear that the information sought can have no possible bearing’ on the claim or defense of a party.”).
- 25 See, e.g., *Quest Communications International, Inc. v. WorldQuest Networks, Inc.*, 213 F.R.D. 418, 419 (D. Colo. 2003) (Shaffer, M.J.) (“[i]n every case, the court has the discretion, in the interests of justice, to prevent excessive or burdensome discovery”).
- 26 See *Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities, LLC*, 685 F. Supp. 2d 456, 461 (S.D.N.Y. 2010). Cf. *Lewis v. Sch. Dist. #70*, 2006 WL 2506465, at \*2 (S.D. Ill. Aug. 25, 2006) (“The Court does not doubt that modern technology would lessen the burden of search for relevant e-mails, but the search would undoubtedly not be perfect.”).
- 27 See, e.g. *In re Delta/AirTran Baggage Fee Antitrust Litigation*, \_\_ F. Supp. 2d \_\_, 2012 WL 360509, at \*13-14 (N.D. Ga. Feb. 3, 2012) (finding that defendant had failed to conduct a reasonable inquiry to support its implicit representations that all relevant hard drives had been identified and searched, and therefore its discovery responses were not complete or correct); *Fendi Adele v. Filene’s Basement, Inc.*, 2009 WL 855955, at \*8 (S.D.N.Y. Mar. 24, 2009) (“litigants have an obligation, when discovery is sought from them, to make reasonable efforts to locate responsive documents, including setting up ‘a reasonable procedure to distribute discovery requests to all employees and agents . . . potentially possessing responsive information, and to account for the collection and subsequent production of the information . . . .’”) (internal citations omitted); *Treppel v. Biouvail Corporation*, 233 F.R.D. 363, 374 (S.D.N.Y. 2006) (“Even in a case involving exclusively hard copy documents, there is no obligation on the part of a responding party to examine every scrap of paper in its potentially voluminous files in order to comply with its discovery obligations. Rather, it must conduct a diligent search which involves developing a reasonably comprehensive search strategy. . . . Defined search strategies are even more appropriate in cases involving electronic data, where the number of documents may be exponentially greater.”) (internal citations omitted).

This “reasonableness” standard is a defining characteristic of the discovery rules<sup>28</sup> and The Sedona Principles.<sup>29</sup>

To adequately respond to a request for production, the respondent must “conduct a reasonable search for responsive documents. Parties, along with their employees and attorneys, have a duty to act competently, diligently and ethically” with respect to discharging discovery obligations. . . . Parties “jeopardize the integrity of the discovery process by engaging in halfhearted and ineffective efforts to identify and produce relevant documents.”<sup>30</sup>

Litigation brought under the Freedom of Information Act (“FOIA”) provides a useful construct for applying the “reasonableness” standard to technology-assisted search methodologies. In response to a FOIA request, a government agency is expected to conduct a good faith search for the requested documents, using methods that can be reasonably expected to produce the information requested. The agency’s search “need not be perfect, only adequate,” and the measure of adequacy is defined as “the reasonableness of the effort in light of the [opposing party’s] specific request.”<sup>31</sup> As one court has acknowledged, “[r]easonableness does not require defendant to search every record system or to demonstrate that no other potentially responsive documents might exist to demonstrate reasonableness, but it must show ‘that it made a good faith effort to conduct a search for the requested records, using methods which can be reasonably expected to produce the information requested.’”<sup>32</sup> By analogy, a party should not be required to show that a search methodology is infallible or that the methodology is certain to find every potentially responsive document.

If “reasonableness” is the applicable measure of performance, the Federal Rules also identify factors that the court should consider in weighing a party’s efforts at compliance. The court is required to limit the frequency or extent of discovery where “the burden or expense of the proposed discovery outweighs its likely benefit, considering the needs of the case, the amount in controversy, the parties’ resources, the importance of the issues at stake in the action, and the importance of the discovery in resolving the issues.”<sup>33</sup>

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- 28 For example, a party is not required to provide electronically stored information from sources that the party identifies “as not reasonably accessible because of undue burden or cost.” See Fed. R. Civ. P. 26(b)(2)(B). *But see Carvel Asset Management v. Owen Financial Corp.*, 2010 WL 502721, at \*15 (D. Colo. Feb. 8, 2010) (a party seeking relief under Rule 26(b)(2)(B) “should present details sufficient to allow the requesting party [and the court] to evaluate the costs and benefits of searching and producing the identified sources”) (quoting *Mikron Indus., Inc. v. Hurd Windows & Doors, Inc.*, 2008 WL 1805727, at \*1 (W.D. Wash. Apr. 21, 2008) (internal quotation marks omitted). Similarly, a party serving a subpoena is required to “take reasonable steps to avoid imposing undue burden or expense on a party subject to the subpoena.” See Fed. R. Civ. P. 45(c). *Cf. Artbrex, Inc. v. Parcus Medical, LLC*, 2011 WL 6415540, at \*8 (S.D. Ind. Dec. 21, 2011) (in determining whether to shift costs under Rule 45(c), the court should consider various factors, including “the breadth of the materials to be produced; whether that breadth looks like a fishing expedition; whether the production necessarily requires expert involvement because of difficult electronic discovery issues, or the need for special and detailed review for privileged information; the relative resources of the party and non-party; whether the non-party is disinterested in the litigation or has a connection to the issuing party’s adversary; whether the non-party could have expected to have been drawn into the litigation or has an interest in the outcome of the case; and the reasonableness of the costs sought”).
- 29 See *The Sedona Principles, Second Edition: Best Practices Recommendations & Principles for Addressing Electronic Document Production* (The Sedona Conference Working Group Series, 2007) (“*The Sedona Conference Principles, Second Edition 2007*”), available at [www.thesedonaconference.org](http://www.thesedonaconference.org), and Principles 1 and 5 (the scope of preservation obligations involves “reasonable and good faith efforts” to preserve information that can “reasonably be anticipated to be relevant to litigation); Principle 8 (the primary source of ESI should be active data and resort to sources “not reasonably accessible” should be limited by proportionality concerns); Principle 11 (sources of data “reasonably likely to contain relevant information” can be identified by using “electronic tools and processes”); and Principle 12 (production of metadata extends to “reasonably accessible metadata” under certain conditions).
- 30 *Robinson v. City of Arkansas City, Kansas*, 2012 WL 603576, at \*4 (D. Kan. Feb. 24, 2012). *But see Benson v. Sanford Health*, 2011 WL 1135379, at \*4 (D.S.D. Mar. 25, 2011) (noting that Rule 34 does not “describe the lengths” to which a party must go to search for electronically stored information).
- 31 See, e.g., *Cuban v. S.E.C.*, 744 F. Supp. 2d 60, 69 (D.D.C. 2010).
- 32 *Information Network for Responsible Mining v. Department of Energy*, 2008 WL 762248, at \*4 (D. Colo. Mar. 18, 2008).
- 33 Fed. R. Civ. P. 26(b)(2)(C).

The scope of discovery in a particular case, and a party's corresponding discovery obligations, must be proportionate in light of the foregoing factors.<sup>34</sup> So, for example, in *Hock Foods, Inc. v. William Blair & Co., LLC*,<sup>35</sup> the court denied a motion to compel that sought "an order requiring Defendant to modify its protocol for searching electronically stored information." In opposing this motion, the defendant provided affidavits from its general counsel and a litigation technology project manager, who indicated that it would cost between \$1.3 and \$3.6 million to run the requested search terms. The court declined to require the defendant to undertake the requested search, finding that it would be "unduly burdensome for Defendant to search all of its electronic records for responsive information as originally requested."<sup>36</sup> While proportionality typically focuses on the scope of a discovery request or the results of the attendant production, proportionality considerations also are implicated by the *method* of production. Traditional manual review may be reasonable and effective when the requested production involves a very small set of documents or data. That same linear review methodology may be antithetical to the "just, speedy and inexpensive determination of [an] action"<sup>37</sup> where the requested production involves several terabytes of data. A defensible discovery process must take into considerable the certification requirement imposed by Fed. R. Civ. P. 26(g). By signing discovery responses or objections, counsel is certifying "to the best of [their] knowledge, information and belief formed after a reasonable inquiry . . . [that the response or objection] is consistent with these rules and warranted by existing law, . . . [is] not interposed for any improper purpose . . . and neither unreasonable or expensive considering the needs of the case, prior discovery in the case, the amount in controversy, and the importance of the issues at stake in the action."<sup>38</sup> Counsel further certifies under Rule 26(g) that his or her client has made "a timely, *reasonable, and diligent* search for all documents responsive to the [the opposing party's] discovery requests."<sup>39</sup>

Given the foregoing requirements under the Federal Rules of Civil Procedure, a defensible search protocol should satisfy the following criteria. First, the selected process must be *functional* (*i.e.*, the proposed methodology should be commensurate with the quantity of potentially responsive ESI and all pertinent data types, repositories and custodians/users). Here, the focus should be on the "fit" between the technology and the data collection to be searched. It would be a mistake to believe that one search methodology would be optimal for all cases and all data collections.<sup>40</sup> Second, the selected search methodology should be *reasonable* when measured against the proportionality factors set forth in Rule 26(b)(2)(C) and Rule 26(g). This factor considers the "fit" between the

34 See, e.g., *Victor Stanley, Inc. v. Creative Pipe, Inc.*, 269 F.R.D. 497, 524 (D. Md. 2010).

35 2011 WL 884446 (D. Kan. Mar. 11, 2011).

36 *Id.* at \*9.

37 Fed. R. Civ. P. 1.

38 Fed. R. Civ. P. 26(g)(1)(B).

39 *Zander v. Craig Hospital*, 2011 WL 834190, at \*1 (D. Colo. Mar. 4, 2011) (emphasis added).

40 See, e.g., *National Association of Radiation Survivors v. Turnage*, 115 F.R.D. 543, 556 (N.D. Cal. 1987) (holding that defendant's discovery omissions were directly attributable to the failure of the defendant and its counsel "to establish a coherent and effective system to faithfully and effectively respond to discovery requests;" that a reasonable inquiry "would have required, at a minimum, a reasonable procedure to distribute discovery requests to all employees and agents of the defendant potentially possessing responsive information and to account for the collection and subsequent production of the information to plaintiffs"). See also *I-Med Pharma Inc. v. Biomatrix, Inc.*, 2011 WL 6140658, at \*5 (D.N.J. Dec. 9, 2011) ("In evaluating whether a set of search terms are reasonable, a party should consider a variety of factors, including: (1) the scope of documents searched and whether the search is restricted to specific computers, file systems, or document custodians; (2) any date restrictions imposed on the search; (3) whether the search terms contain proper names, uncommon abbreviations, or other terms unlikely to occur in irrelevant documents; (4) whether operators such as "and," "not" or "near" are used to restrict the universe of possible results; and] (5) whether the number of results obtained could be practically reviewed given the economics of the case and the amount of money at issue.").

costs associated with the search methodology and the overall value of the litigation.<sup>41</sup> Third, the methodology must be demonstrably *reliable* in terms of recall and precision, or other appropriate metrics.<sup>42</sup> Admittedly, this criterion may present challenges to counsel and the court in selecting the proper metrics for quantifying accuracy and reliability. The producing party should anticipate future reliability challenges and incorporate quality assurance checks throughout the identification, collection, review and production process.

Finally, the selected methodology must be readily *understandable* to multiple audiences (e.g., the client, opposing counsel and the court).<sup>43</sup> Defensibility ultimately depends upon counsel’s ability to communicate in a clear and comprehensible way the technical and qualitative aspects of the methodology and the rationale for its selection. While many federal and state judges are becoming more comfortable with e-discovery issues, the reality is that most jurists have a steep learning curve when it comes to search methodologies and the technical challenges associated with electronic records management.<sup>44</sup> Lawyers remain resistant to technology-assisted search methodologies either because they lack sufficient knowledge about the capabilities of automated search tools or because there is a “perception that there is a lack of scientific validity of search technologies necessary to defend against a court challenge.”<sup>45</sup> The judiciary shares many of these limitations or misconceptions. Thus, counsel should approach defensibility from an educational, rather than adversarial perspective. Counsel should view their role as assisting the court, not in advocating for a zero-sum result. While counsel may erroneously believe that transparency is anathema to traditional notions of zealous advocacy, a defensible search methodology is one that is perceived by the court as reasonable and reliable.<sup>46</sup> In that respect, candor is counsel’s ally.

## WHEN AND HOW TO ADDRESS DEFENSIBILITY

From a procedural perspective, the issue of defensibility can arise at several different points in the pretrial process and require counsel to weigh important tactical considerations. Counsel will be making a record throughout the pretrial process that will have significant implications for any defensibility challenge. A producing party may choose a proactive approach from the outset of the litigation and address defensibility at the Rule 26(f) conference or during the Rule 16(b) scheduling conference. In that context, the goal

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- 41 See, e.g. Maura R. Grossman & Gordon V. Cormack, *Some Thoughts On Incentives, Rules and Ethics Concerning the Use of Search Technology in E-Discovery*, 12 Sedona Conf. J. 89, 94 (Fall 2011) (“If the cost of search exceeds the cost of resolving the dispute, the search method is clearly unjustified. To make an informed choice of search method, it is necessary for counsel to have a reliable estimate of the cost and effectiveness of the various alternatives. If the case is strong and can be supported by a few easy-to-find documents, there is little reason for the responding party conduct a more thorough, more expensive search.”).
- 42 “Recall, by definition, is an information retrieval performance measure that quantifies the fraction of known relevant documents that were effectively retrieved.” Another way to think about it is: out of the total number of relevant documents in the document collection, how many were retrieved correctly? *Precision* is defined as an information retrieval performance measure that quantifies the fraction of retrieved documents which are known to be relevant.’ Put another way, how much of the returned result set is on target.” *The Sedona Conference® Best Practices Commentary on the Use of Search and Information Retrieval Methods in E-Discovery*, 8 Sedona Conf. J. 189, 205 (Fall 2007).
- 43 See, e.g., Anne Kershaw & Joe Howie, *Judges’ Guide to Cost-Effective E-Discovery* 14 (Federal Judicial Center 2010) (indicating that a recent survey showed that while, on average predictive coding reduced review costs by 45 percent, “the largest single obstacle to more widespread adoption of predictive coding was the uncertainty over judicial acceptance of this approach”). See also *Bank of Mongolia v. M & P Global Financial Services, Inc.*, 258 F.R.D. 514, 519-20 (S.D. Fla. 2009) (in granting plaintiff’s motion to compel, the court noted that defense counsel “forthrightly acknowledged that he was unable to identify the steps taken to identify responsive documents” and “counsel was not able to articulate what Defendants had done in order to search for responsive documents”).
- 44 See, e.g., *United States v. Farlow*, 2009 WL 4728690, at \*6 n.3 (D. Me. Dec. 3, 2009) (“[e]ven the most computer literate of judges would struggle to know what protocol is appropriate in any individual case”).
- 45 *The Sedona Conference® Best Practices Commentary on the Use of Search and Information Retrieval Methods in E-Discovery*, 8 The Sedona Conf. J. 189, 203 (Fall 2007). See also Sonya L. Sigler, *Permission is One Thing; Adoption Quite Another*, The National Law Journal, May 21, 2012, available at [www.law.com/jsp/nlj/PubArticleNLJ.jsp](http://www.law.com/jsp/nlj/PubArticleNLJ.jsp); and Patrick Oot, Anne Kershaw & Herbert L. Roitblat, *Mandating Reasonableness in a Reasonable Inquiry*, 87 Denv. U. L. Rev. 533, 544-45 (2010) (“Unfortunately, many attorneys, judges, and other practitioners still maintain the mindset that traditional brute-force page-by-page attorney document review is a best practice when responding to massive discovery requests.”).
- 46 *The Sedona Conference® Commentary on Achieving Quality in the E-Discovery Process*, 10 Sedona Conf. J. 299, 307 (Fall 2009).



is to negotiate a mutually acceptable search protocol with the opposing party and then to have the court incorporate that protocol in the final scheduling order or adopt the protocol in a separate stipulated order.

Alternatively, a producing party may attempt to obtain some certainty at the outset of the discovery process by filing a motion for protective order under Rule 26(c). Adopting a proactive strategy does place the burden of persuasion on the moving party, but may establish some parameters on the identification, collection, review and production of ESI before substantial amounts of time and money are expended. More often, issues of defensibility surface in the context of a motion to compel or for sanctions filed near the end of the discovery process. At that point, the court is asked to resolve an after-the-fact and often irreconcilable conflict between the parties. Rather than seeking permission for a particular search protocol, the producing party may be in the more uncomfortable position of seeking approval (or forgiveness) or having to justify difficult decisions taken unilaterally earlier in the pretrial process. Resolution of defensibility issues in that context may turn on who bears the burden of persuasion and the quantum of proof necessary to sustain that burden.

#### *A. Rule 26(f) and The Advantages of Cooperation*

Once again, a defensible e-discovery plan should lead to the reliable and accurate identification and production of responsive, non-privileged materials using a search methodology that is reasonably transparent and justifiable in the context of the circumstances of the particular case. A defensible search protocol also should expedite the discovery process and minimize, if not eliminate completely, the need for judicial intervention. All of these goals can be achieved most efficiently and cost-effectively, from the outset of the litigation, through meaningful cooperation and dialogue between the parties.<sup>47</sup> The most “defensible” search methodology is one has been jointly adopted by the parties and endorsed by the court.

The court in *DeGeer v. Gillis*<sup>48</sup> described the lack of communication and unnecessary wrangling that all too frequently occurs in an ESI-intensive case:

Huron was in the best position to take the lead in selecting data custodians and search terms, but it should have been up-front with defense counsel regarding its proposed custodians and search terms and then receptive to defense counsel’s input. . . . On the other hand, Huron asked defense counsel repeatedly to suggest search terms, and Defendants’ counsel did not respond to those requests. Huron’s refusal to disclose the data custodians it identified and its search terms did not excuse Defendants from providing proposed data custodians and search terms in advance of the searches. This is not the kind of collaboration and cooperation needed to manage e-discovery efficiently and with the least expense possible. The proper and most efficient course of action would have been agreement by Huron and Defendants as to search terms

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<sup>47</sup> Cf. *Trusz v. UBS Realty Investors LLC*, 2010 WL 3583064, at \*4 (D. Conn. Sept. 7, 2010) (noting that cooperation “regarding the production of electronically stored information . . . allows the parties to save money, maintain greater control over the dispersal of information, maintain goodwill with courts, and generally get to the litigation merits at the earliest practicable time”); *William A. Gross Construction Associates, Inc. v. American Manufacturers Mutual Insurance Co.*, 256 F.R.D. 134 (S.D.N.Y. 2009) (acknowledging the “need for careful thought, quality control, testing, and cooperation with opposing counsel in designing search terms or ‘keywords’ to be used to produce emails or other electronically stored information”).

<sup>48</sup> 755 F. Supp. 2d 909, 929 (N.D. Ill. 2010).

and data custodians prior to Huron’s electronic document retrieval. Selecting search terms and data custodians should be a matter of cooperation and transparency among parties and non-parties.<sup>49</sup>

Rule 26(f)(3) requires the parties, in advance of the Rule 16 scheduling conference, to consider “the subjects on which discovery may be needed . . . whether discovery should be conducted in phases or be limited to or focus on particular issues, . . . [and] any issues about disclosure or discovery of electronically stored information.”<sup>50</sup> Notably, Rule 26(f)(3) is written in mandatory terms. The goal is to expedite the exchange of information and thereby avoid unnecessary discovery disputes.

Rather than dismissing the Rule 26(f) conference as an inconvenient or perfunctory exercise, litigants in an ESI-intensive lawsuit should view this procedure as a strategic opportunity.<sup>51</sup> In a perfect world, the parties will leave the Rule 26(f) conference with agreements on a range of subjects, including the scope of preservation and retention obligations; relevant data and ESI custodians; form of production, and the time required to identify, collect, review and produce ESI.<sup>52</sup> From the standpoint of defensibility, the parties should discuss what search techniques will be used to identify responsive or privileged ESI and what keyword or other filtering protocols would be appropriate.<sup>53</sup> While agreement on all of these issues is ideal, *any* understanding between the parties on e-discovery issues is preferable to gridlock.<sup>54</sup>

For the producing party, particularly in a case involving asymmetrical e-discovery burdens, the advantages of cooperation should be self-evident. However, the party seeking electronically stored information has just as much reason to avoid the “missed opportunity” of negotiating search parameters and methodologies.<sup>55</sup> The issue of search protocols should be approached as a topic of mutual interest, rather than as a friction point or an opportunity for gamesmanship.<sup>56</sup> The dispute in *Da Silva Moore* should not discourage

- 49 The court in *DeGeer* pointedly observed that while counsel “spent a significant amount of time exchanging letters and emails with each other relating to the motion to compel, they did not engage in meaningful discussions with each other.” *Id.*
- 50 Fed. R. Civ. P. 26(f)(3)(B) and (C). *Cf. Hopson v. Mayor and City Council of Baltimore*, 232 F.R.D. 228, 245 (D. Md. 2005) (observing that counsel have an obligation at the commencement of the litigation “to take the initiative in meeting and conferring” to develop a plan for the discovery of appropriate electronically stored information).
- 51 See Emery G. Lee, III & Kenneth J. Withers, *Survey of United States Magistrate Judges on the Effectiveness of the 2006 Amendments to the 2006 Amendments to the Federal Rules of Civil Procedure*, 11 Sedona Conf. J. 201, 207 (Fall 2010) (noting that 61% of of responding magistrate judges reported that Rule 26(f) conferences had reduced the number of e-discovery disputes they had been called upon to resolve).
- 52 See *Equal Employment Opportunity Commission v. McCormick & Schmick’s Seafood Restaurants, Inc.*, 2012 WL 380048, at \*4 (D. Md. Feb. 3, 2012) (while noting that the use of search terms is a common practice to reduce the burden of reviewing ESI, “[i]f the producing party generates the search terms on its own, the inevitable result will be complaints that the search terms were inadequate;” the court required “the parties to confer on the development of reasonable search terms to be used to obtain responsive email communications in this case”).
- 53 *Cf. S.E.C. v. Collins & Aikman Corporation*, 256 F.R.D. 403, 414 (S.D.N.Y. 2009) (observing that the “SEC’s blanket refusal to negotiate a workable search protocol responsive to [defendant’s] requests [was] patently unreasonable”). See also *McNulty v. Reddy Ice Holdings, Inc.*, 271 F.R.D. 569, 571 (E.D. Mich. 2011) (the court required counsel for the parties to “meet and confer, in good faith, in order to develop search terms or objective search criteria for use in identifying responsive and non-privileged documents within Home City’s reasonably accessible ESI material,” and further required “[a]s part of this meet-and-confer, [that] Plaintiff will provide for discussion reasonably fashioned search terms and criteria.”); *Board of Regents of University of Nebraska v. BASF Corp.*, 2007 WL 3342423, at \*5 (noting that in the discovery process, counsel have an obligation to remove contentiousness “as much as practicable” in order to expedite the pretrial process and minimize burden and expense).
- 54 *In re Facebook PPC Advertising Litigation*, 2011 WL 1324516, at \*1 (N.D. Cal. Apr. 6, 2011) (“[T]he argument that an ESI Protocol cannot address every single issue that may arise is not an argument to have no ESI Protocol at all. . . . [T]he clear thrust of the discovery-related rules, case law, and commentary suggests that ‘communication among counsel is crucial to a successful electronic discovery process’”).
- 55 See, e.g., *Ingersoll v. Farmland Foods, Inc.*, 2011 WL 1131129, at \*17-19 (W.D. Mo. March 28, 2011). In that case, the court denied the plaintiffs’ motion to compel after noting that the plaintiffs had refused to provide the defendant “with a list of proposed individuals and search terms related to [ESI]” and were now demanding “that Farmland produce ESI regardless of its relevancy and without first allowing Farmland the opportunity to assess the adequacy of its ESI proposal.”
- 56 *Trusz v. US Realty Investors LLC*, 2010 WL 3583064, at \*5 (“Among the items about which the court expects counsel to ‘reach practical agreement’ without the court having to micro-manage e-discovery are ‘search terms, date ranges, key players and the like.’”).

parties from considering the benefits of technology-assisted review, but it does highlight the need for counsel to maximize the opportunity for cooperation afforded by the Rule 26(f) process. The “growing pains” associated with technology-assisted review being played out *Da Silva Moore*, while expectable in this ever-evolving field, can be substantially diminished or avoided completely by counsel who are truly committed to controlling the costs and burdens of e-discovery.

It cannot be gainsaid that an adversarial approach to e-discovery only serves to increase the financial burdens of civil litigation and generate unnecessary delay. That realization lies at the heart of The Sedona Conference’s® Cooperation Proclamation and its call for a proactive and collaborative approach to e-discovery.

[W]orking cooperatively with opposing counsel to identify a reasonable search protocol, rather than making boilerplate objections to the breadth of a requested protocol or unilaterally selecting the keywords used without disclosure to opposing counsel, may help avoid sanctions or allegations of intentional suppression. Indeed, because knowledge of the producing party’s data is usually asymmetrical, it is possible that refusing to “aid” opposing counsel in designing an appropriate search protocol that the party holding the data knows will produce responsive documents could be tantamount to concealing relevant evidence.<sup>57</sup>

Early agreement on search methodologies should reduce the potential for time-consuming motion practice and expensive supplemental production. More importantly, cooperation in the selection of search methodologies will facilitate the production of relevant information and thereby eliminate surprise, promote the possibility of settlement, and set the stage for a well-trying case.

Too many litigants and their counsel fail to avail themselves of the benefits of the Rule 26(f) process, based on the misguided belief that intransigence or obfuscation translates into tactical advantage. The Federal Rules belie that notion. Discovery disputes and the resulting motion practice are all too common in an ESI-intensive case, and a party that fails to participate in good-faith in the Rule 26(f) process risks paying a price for that strategy. For example, an attorney or party that does not participate in good faith in developing and submitting a proposed discovery plan as required by Rule 26(f) can be required to pay the other party’s reasonable fees and costs caused by that failure.<sup>58</sup> The same sanctions can be imposed on a party or attorney who is substantially unprepared to participate in the Rule 16(b) scheduling conference.<sup>59</sup>

Rule 37(a)(5) provides that in the context of a motion to compel, a prevailing party may recover reasonable fees and costs, unless the court finds, *inter alia*, that “other circumstances make an award of expenses unjust.” In applying that Rule, the court cannot consider the non-prevailing party’s conduct in isolation, but rather should ask whether the “prevailing party also acted unjustifiably.”<sup>60</sup> Rule 37(a)(1) contemplates that both parties will make reasonable efforts to pursue discovery and resolve pretrial disputes without the need for court intervention. Given the parties’ obligation to participate in good faith in the

57 *The Case for Cooperation*, 10 The Sedona Conf. J. 339, 344 (Fall 2009) (internal citations omitted).

58 Fed. R. Civ. P. 37(f).

59 Fed. R. Civ. P. 16(f).

60 Advisory Committee Notes 10 1970 Amendments to Fed. R. Civ. P. 37(a)(4). Cf. *Burlington Insurance Co. v. Okie Dokie, Inc.*, 368 F. Supp. 2d 83, 91 (D.D.C. 2005) (finding that the “interests of justice [did] not warrant awarding expenses to plaintiff’s counsel” under Rule 37(a)(4) based upon the plaintiff’s own counterbalancing procedural violations).

preparation of a discovery plan, sanctions under Rule 37(a)(5) would seem to be “unjust” where a prevailing requesting party rebuffed the producing party’s good faith efforts to negotiate a mutually acceptable search protocol in the context of the Rule 26(f) process.

Similarly, Rule 26(b)(2)(C)(i) provides that the court must limit the frequency or extent of discovery where, *inter alia*, the discovery sought “can be obtained by some other source that is more convenient, less burdensome or less expensive.” By refusing to negotiate a mutually acceptable search protocol, it could be argued that the requesting party failed to take advantage of an early opportunity to obtain the desired information by a means that was “more convenient, less burdensome or less expensive.” The court’s observation in *Covad Communications Co. v. Revonet, Inc.*<sup>61</sup> is instructive. In that case, plaintiff’s counsel ignored the defendant’s repeated requests for suggested search terms. The court observed that “[g]iven that history it is unfair to allow Covad to fail to participate in the process and then argue that the search terms were inadequate.”<sup>62</sup> A party should understand that it ignores the potential benefits of Rule 26(f) at its peril.

### B. A Motion for Protective Order Under Rule 26(c)

If the parties cannot negotiate a mutually acceptable search protocol at the outset of the litigation, the producing party may still proactively seek relief, as did the defendants in *Global Aerospace*, and obtain early judicial approval for their proposed methodology. Rule 26(c) permits a party or person “from whom discovery is sought” to seek relief from “undue burden or expense.”<sup>63</sup> Upon a showing of good cause, the court has considerable discretion to provide alternative forms of relief, including “specifying terms . . . for the disclosure or discovery,” “prescribing a discovery method other than the one selected by the party seeking discovery,” or “forbidding inquiry into certain matters, or limiting the scope of disclosure or discovery to certain matters.”<sup>64</sup> In exercising its discretion under Rule 26(c), the court must balance the competing considerations of allowing discovery and protecting parties or other persons from undue burdens.<sup>65</sup>

A party seeking relief under Rule 26(c) bears the burden of persuasion and must make a “particular and specific demonstration of fact’ in support of its request.”<sup>66</sup> To support a motion for protective order proposing a particular search protocol, the producing party should provide the court with information from which it can reasonably conclude that the proposed methodology is both reliable and a reasonable response to the nature and magnitude of the ESI at issue in the case. The moving party also should remain mindful of the reasonable discovery needs of the opposing party and be prepared to explain to the court how those needs will be met by the proposed methodology.<sup>67</sup>

61 258 F.R.D. 5, 13 (D.D.C. 2009) (noting that “[i]t is the rare case that a litigant does not allege some deficiency in the production of electronically stored information, particularly e-mail.”).

62 *Id.* at 14.

63 Fed. R. Civ. P. 26(c).

64 *Id.*

65 *Cf. Exam v. United States Olympic Comm.*, 209 F.R.D. 201, 206 (D. Colo. 2002). *See also St. John v. Napolitano*, 274 F.R.D. 12, 16 (D.D.C. 2011) (noting that the court has “broad discretion to tailor discovery narrowly” under Rule 26 and suggesting that “[i]t is appropriate for the court, in exercising its discretion . . . to undertake some substantive balancing of interests”).

66 *See, e.g., Aikens v. Deluxe Financial Services, Inc.*, 217 F.R.D. 533, 536-37 (D. Kan. 2003) (holding that where a Rule 26(c) motion is based upon claim of undue expense or burden, the moving party must submit affidavits or other detailed explanation as to the nature and extent of the burden or expense); *Flint Hills Scientific, LLC v. Davidchack*, 2001 WL 1718291, at \*2 (D. Kan. Dec. 3, 2001) (Rule 26(c) requires a “particular and specific demonstration of fact, as distinguished from stereotyped and conclusory statements”) (quoting *Gulf Oil Co. v. Bernard*, 452 U.S. 89, 102 n. 16 (1981)).

67 *Cf. Duling v. Gristede’s Operating Corp.*, 266 F.R.D. 66, 71 (S.D.N.Y. 2010) (the court, in ruling on a motion for protective order, must balance the litigation needs of the discovering party and the countervailing interests of the producing party).

There are significant tactical advantages to pursuing early relief under Rule 26(c). A successful motion for protective order will provide the producing party with a measure of certainty before incurring considerable time and expense in document collection and review, even if the court declines to adopt the proposed methodology in its entirety.<sup>68</sup> To be sure, a protective order endorsing the producing party's preferred search methodology will not preclude a subsequent motion challenging the results of the production process. However, a successful Rule 26(c) motion may go a long way toward circumscribing a future motion to compel and neutralizing a request for fees and costs under Rule 37(a)(5).

### C. A Motion to Compel Under Rule 37(a)

A producing party loath to exploit the tactical advantages of Rule 26(f) and Rule 26(c) faces the very real possibility of having to defend the reliability and legal sufficiency of its search methodology in the context of a motion to compel filed in the late stages of the discovery process. One need only read the transcripts from the *Kleen Products* hearing to appreciate the implications of such a motion.

In the typical discovery dispute, the requesting party challenges the sufficiency of the responding party's interrogatory responses and/or document production by filing a motion to compel under Rule 37(a)(3).<sup>69</sup> The motion invariably argues that the producing party has frustrated the objectives underlying the discovery process by withholding relevant, non-privileged information, making spurious objections or improperly asserting privileges. In short, the typical motion to compel is directed to the sufficiency of the responding party's response or final product, not to the *process* from which that product is derived.

Assuming the requested information or material is facially relevant to a claim or defense or likely to lead to the discovery of relevant information, the party resisting discovery assumes the burden of persuasion.<sup>70</sup> "In most cases, the moving party need only file its motion to compel and draw the court's attention to the relief the party seeks. At that point, the burden is on the nonmoving party to support its objections with specificity and, where appropriate, with reference to affidavits and other evidence."<sup>71</sup> The court is not required to have a hearing and may decide the motion based solely on the written submissions of the parties.<sup>72</sup>

This conventional approach and the corresponding burden of persuasion is not appropriate where the motion to compel is directed primarily at the producing party's search methodology. Rule 34 does not specify *how* a party must search the documents or ESI in its possession, custody or control, and does not assign that decision to the requesting party. To the contrary, as noted in Principle 6 of The Sedona Principles, the producing party is in the best position to select the most appropriate methods or procedures for reviewing, evaluating and producing its electronically stored information.<sup>73</sup> As a technical

68 See, e.g., *Wood v. Capital One Services, LLC*, 2011 WL 2154279, at \*8 (N.D.N.Y. Apr. 15, 2011) (in granting defendants' motion for protective order, the court held that defendants had sustained their burden of showing that the effort and expense associated with search for and producing requested information far outweighed any potential relevance; the court noted that the parties had already engaged in substantial discovery and that plaintiff's additional requested searches would generate, after elimination of duplicates, approximately 1,753,537 additional documents at a cost of more than \$5,000,000 to process, review and produce).

69 Fed. R. Civ. P. 37(a)(3)(A) and (B).

70 See, e.g., *Morris v. Lowe's Home Centers, Inc.*, 2012 WL 1073405, at \*3 (M.D.N.C. Mar. 29, 2012).

71 *Ice Corp. v. Hamilton Sundstrand Corp.*, 2007 WL 1364984, at \*6 (D. Kan. May 9, 2007) (quoting *Williams v. Sprint/United Management Co.*, 2005 WL 731070, at \*7, 13 (D. Kan. March 30, 2005)).

72 See, e.g., *Cummings v. General Motors Corp.*, 2002 WL 32713320, at \*1 (W.D. Okl. June 18, 2002), *aff'd*, 365 F.3d 944 (10th Cir. 2004).

73 *The Sedona Principles, Second Edition: Best Practices Recommendations & Principles for Addressing Electronic Document Production (The Sedona Conference® Working Group Series, 2007)* ("The Sedona Conference® Principles, Second Edition 2007"), available at [www.thosedonaconference.org](http://www.thosedonaconference.org).

matter, no methodology can produce perfect results. Given that there “are probably more ways of gathering, processing and producing ESI than there are lawyers,”<sup>74</sup> a producing party should not have to “prove the correctness” of its selected protocol to the exclusion of all other methodologies.<sup>75</sup> For that reason, applying the usual motion to compel paradigm to disputes concerning search methodologies simply invites a protracted evidentiary hearing that may devolve into a battle between competing vendors advocating for their own software product.<sup>76</sup>

Where the motion to compel challenges the search methodology employed by the producing party, the requesting party should be required, as a threshold matter, to demonstrate the relevance of the desired ESI under Rule 26(b)(1)<sup>77</sup> and the “reasonableness” of the requested discovery under the proportionality factors set forth in Rule 26(g). The moving party also should be required to show that the opposing party actually failed to produce responsive materials as a result of the methodology employed or that the selected protocol is demonstrably likely to miss responsive documents.

Assuming this threshold showing is made, the burden should shift to the producing party to demonstrate the reasonableness of the selected protocol in light of the particular circumstances of the pending case. The producing party should be prepared to defend its technological decisions “with affidavits or other equivalent information from persons with the requisite qualifications and experience, based on sufficient facts or data and using reliable principles or methodology.”<sup>78</sup> It remains for the producing party to explain the rationale underlying the selected search methodology, “demonstrate that it is appropriate for the task, and show that it was properly implemented.”<sup>79</sup>

However, the producing party should not be required to prove that the selected methodology is “correct” or infallible, or that the resulting production was perfect. A search methodology should not be subject to challenge simply because experts or opposing parties have their own preferred approach, or have vague, unsubstantiated suspicions that documents or ESI are missing. Again, the court’s focus under Rule 37(a) should be on the result of the search, not the process itself. The court should resist a *post hoc* invitation to

74 Anne Kershaw & Joe Howie, *Judges’ Guide to Cost-Effective E-Discovery*, at iii (Federal Judicial Center 2010).

75 *The Sedona Conference\* Commentary on Achieving Quality in the E-Discovery Process*, 10 Sedona Conf. J. 299, 315-16 (Fall 2009) (“Given the ad hoc nature of the [data collection] process, it is not surprising that objective benchmarks, standards and regulations specific to the governing of this process do not exist.”).

76 To paraphrase the notable military theorist, Carl von Clausewitz, litigation should not be the continuation of marketing by other means.

77 *Cf. Davis v. Young*, 2012 WL 530917, at \*3 (E.D. La. Feb. 16, 2012). See also *Jones v. National Council of Young Men’s Christian Associations of the United States*, 2011 WL 7568591, at \*2 (N.D. Ill. Oct. 21, 2011) (in denying in part plaintiffs’ motion to compel the production of additional ESI, the court concluded that “plaintiffs’ untargeted, all-encompassing request fails to focus on key individuals and the likelihood of receiving relevant information;” finding that “the Court needs to step in as Plaintiffs are asking for too much here and the entire burden should not be on Defendants”).

78 *Victor Stanley, Inc. v. Creative Pipe, Inc.*, 250 F.R.D. 251, 261 n. 10 (D. Md. 2008). See also *Seven Seas Cruises S. De R.L. v. V. Ships Leisure SAM*, 2011 WL 772855, at \*1 (S.D. Fla. Feb. 19, 2011) (in response to plaintiffs’ motion to compel electronically stored information, the court ordered the defendants to submit an affidavit setting forth the steps undertaken by the defendants to respond to plaintiffs’ ESI requests); *Dorsey v. Equal Employment Opportunity Commission*, 2010 WL 3894590, at \*2 (S.D. Cal. Sept. 29, 2010) (holding in a FOIA case that the defendant agency can prove the reasonableness of its search “through affidavits of responsible agency officials so long as the affidavits are relatively detailed, nonconclusory and submitted in good faith. . . . They must describe what records were searched, by whom, and through what processes’ . . . [and] must demonstrate that the search was reasonably calculated to uncover all relevant documents”); *White v. Graceland College Center for Professional Development & Lifelong Learning, Inc.*, 586 F. Supp. 2d. 1250, 1262 (D. Kan. 2008) (in response to a motion to compel, defendants produced an affidavit from their Director of Information Systems; plaintiff challenged the sufficiency of that affidavit, arguing that the affiant had not “indicated when he conducted his searches, how he conducted the searches, and whether he found any documents as a result of his searches;” the court rejected that challenge, finding that the defendants had sufficiently identified the “computers and networks that were searched for responsive documents and explained why some old computers and loaner” computers were not searched).

79 *Cf. Victor Stanley, Inc. v. Creative Pipe, Inc.*, 250 F.R.D. at 260, 262. But see *Chura v. Delmar Gardens of Lenexa, Inc.*, 2012 WL 940270, at \*12 (D. Kan. Mar. 20, 2012) (finding that an evidentiary hearing was necessary as the “minimal information” provided limited the court’s “ability to determine whether Defendant met its duty to conduct a reasonable search for ESI responsive to many of Plaintiff’s discovery requests . . . [and] [i]t is unclear what actions Defendant undertook in order to preserve and search for responsive ESI.”).

second-guess or draw qualitative or narrow quantitative distinctions between competing search methodologies. To borrow from the United States Supreme Court, even assuming that alternative search methodologies are available, “it does not follow that the search as conducted was unreasonable.”<sup>80</sup>

The analysis suggested in this article is not unlike the standard set forth in Rule 37(a)(5)(A)(ii), which provides that the court should not impose fees and costs where the non-prevailing party’s position was “substantially justified.”<sup>81</sup> For purposes of Rule 37(a)(5)(A)(ii), a non-prevailing party’s position is substantially justified where that position is “justified in substance or in the main – that is, justified to a degree that could satisfy a reasonable person.”<sup>82</sup> Stated alternatively, “substantial justification” is “justification to a degree that could satisfy a reasonable person that parties could differ” on the point at issue.<sup>83</sup>

Once the producing party has demonstrated the reasonableness and reliability of its preferred methodology, the ultimate burden of persuasion should fall on the requesting party.<sup>84</sup> That party should be required to show that the producing party selected its methodology in bad faith (e.g., that the producing party selected search terms or a “seed set” of relevant exemplars fully realizing that the resulting search would omit obviously responsive documents),<sup>85</sup> or that the chosen protocol is so statistically or scientifically unreliable as to cause actual and substantial prejudice to the requesting party. It should be self-evident that the requesting party could not sustain its burden of persuasion based solely on suspicions or assumptions.<sup>86</sup>

## THE APPLICABILITY OF RULE 702 AND *DAUBERT*

Application of the “reasonableness” standard in the context of a technology-assisted e-discovery process invariably will present the court with methodologies or forensic techniques which are beyond the knowledge or skills of a layperson, and certainly outside the experience of most judges. The court inevitably will find itself in the “uncomfortable position” of having to weigh dueling expert opinions and evaluate the merits of competing e-discovery search protocols.<sup>87</sup>

80 *Cf. City of Ontario, California v. Quon*, \_\_ U.S. \_\_, 130 S.Ct. 2619, 2632 (2010) (in the context of a Fourth Amendment search, noting that “judges engaged in *post hoc* evaluations of government conduct can almost always imagine some alternative means by which the objectives of the government might be accomplished”).

81 Fed. R. Civ. P. 37(a)(5)(A)(ii).

82 *Romary Associates, Inc. v. Kibbi LLC*, 2011 WL 4005346, at \*6 (N.D. Ind. Sept. 8, 2011). See also *Underdog Trucking, LLC v. Verizon Services Corp.*, 273 F.R.D. 372, 377 (S.D.N.Y. 2011); *JSR Micro, Inc. v. QBE Insurance Co.*, 2010 WL 1957465, at \*2 (N.D. Cal. May 14, 2010).

83 *Klatch-Maynard v. Sugarloaf Township*, 2011 WL 2006424, at \*2 (M.D. Pa. May 23, 2011).

84 *Covad Communications Co. v. Revonet, Inc.*, 258 F.R.D. at 15 (holding that if a party seeks to conduct additional searches, that party must file a motion “explaining why the results of the search conducted, the history of the controversy between the parties and of this litigation, the controlling law and any other factor, justify the additional search sought”).

85 See, e.g., *Bailey Industries, Inc. v. CLJP, Inc.*, 270 F.R.D. 662, 671 (N.D. Fla. 2010) (granting the plaintiff’s motion to compel email communications after concluding that the subpoena recipient’s production was demonstrably incomplete and that “the search conducted by CLJP did not include obviously relevant search terms”).

86 *Cf. Orillaneda v. French Culinary Institute*, 2011 WL 4375365, at \*7 (S.D.N.Y. Sept. 19, 2011) (in granting in part the defendant’s motion for protective order, the court noted that the “[p]laintiff’s general statements concerning defendant’s production do not identify the ways in which this production was deficient”); *Averill v. Gleaner Life Insurance Soc.*, 626 F. Supp. 2d 756, 766 (N.D. Ohio 2009) (the mere suspicion that the responding party must have additional documents will not suffice to warrant granting a motion to compel); *In re Application for an Order for Judicial Assistance*, 244 F.R.D. 434, 437-38 (N.D. Ill. 2007) (denying a motion to compel that was based the petitioners’ own notions of what is conceivable for McDonald’s to possess; the court concluded that “[t]he evidence and speculation on which Petitioners base their belief is simply insufficient to support their motion to compel”). See also *Lazaridis v. United States Department of Justice*, 766 F. Supp. 2d 134, 141 (D.D.C. 2011) (in the context of FOIA litigation, a party challenging the agency’s production must raise “substantial doubt” about the adequacy of the search; “the [mere] fact that a particular document was not found does not demonstrate the inadequacy of a search”).

87 *Cf. William A. Gross Construction Associates, Inc. v. American Manufacturers Mutual Insurance Co.*, 256 F.R.D. at 135.

Acknowledging the role that experts inevitably will likely play in the development, implementation and defense of a technology-assisted discovery process frames the next question. What standard should the court apply in evaluating expert testimony regarding the producing party’s search methodology? Unfortunately, case law provides little guidance in answering that question. In *O’Keefe*, Magistrate Judge Facciola concluded that the selection and development of e-discovery search terms “is clearly beyond the ken of a layman and requires that any such conclusion be based on evidence that, for example, meets the criteria of Rule 702 of the Federal Rules of Evidence.”<sup>88</sup>

[I]f defendants are going to contend that the search terms used by the government were insufficient, they will have to specifically so contend in a motion to compel and their contention must be based on evidence that meets the requirements of Rule 702 of the Federal Rules of Evidence.<sup>89</sup>

More recently, Magistrate Judge Peck suggested that “Rule 702 and *Daubert* simply are not applicable to how documents are searched for and found in discovery.”<sup>90</sup> The seemingly conflicting positions articulated in *O’Keefe* and *Moore I* are not irreconcilable. While Judges Facciola and Peck may have differing views on the applicability of Rule 702 in an e-discovery pretrial context, the decisions in *O’Keefe* and *Moore I* reflect the same underlying concern: will the discovery protocol in question produce results that are reliable and consistent with the requirements and objectives underlying the Federal Rules of Civil Procedure? In the final analysis, a debate over the literal applicability of Rule 702 may be more distracting than helpful.

It is important to remember that Rule 702 establishes a legal framework for the admission of expert opinion and, in that respect, is not a rule of exclusion.<sup>91</sup> Expert testimony should be permitted to the extent it “will help the trier of fact to understand the evidence or to determine a fact in issue.”<sup>92</sup> The judge typically serves as a “gatekeeper” for the jury, providing a preliminary assessment of the expert’s qualifications and methodology, and the “fit” between the expert’s opinions and the facts at issue.<sup>93</sup> Expert opinion testimony is admissible if the expert is appropriately qualified and if “(1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.”<sup>94</sup> In applying the Rule 702 factors, the court has considerable discretion.<sup>95</sup>

88 *United States v. O’Keefe*, 537 F. Supp. 2d at 24. See also *Equity Analytics LLC v. Lundin*, 248 F.R.D. at 333 (requiring the defendant “to submit an affidavit from its examiner explaining why the limitations proposed by plaintiff are unlikely to capture all the information Equity seeks and the impact, if any, of the loading of the new operating system on Lundin’s computer and the data that was on it before the new operating system was loaded. The expert shall also describe in detail how the search will be conducted. Armed with that information, supplemented if necessary by a hearing at which the expert will be cross examined, [the court] can make the best possible judgment as to how to balance Equity’s need for information against Lundin’s privacy.”).

89 *Id.* See also Fed. R. Evid. 1101 (“These rules apply to the United States district courts . . . and United States magistrate judges, in the actions, cases and proceedings and to the extent hereinafter set forth. . . . These rules apply generally to civil actions and proceedings . . .”).

90 *Moore I*, 2012 WL 607412, at \*7.

91 See *Arcoren v. United States*, 929 F.2d 1235, 1239 (8th Cir.), cert. denied, 502 U.S. 913 (1991). See also *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 588-89 (1993) (acknowledging the Federal Rules of Evidence’s “permissive backdrop” and their “general approach of relaxing the traditional barriers of ‘opinion’ testimony”).

92 Fed. R. Evid. 702(a).

93 See, e.g., *Samuels v. Holland American Line-USA, Inc.*, 656 F.3d 948, 952 (9th Cir. 2011).

94 Fed. R. Evid. 702.

95 *Smith v. Ingersoll-Rand Co.*, 214 F.3d 1235, 1243 (10th Cir. 2000) (Rule 702 analysis involves “a flexible and commonsense undertaking in which the trial judge is granted ‘broad latitude’ in deciding both how to determine reliability as well as in the ultimate decision of whether the testimony is reliable”). See also *Murray v. Marina Dist. Development Co.*, 311 Fed. Appx. 521, 523 (3rd Cir. 2008) (holding that the trial court did not abuse its discretion by failing to hold a *Daubert* hearing where the evidentiary record was otherwise sufficient to allow the court to ascertain the expert’s methodology and make a proper reliability determination); *Corwin v. Walt Disney Co.*, 475 F.3d 1239, 1252 (11th Cir. 2007) (noting that while *Daubert* hearings are often helpful, hearings are not a prerequisite under Rule 702).



“There is less need for the gatekeeper to keep the gate when the gatekeeper is keeping the gate only for himself.”<sup>96</sup> At a bench trial, for example, the judge may permit the challenged expert to testify, subject to the rigors of cross-examination, and decide later whether the expert’s opinions are entitled to some consideration or whether they should be excluded as unreliable or irrelevant.<sup>97</sup> Similarly, there is little need for a Rule 702 “gatekeeper” in the context of a motion to compel or motion for protective order, as there is no trier of fact to “protect.” The court can simply hear the expert testimony and give the opinions whatever weight the court deems appropriate.<sup>98</sup>

While a motion to compel or motion for protective order may not trigger the same “gatekeeper” responsibilities that would apply in a jury trial setting, motions in an ESI-intensive case not infrequently may require expert testimony. The reasonableness of a technology-assisted review process ultimately may turn on why and how a particular protocol was selected and implemented, and whether that protocol appropriately discharges the producing party’s discovery obligations. Answering those questions almost certainly will require affidavits or testimony from individuals with education, training or experience beyond a layperson’s common knowledge, but they should not provide an opportunity for the opposing party to eviscerate the time and cost savings the new technologies were designed to produce.

Even if a party is inclined to argue that the Federal Rules of Evidence do not apply in the context of a motion for protective order or motion to compel, courts confronted with opinion testimony in support of or in opposition to a technology-assisted discovery process likely will look to Rule 702 case law for guidance. Indeed, the Rule 702 standards are well-suited to the constantly evolving technology impacting e-discovery.

An expert is “‘required to possess’ such skill, experience or knowledge in that particular field as to make it appear that his opinion would rest on substantial foundation.”<sup>99</sup> In defending a particular e-discovery protocol as reasonable, a party should be prepared to offer testimony from an individual with actual knowledge pertinent to the specific issues raised by the motion.<sup>100</sup> The qualifications prong of Rule 702 does not require more than that. The court should not exclude appropriate expert testimony simply because the witness is not the “most qualified”<sup>101</sup> or does not have the specialization considered most appropriate by the opposing party or the court.<sup>102</sup>

96 *United States v. Brown*, 415 F.3d 1257, 1269 (11th Cir. 2005), cert. denied, 547 U.S. 1023 (2006). Cf. *Davis v. United States*, 2012 WL 424887, at \*5 (E.D. Ky. Feb. 9, 2012) (acknowledging that “[t]he main purpose of *Daubert* exclusion is to protect juries from being swayed by dubious scientific testimony” and “[t]hat interest is not implicated . . . where the judge is the decision maker”) (quoting *In re Zurn Pex Plumbing Products Liability Litigation*, 644 F.3d 604, 613 (8th Cir. 2011)).

97 Cf. *Fowler v. United States*, 2011 WL 1004574, at \*6 (N.D. Ill. Mar. 18, 2011). See also *New York v. Solvent Chemical Company, Inc.*, 2006 WL 2640647, at \*2 (W.D.N.Y. Sept. 14, 2006).

98 See Fed. R. Evid. 102 (acknowledging that the Federal Rules of Evidence “should be construed so as to administer every proceeding fairly, eliminate unjustifiable expense and delay . . . to the end of ascertaining the truth and securing a just determination”).

99 *Markham v. BTM Corp.*, 2011 WL 1231084, at \*16 (D. Kan. Mar. 30, 2011) (quoting *LifeWise Master Funding v. Telebank*, 374 F.3d 917, 928 (10th Cir. 2004)).

100 See, e.g., *Veritas Operating Corp. v. Microsoft Corp.*, 2008 WL 687118, at \*3 (W.D. Wash. Mar. 11, 2008) (while acknowledging that the defendant’s expert was qualified to testify as to programming standards within the computer software industry, precluded that expert from offering opinions on issues that required source code analysis as the witness acknowledged during his deposition that he was not an expert with regard to code analysis or software architecture). But see *Galaxy Computer Services, Inc. v. Baker*, 325 B.R. 544, 563 (E.D. Va. 2005) (held that plaintiff’s computer expert was qualified under Rule 702 even though none of his degrees were in computer science, he was not fluent in any computer language, and he did not hold any certificates in computer science; the court concluded that “the field of computer forensics does not require a background in computer programming or reading and writing code”).

101 *Raytheon Co. v. United States*, 2009 WL 1373959, at \*1 (Fed. Cl. May 13, 2009) (citing *Hollbrook v. Lykes Brothers S.S. Co.*, 80 F.3d 777, 782 (3rd Cir. 1996)).

102 *Squires ex rel. Squires v. Goodwin*, \_\_\_ F. Supp. 2d \_\_\_, 2011 WL 5331583, at \*4 (D. Colo. Nov. 7, 2011) (Shaffer, M.J.). But see *Solaia Technology LLC v. ArvinMeritor, Inc.*, 361 F. Supp. 2d 797, 812-14 (N.D. Ill. 2005) (in an action alleging infringement of plaintiff’s software, held that a computer expert’s qualifications to testify regarding industrial controls generally would not suffice to overcome the witness’ own disclaimer of expertise in the analysis of Windows programming or a particular operating system at issue).

Similarly, the court’s responsibility under Rule 702 is not to determine whether the witness’ opinion (or the selected search methodology) is “correct,” but rather whether the opinion is based upon a reliable methodology.<sup>103</sup> The court, in applying this factor, “not only has broad latitude in determining whether an expert’s testimony is reliable, but also in deciding *how* to determine the testimony’s reliability.”<sup>104</sup> Drawing on the Rule 702 standard for reliability, the proponent of an e-discovery search protocol process should be required to demonstrate that the selected “tool or method has adequately and accurately collected or captured responsive documents and ESI”;<sup>105</sup> in sum, that the process and the outcome are reasonable.

## CONCLUSION

Technology-assisted review procedures have the potential to reduce discovery costs and expedite the production of relevant, non-privileged ESI. All of these benefits, however, are lost if counsel and their clients, as well as the courts, become embroiled in unnecessary and distracting motion practice. In the wake of recent court decisions, particularly *Da Silva Moore*, clients and their counsel must consider issues of defensibility in selecting and implementing an ESI search methodology. A defensible e-discovery protocol is one that is reliable, reasonable under the circumstances of the subject litigation, and promotes the “just, speed, and inexpensive determination of [the] action.” Each of these goals, and the ultimate defensibility of any search methodology, is best achieved through cooperative interaction between counsel for the parties.

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103 See, e.g., *In re Scrap Metal Antitrust Litigation*, 527 F.3d 517, 529-30 (6th Cir. 2008), cert. denied, \_\_\_ U.S. \_\_\_, 129 S.Ct. 1673 (2009). See also *United States v. Williams*, 235 Fed. Appx. 925, 928 (3rd Cir.) (“The requirement of reliability is lower than the standard of correctness.”), cert. denied, 552 U.S. 1082 (2007).

104 *Hangarter v. Provident Life and Accident Insurance, Co.*, 373 F.3d 998, 1017 (9th Cir. 2004)( internal citations omitted) (emphasis in original).

105 See *The Sedona Conference® Commentary on Achieving Quality in the E-Discovery Process*, 10 Sedona Conf. J. 299, 308 (Fall 2009).

# STORM CLOUDS GATHERING FOR CROSS-BORDER DISCOVERY AND DATA PRIVACY: CLOUD COMPUTING MEETS THE U.S.A. PATRIOT ACT

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Last June, a Microsoft executive noted at a launch of Microsoft 365 in London that U.S.-based Cloud Computing<sup>1</sup> providers could be compelled, notwithstanding the EU Data Protection Directive,<sup>2</sup> to secretly release personal data of EU citizens pursuant to a National Security Letter (NSL) under the U.S.A. Patriot Act (“Patriot Act”), even if that data is stored on servers physically located within the EU region. These statements sparked a more vigorous global debate regarding the conflict between cross-border discovery and data privacy.<sup>3</sup> This article examines the controversy surrounding the extraterritorial reach of the Patriot Act to global “Cloud Computing” providers.<sup>4</sup> In particular, it considers whether, and to what extent, the Patriot Act<sup>5</sup> may apply to Cloud Computing providers, and how this may impact the cross-border discovery/disclosure and data privacy conflict. The article also suggests some best practices to help mitigate risk in this context.

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- 1 Cloud computing is defined as “a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction.” Peter Mell, “The NIST Definition of Cloud Computing, Recommendations of the National Institute of Standards and Technology,” *NIST Special Publication*, 800-145, September 2011, <http://csrc.nist.gov/publications/nistpubs/800-145/SP800-145.pdf>; see also W. Kuan Hon, Christopher Millard, Ian Walden, “The Problem of ‘Personal Data’ in Cloud Computing – What Information Is Regulated?,” 2001, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1783577](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1783577).
- 2 Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data. *Official Journal L 281*, 23/11/1995.
- 3 See Jennifer Baker, “EU upset by Microsoft warning on U.S. access to EU Cloud,” *Computerworld*, July 5, 2011, <http://www.computerworld.com/s/article/9218167>. Jeff Bullwinkle, Director of Legal and Corporate Affairs at Microsoft Australia, stated: “In a limited number of circumstances, Microsoft may need to disclose data without your prior consent, including as needed to satisfy legal requirements, or to protect the rights or property of Microsoft.” See also Zach Whittaker, “European companies ‘need confidence’ over Patriot Act concerns,” September 1, 2011, <http://www.zdnet.com/blog/btl/european-companies-need-confidence-over-patriot-act-concerns/56878>.
- 4 Deputy Assistant Attorney General Bruce Schwartz is reported to have commented: “The Patriot Act really in this context is a red herring. It didn’t work a fundamental change in how we approach the issues of stored data.” Kenneth Corbin, “Foreign Cloud Privacy Issues Dismissed by U.S. Officials,” *CIO Magazine*, January 19, 2012, [http://www.cio.com/article/698312/Foreign\\_Cloud\\_Privacy\\_Issues\\_Dismissed\\_by\\_U.S.\\_Officials](http://www.cio.com/article/698312/Foreign_Cloud_Privacy_Issues_Dismissed_by_U.S._Officials).

## THE DRIVE TOWARD CLOUD COMPUTING

Although “Cloud Computing” is an evolving technology paradigm, it essentially involves remote hosting and Internet access to various combinations of computer hardware, software, and data.<sup>6</sup> The drive toward Cloud Computing is fueled by economics – the ability to reduce the increasingly high cost of in-house information technology (“IT”) systems and services.<sup>7</sup> According to an independent study by the Pew Research Center, 71% of technology experts and stakeholders expect that by 2020, most people will access software applications online and share and access information through the use of remote Cloud Computing networks, rather than individual, personal computers.<sup>8</sup> And according to independent technology consultant Gartner, the Cloud Computing industry is expected to grow from annual revenues of \$68.3b in 2010 to \$148.8b in 2014.<sup>9</sup> By leveraging and sharing large IT infrastructures, platforms, software, and data storage centers, Cloud Computing can, by conservative estimates, reduce by 25 to 30 percent the “all-in” costs of traditional IT services.<sup>10</sup> It also provides small and medium size organizations without sufficient budget with a reliable, available, and affordable IT option. In this sense, Cloud Computing can use economies of scale to “even the playing field” between small and large business. Cloud Computing allows companies to outsource IT service, cutting expenses for equipment, labor, training, security, and other costs associated with maintaining an on-site data services.<sup>11</sup>

Cloud Computing also significantly alters the data security risk landscape in one important respect – now, the obligation for data security and the protection of personal information stored in the cloud squarely rests upon the shoulders of the cloud service provider.<sup>12</sup> Cloud service providers may be located and do business anywhere in the world, thus subjecting them to the laws of the many jurisdictions. The Patriot Act is one such law, which may create serious complications for cloud service providers and those who choose to use them.

## APPLICATION OF THE PATRIOT ACT

The Patriot Act essentially aggregates a variety of U.S. statutory provisions and procedures related to law enforcement, surveillance, and privacy protection, including the

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- 5 Pub. L. No. 107-56, 115 Stat. 272 (2001). The full title of the Act is “Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (U.S.A. PATRIOT ACT) Act of 2001.”
  - 6 See Jared A. Harshbarger, “Cloud Computing Providers and Data Security Laws: Building Trust With United States Companies,” *16 J. Tech. L. & Pol’y* (2011): 229, 231; see also National Institute of Standards and Technology, “Cloud Computing Synopsis and Recommendations” (May 2012): § 2 (discussing the essential characteristics, service models, and deployment models with respect to cloud computing).
  - 7 For additional background regarding the impact of new technologies on cross-border discovery and data privacy conflicts, see also M. James Daley, “Information Age Catch 22: The Challenge of Technology to Cross-Border Disclosure and Data Privacy,” *11 Sedona Conf. J. 121* (Fall 2011).
  - 8 “Cloud Computing,” “Cloud Recovery,” “Elon University Cloud Survey,” Pew Research Center, June 16, 2010, <http://cloudrecovery.info/2010/06/16/responses-to-a-tension-pair-on-the-likely-future-of-cloud-computing/>.
  - 9 See Cornelius Rahn, “Deutsche Telekom Wants ‘German Cloud’ to Shield Data From U.S.,” Bloomberg, September 14, 2011, <http://www.bloomberg.com/news/2011-09-13/deutsche-telekom-wants-german-cloud-to-shield-data-from-u-s-.html>.
  - 10 See Afzal Bari, “Federal Cloud Computing and Data Center Consolidation,” a Bloomberg study, <http://www.actgon.org/events/managementofchange/MOC2011/MOC%202011%20Documents%20and%20Presentations/federal%20cloud%20computing%20and%20data%20center%20consolidation.pdf>; see also, e.g., Booz Allen Hamilton, “The Economics of Cloud Computing,” <http://www.boozallen.com/media/file/Economics-of-Cloud-Computing-fact-sheet.pdf>.
  - 11 Harshbarger, *16 J. Tech. L. & Pol’y*: 232-33; for a discussion of these benefits and the expected growth of cloud computing, see Janna Quinney Anderson and Lee Rainie, “The Future of Cloud Computing,” Pew Internet & American Life Project, <http://pewresearch.org> (almost three quarters of surveyed technology experts and stakeholders believed that by 2020 most people will access software applications online and as a result they will “live mostly in the cloud”).
  - 12 Harshbarger, *16 J. Tech. L. & Pol’y*: 235; see also National Institute of Standards and Technology, “Cloud Computing Synopsis and Recommendations” (May 2012): § 8.5 (discussing generally cloud computing information security issues); ENISA, “Cloud Computing: Benefits, Risks and Recommendations for Information Security” (November 2009); “Who’s Responsible for Personal Data in Cloud Computing?,” May 23, 2011, <http://blogs.computerworlduk.com/cloud-vision/2011/05/whos-responsible-for-personal-data-in-cloud-computing/index.htm>.

Foreign Intelligence Act of 1978 (“FISA”), the Electronic Communications Privacy Act of 1986 (“ECPA”), the Money Laundering Control Act of 1986, and the Bank Secrecy Act (“BSA”).<sup>13</sup> In broad terms, the Act permits and amplifies the application to terrorism of techniques commonly used to fight organized crime. One of the most controversial changes of The Patriot Act is to expand the availability and scope of National Security Letters (“NSLs”). NSLs are essentially subpoenas that that can require service providers to provide non-content information (*e.g.*, telephone numbers) about a subscriber’s transactions, without a court order. The Patriot Act makes NSLs more widely available by removing the limitation that they relate to non-content information (*e.g.*, telephone numbers) pertaining to a foreign power or its agents. In addition, the Patriot Act also makes NSLs more readily available by removing the time-consuming requirement that they be approved in advance by senior FBI agents.

Even more alarming to EU Regulators, a secret U.S. court can issue FISA letters to compel the production of the actual content of communications. And FISA orders typically are accompanied by a gag order, prohibiting the recipient from any statement about the FISA order. Although the Patriot Act is intended to enhance the ability of U.S. law enforcement agencies to obtain information relevant to terrorist activities, the ability to obtain electronic communication data, including personal data, without any notice to customers or data controllers constitutes a significant change in the law.<sup>14</sup>

Specifically, the Act provides that the contents of electronic communications held by a “remote computing service” may be disclosed “without notice to the subscriber or customer” if the government obtains a warrant using procedures described in the Federal Rules of Criminal Procedure by a “court with jurisdiction over the offense under investigation.”<sup>15</sup> To obtain such information, the government must provide a “court of competent jurisdiction” with “specific and particular facts showing that there are reasonable grounds to believe that the contents of a wire or electronic communication” are “relevant and material to an ongoing criminal investigation.”<sup>16</sup> A court of “competent jurisdiction” includes a court in the district where the offense is under investigation, or a district where the wire or electronic communication service is located.<sup>17</sup> Alternatively, a limited amount of record information, such as subscriber names and addresses, telephone numbers, credit card and bank account numbers, and billing records, can be obtained using an administrative, grand jury, or trial court subpoena.<sup>18</sup>

FISA orders apply “without geographic limitation,”<sup>19</sup> a change the Department of Justice requested.<sup>20</sup> Thus, courts are authorized “to compel evidence directly, without requiring the intervention of their counterparts in other districts where major Internet service providers are located.”<sup>21</sup> The Act permits “computer taps” as well, involving the installation of devices to record information kept by a computer regarding routing, addressing, and signaling.<sup>22</sup>

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13 Congressional Record: October 11, 2001 (Senate) Page S10547-S10630.

14 See 18 U.S.C. Sec. 2703(a), (d).

15 See 18 U.S.C. Sec. 2703(a).

16 See 18 U.S.C. Sec. 2703(d).

17 18 U.S.C. Sec. 3127(2) (definitions).

18 18 U.S.C. Sec. 2703(c)(1)(C).

19 18 U.S.C. Sec. 2703.

20 Charles Doyle, “The USA Patriot Act: A Legal Analysis 6 n.12,” *CRS Rep.No. RL31377* (2002).

21 *Id.* at 7 n.14.

22 Janine Anthony Bowen, “Cloud Computing: Issues in Data Privacy/Security and Commercial Considerations,” *1043 PLI/Pat* (2011): 375, 383.

## U.S. APPROACH TO JURISDICTION OVER INFORMATION

### *Criminal Discovery Procedures*

The Patriot Act does not modify the “possession, custody, or control” standard for discovery set forth in the Federal Rules of Criminal Procedure.<sup>23</sup> Nor does it expressly address the extraterritorial effect of warrant provisions of U.S. criminal procedure. And due to the broad judicial interpretations of the “possession, custody or control” standard in the Federal Rules of Criminal Procedure, the U.S. government could (in theory) obtain information from a U.S.-based cloud service provider – including records related to foreign customers (perhaps including customers in EU countries – without any notice to those customers.

### *Civil Discovery Procedures*

Information stored electronically has become one of the most important sources of discoverable material, and because many use electronic devices such as computers and smart phones for both business and personal reasons, U.S. discovery rules often sweep in documents that include personal data.<sup>24</sup> Under long-standing principles of U.S. law, a U.S. court with jurisdiction over a company may compel the company to produce information in the company’s “possession, custody, or control.”<sup>25</sup> Thus, under U.S. law, even if a court cannot exercise jurisdiction over an absent party, it may nevertheless compel access to information in the hands of the absent party where another party, subject to the court’s jurisdiction has, through the absent party, “possession, custody, or control” of the information.<sup>26</sup>

Thus, “the test for production of documents is control, not locations.”<sup>27</sup> Further, U.S. courts have interpreted the concept of control “broadly as the legal right, authority, or practical ability to obtain the materials sought upon demand.”<sup>28</sup> Using this analysis on “possession, custody, or control,” U.S. courts have, on many occasions, ordered the production of information in the possession of foreign entities, where the court has jurisdiction over a related entity in a U.S. proceeding.<sup>29</sup>

## APPLICATION OF THE EU DATA PROTECTION DIRECTIVE TO CLOUD SERVICE PROVIDERS

A cloud service provider’s production of data stored outside the U.S., or relating to foreign citizens pursuant to the Patriot Act, may subject the provider to legal sanctions

23 Fed. R. Crim. P. 16(b)(1).

24 Alan Charles Raul et al., “Reconciling European Data Privacy Concerns with US Discovery Rules: Conflict and Comity,” *Global Competition Litigation Review*, no. 3, (2009): 119, 120.

25 See Federal Rules of Criminal Procedure (“Fed. R. Crim. P.”) 16(a)(1)(E), 16(b)(1)(A), 17(c)(1) (subpoenas); Federal Rules of Civil Procedure (“Fed. R. Civ. P.”) 34, 45 (subpoenas).

26 See *Dietrich v. Bauer*, 2000 U.S. Dist. LEXIS 11729 (S.D.N.Y. 2000) (citing *Afros S/P.A. c. Krauss-Maffei Corp.*, 113 F.R.D. 127, 129 (D. Del. 1986) (“personal jurisdiction and ‘control’ of documents are distinct issues in that [the] court can compel discovery of documents in [the] ‘control’ of a party although in ‘possession’ of a person over whom there is no personal jurisdiction.”).

27 *Dietrich v. Bauer*, 2000 WL 1171132 at \*2 (S.D.N.Y. Aug. 16, 2000) (quoting *Marc Rich & Co., A.G. v. United States*, 707 F.2d 663, 667 (2d Cir. 1983)).

28 See *Bank of New York v. Meridien Biao Bank Tanzania*, 171 F.R.D. 135, 146 (S.D.N.Y. 1977); see also *Goodman v. Praxair Servs. Inc.*, 632 F. Supp. 494, 516 n.11 (D. Md. 2009); *In re NTL, Inc. Sec. Litig.*, 244 F.R.D. 179, 195 (S.D.N.Y. 2007); *Asset Value Fund, Ltd. V. The Care Group, Inc.*, 1997 U.S. Dist. LEXIS 19768 at 9 (S.D.N.Y. 1997).

29 See, e.g., *Gucci Amer., Inc. v. Curveal Fashion*, 2010 WL 808639 (S.D.N.Y. Mar. 8, 2010) (ordering party discovery from Malaysia); *AccessData Corp v. ALSTE Techs.*, 2010 WL 318477, at \*7 (D. Utah Jan. 21, 2010) (ordering party discovery from Germany); *In Re Cargo Shipping Srvs. Antitrust Litig.*, 2010 WL 1189341, at \*5 (E.D.N.Y. Mar. 29, 2010) (ordering party discovery from France).

under the laws of other nations.<sup>30</sup> In particular, as briefly summarized below with respect to the EU, compliance with such demands may violate laws governing privacy protection for personal data.

*The EU Data Protection Directive*

Directive 95/46/EC of the European Parliament and Council,<sup>31</sup> commonly called the Data Protection Directive (“Directive”), essentially requires all EU member states to adopt legislation to enforce certain essential data protection principles. These data protection principles include:

1. Notice (providing data subjects with notice when their data is collected);
2. Purpose (data should only be used for the purpose stated);
3. Consent (data should not be disclosed without the data subject’s consent);
4. Security (data should be kept secure from potential abuses);
5. Disclosure (data subjects should be informed as to their data);
6. Access (data subjects must be able to access and correct their data; and
7. Accountability (data controllers are accountable for ensuring adherence with data protection principles).

The Directive forbids transfer of personal data of a data subject, without notice and consent, to a government or entity that has not committed to follow EU data protection principles. Currently, only a few countries are considered to have “adequate” data protection under the Directive, with the U.S. notably excluded.<sup>32</sup>

Thus, for example, in 2006 the European Court of Justice, applying the Directive, struck down a negotiated agreement between the European Council and U.S. Customs to share information regarding the names of passengers involved in trans-Atlantic flights, where prior arrangements had not been made to ensure adequate protection of the information.<sup>33</sup>

*The EU Data Directive*

Article 4 of the Directive, as adopted by individual EU member states, governs the application of the Directive to Cloud Computing. The EU Article 29 Data Protection Working Party, an independent advisory body established pursuant to Article 29 of the Directive, has issued a specific opinion on Cloud Computing.<sup>34</sup> In its opinion,

30 See “Data Protection, the Law and You: The Cloud of Unknowing,” and the “Personal Data” Problem,” April, 13, 2011, <http://blogs.computerworlduk.com/cloud-vision/2011/04/data-protection-the-law-and-you-1/index.htm>.

31 Available at [www.eur-lex.europa.eu](http://www.eur-lex.europa.eu); see generally Peter Hustinx, “Data Protection and Cloud Computing Under EU Law” (speech given at Third European Cyber Security Awareness Day, BSA, European Parliament, 13 April 2010).

32 See “European Commission Frequently Asked Questions Relating to Transfers of Personal Data from the EU/EEA to Third Countries,” “List of Countries Covered by a Commission Adequacy Finding Decision,” [www.ec.europa.eu/justice/](http://www.ec.europa.eu/justice/).

33 See “Article 29 Data Protection Working Party, Opinion 5/2006 on the ruling by the European Court of Justice,” adopted June 14, 2006, [www.ec.europa.eu/justice](http://www.ec.europa.eu/justice) (in light of ruling “any transfer of passenger data to the U.S. would be without a legal basis in European law”).

34 Opinion 8/2010 on “Applicable Law,” December 16, 2010, [www.ec.europa.eu/justice](http://www.ec.europa.eu/justice).

the Article 20 Working Party noted that, in circumstances involving Cloud Computing, “[t]he exact place where data are located is not always known,” but it is “sufficient” for EU jurisdiction to enforce privacy standards that a data “controller,” such as a cloud service user/customer, “carries out processing in the context of an establishment within the EU.” Thus, “[i]f the company [customer] uses the service in the context of the activities of its establishment in the EU,” then in the opinion of the Article 29 Working Party, the Directive will apply, and “[t]he company should make sure that the service provides for adequate data protection safeguards [.]”<sup>35</sup>

Article 4 and the scope of the national laws have in the past been applied quite broadly,<sup>36</sup> and some Data Protection Authorities (“DPAs”) have even conducted enforcement audits in countries outside the EU.<sup>37</sup> In this light, a Patriot Act request for information regarding EU data subjects, whether from a U.S.-based cloud service provider or an EU-based provider, would appear to implicate the Directive. The Directive states that processing of personal information is justified only where necessary because of a “legal obligation,” or where the processing aligns with the data controller’s “legitimate interests.” Because U.S. discovery has not generally been regarded as either a “legal obligation” or “legitimate interest” in the EU, the Directive limits the collection, processing, and transfer of personal information to satisfy U.S. litigation requirements.<sup>38</sup> This restriction could create a conflict between obligations under U.S. and EU law. The easiest way to comply with the EU Data Protection Directive – ensuring that personal data stays within the EU – is not always achievable due to the very nature of Cloud Computing.<sup>39</sup>

Companies do, however, have other options to comply with the Directive.<sup>40</sup>

### *Safe Harbor*

A cloud provider can subscribe to the International Safe Harbor Certification program.<sup>41</sup> The Safe Harbor program was developed by the U.S. Department of Commerce, and approved by the European Commission, and consists of a standard set of privacy principles to which companies must agree in order to create and ensure an “adequate level of protection” of personal data, consistent with the Directive.<sup>42</sup> U.S. companies that publicly certify compliance with the principles are therefore allowed to pass data from the EU to the U.S., although if data is stored outside the EU or the U.S., the Safe Harbor becomes ineffective.<sup>43</sup> The problem, of course, is that although the Safe

35 *Id.* at 21; see also “Cloud Computing and EU Data Protection Law, Part One: Understanding the International Issues,” September 28, 2011, <http://blogs.computerworlduk.com/cloud-vision/2011/09/cloud-computing-and-eu-data-protection-law/index.htm>.

36 See excellent analysis by C. Kuner, Submission to the “Consultation on the Commission’s comprehensive approach on personal data protection in the European Union,” [http://ec.europa.eu/justice/news/consulting\\_public/0006/contributions/citizens/kuner\\_christopher\\_en.pdf](http://ec.europa.eu/justice/news/consulting_public/0006/contributions/citizens/kuner_christopher_en.pdf), p. 5 ff., with a call to narrow the focus of the future Art. 4.

37 See, e.g., Agencia Española de Protección de Datos, “Report on International Data Transfers: Ex officio Sectorial Inspection of Spain-Colombia at Call Centres,” July 2007, [https://www.agpd.es/portalesweb/jornadas/transferencias\\_internacionales\\_datos/common/pdfs/repport\\_Inter\\_data\\_transfers\\_colombia\\_en.pdf](https://www.agpd.es/portalesweb/jornadas/transferencias_internacionales_datos/common/pdfs/repport_Inter_data_transfers_colombia_en.pdf).

38 Raul, *supra* note 18, at 120.

39 See generally Andrew Geyer and Melinda McLellan, contributors, “Strategies for Evaluating Cloud Computing Agreements,” *Bloomberg Law Reports* (2011).

40 See “Cloud Computing and the EU Data Protection Law, Part Two: On International Transfers of Personal Data,” April 23, 2012, <http://blogs.computerworlduk.com/cloud-vision/2012/04/cloud-computing-and-eu-data-protection-law-part-two/index.htm>.

41 “Safe Harbor Overview,” [http://www.export.gov/safeharbor/eg\\_main\\_018236.asp](http://www.export.gov/safeharbor/eg_main_018236.asp) (last updated April 27, 2011, 2:31 PM).

42 Paul Lanois, “Caught in the Clouds: The Web 2.0, Cloud Computing, and Privacy,” 9 *Nw. J. Tech. & Intell. Prop.* (2010): 29, 48. Commentators have pointed to similar certifications for providers who meet HIPAA security requirements and have suggested a similar program be created for cloud providers. See “The Cloud Also Rises: PHI Security in the Era of Cloud Computing,” <http://www2.idxpcorp.com>.

43 Lanois, 9 *Nw. J. Tech. & Intell. Prop.*: 48.



Harbor program permits compliance with the EU directive, once the data is in the U.S., it may become subject to government inspection pursuant to the Patriot Act.<sup>44</sup>

Outside of the question of onward transfer, the Düsseldorf Kreis, a group of top DPAs for the non-public sector in Germany, adopted a resolution on April 29, 2010 setting even stricter requirements for cross-border transfer of data under Safe Harbor, by placing the burden of Safe Harbor certification and compliance onto the transferring company.<sup>45</sup> If the new and stricter requirements cannot be met, the use of standard contractual terms is recommended.<sup>46</sup>

### *Standard Contractual Clauses*

Alternatively a cloud provider located in a country other than the U.S. can sign standard forms of contracts, commonly known as Standard Contractual Clauses (SCC). So far the European Commission has issued two separate sets of SCCs, one for controllers (Set II<sup>47</sup>) and another for processors.<sup>48</sup> These must be used in the precise form approved by the European Commission to provide an adequate level of protection enabling data transfer between a data exporter in the EU and a data importer outside the EU. These SCCs should in theory suffice for an automatic compliance with EU standards, but the strict scrutiny and varied outcome among the Member States<sup>49</sup> make them a difficult tool. The SCCs are independent of the principle contract between the consumer and the cloud provider. While the use of (un-amended) SCCs automatically ensures compliance with EU standards, and can therefore be considered advantageous to the customer, they also bare a risk for the service provider of enforceability beyond the basic contract.<sup>50</sup>

Despite the difficulties surrounding SCCs, cloud providers located in countries that have not been white-listed by the European Commission and which are not Safe Harbor certified might consider making use of SCCs to comply with the requirements of the Directive.

### *Binding Corporate Rules*

Entities with global subsidiaries have the additional option of setting up “binding corporate rules” (BCRs) for the purpose of sharing data within the group in compliance with European regulations. BCRs are a legally binding internal set of documents laying down the group’s intended safeguards to individuals whose personal data is transferred to a third country. The level of protection must be equal to that provided for by the Directive. Following internal agreement on BCRs, they are submitted to one national data protection

44 Zack Whittaker, “Why EU data needs ‘protecting’ from US Law,” April 25, 2011, <http://www.zdnet.com>.

45 [http://www.bfdi.bund.de/SharedDocs/Publikationen/Entschliessungssammlung/DuesseldorferKreis/290410\\_SafeHarbor.html;jsessionid=2FE330DB52E8317B1FDBBE6DBC5C445.1\\_cid136?nn=409242](http://www.bfdi.bund.de/SharedDocs/Publikationen/Entschliessungssammlung/DuesseldorferKreis/290410_SafeHarbor.html;jsessionid=2FE330DB52E8317B1FDBBE6DBC5C445.1_cid136?nn=409242).

46 [http://www.bfdi.bund.de/SharedDocs/Publikationen/Entschliessungssammlung/DuesseldorferKreis/290410\\_SafeHarbor.pdf?\\_\\_blob=publicationFile](http://www.bfdi.bund.de/SharedDocs/Publikationen/Entschliessungssammlung/DuesseldorferKreis/290410_SafeHarbor.pdf?__blob=publicationFile).

47 The initial Set I was considered too restrictive and not used frequently.

48 Available at <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:385:0074:0084:EN:PDF> and <http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:039:0005:0018:EN:PDF>.

49 Certain countries require standard clauses to be filed and approved prior to the initial transfer, while other countries do not call for any additional formalities. In addition, difficulties in characterizing controllers and processors often lead to different classifications of one and the same compliance program. See Renzo Marchini, *Cloud Computing*, 74.

50 See an extensive analysis in Renzo Marchini, *Cloud Computing*, 75 and Christopher Kuner, *European Data Protection Law – Corporate Compliance and Regulation* (2007), 195 et seq.; concerning cloud computing contracts generally, see “Cloud Computing Contracts and Services: What’s Really Happening?,” March 17, 2011, <http://blogs.computerworlduk.com/cloud-computing/2011/03/cloud-computing-contracts-and-services-whats-really-happening/index.htm>; see also Simon Bradshaw, Christopher Millard, and Ian Walden, “Contracts for Clouds: Comparison and Analysis of the Terms and Conditions of Cloud Computing Services,” September 1, 2010, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1662374](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1662374).

regulator, who in turn coordinates the approval required by other national authorities.<sup>51</sup> In 2008 the Article 29 Working Party provided for a ‘one-stop’ shop mutual recognition scheme for BCR covering 19 member states, whereby approval by the leading national authority automatically brings about approval in the other member states.<sup>52</sup> Due to the currently high cost and complexity of this option, it is best suited for facilitating the transfer of data within large entities.

### APPROACHES TO DATA PRIVACY IN OTHER JURISDICTIONS: CANADA AND AUSTRALIA

Aside from the EU, many countries have in place some kind of data protection regime, although the scope and effect of these regimes vary widely. Because Canada and Australia have been leaders in data protection legislation, particularly among non-EU countries, it is helpful to contrast them to the EU data protection framework. Data protection in Canada is governed by the Personal Information Protection and Electronics Documents Act (PIPEDA). Unlike the EU approach, which focuses on the level of privacy protection given by law in other states, Canada focuses on the level of protection guaranteed by particular organizations. That is, organizations themselves are responsible for the information they transfer to third parties, regardless of whether those parties reside within Canada. The law thus encourages contracts between organizations, with the expectation that data service providers will demonstrate adequate methods of protecting personal information. In Canada, organizations must follow ten principles whenever they collect, use, or disclose personal information – as compared with the seven EU data protection principles set out above. These Canadian principles are:

1. Accountability (an organization is responsible for personal information under its control);
2. Identifying Purposes (purposes for which the information is collected must be identified before or at the time of collection);
3. Consent (knowledge and consent of the individual are required except where inappropriate);
4. Limiting Collection (information shall only be collected by fair and lawful means and collection must be limited to that which is necessary for the identified purposes);
5. Limiting Use, Disclosure, and Retention (information must not be used for any purpose other than that for which it was collected, except in the case of consent or as required by law);
6. Accuracy (information must be as accurate as necessary for purposes for which it is to be used);
7. Safeguards (information shall be protected by safeguards appropriate to its sensitivity);

51 Formal approval may at times be required by all 27 member states, depending on the size of the company. See Renzo Marchini, *Cloud Computing*, 81.

52 See Article 29 Working Party, “Working Document: Co-operation Procedure for Binding Corporate Rules,” [http://ec.europa.eu/justice/policies/privacy/binding\\_rules/procedure\\_en.htm](http://ec.europa.eu/justice/policies/privacy/binding_rules/procedure_en.htm). For more information on the coordination procedure see Christopher Kuner, *European Data Protection Law – Corporate Compliance and Regulation* (2007), 222 et seq.

8. Openness (policies and practices regarding an organization's management of information shall be readily available to individuals);
9. Individual Access (upon request, an individual shall have access to his or her information and have the ability to challenge the accuracy of the information and amend as necessary); and
10. Challenging Compliance (an individual retains the right to challenge compliance with the principles).<sup>53</sup>

In Australia, data protection is governed by the Privacy Act. The public sector is subject to 11 "Information Privacy Principles" and the private sector is subject to ten similar "National Privacy Principles." Australian entities may send information to third parties abroad under three circumstances: 1) the entity believes the recipient will uphold the principles; 2) the entity has consent from the data subject; or 3) the transfer is necessary to comply with contractual obligations.<sup>54</sup> The Privacy Act covers foreign entities operating in Australia as well as entities abroad that carry on business in Australia and collect or hold personal information about Australian citizens within Australia.<sup>55</sup>

As in the EU, these laws may create a conflict with the Patriot Act. That is, cloud service providers and other businesses operating in Canada and Australia may find it difficult to comply with national privacy laws when faced with a subpoena or court order for personal information issued pursuant to the Patriot Act.

## U.S. APPROACH TO CONFLICTS OF LAW REGARDING DATA PROTECTION

The U.S. is party to a number of conventions and treaties that impact access to data, including Cloud Computing data, outside the U.S. for litigation and law enforcement purposes. These international agreements include the Hague Evidence Convention, the Agreement on Mutual Legal Assistance between the U.S. and E.U., and Treaties on Mutual Legal Assistance in Criminal Matters with a number of individual countries.<sup>56</sup>

In determining how to respond to requests under these agreements and treaties, EU member governments carefully weigh privacy concerns and often impose confidentiality restrictions to protect further dissemination of the information.<sup>57</sup> Many EU countries consider resort to such conventions and treaties to be the most appropriate – and sometime exclusive – way to seek access to data under the jurisdiction of a foreign sovereign.<sup>58</sup>

53 Leah E. Frazier, "Extraterritorial Enforcement of PIPEDA: A Multi-tiered Analysis," *36 Geo. Wash. Int'l L. Rev.* 203 (2004): 206-08.

54 Russell Allen, "Compliance with Rules and Regulations Pertaining to Cross-Border Transfer of Personnel and Business Data: The Australian Perspective," *18 No. 1 Emp. & Indu. Rel. L.* 36 (2008): 37.

55 *Id.*

56 *See e.g.*, Agreement on Mutual Legal Assistance between the European Union and the U.S. (June 25, 2003) ("E.U.-U.S. Agreement"); U.S.-German Mutual Legal Assistance Treaty in Criminal Matters (October 14, 2003), Treaty Doc. 108-27, 108th Cong. 2d Sess.; Exec. Rept. 109-14, 109th Cong. 2d Sess.; Supplementary Treaty to the Mutual Legal Assistance Treaty in Criminal Matters (April 18, 2006), Treaty Doc. 109-13, 109th Cong. 2d Sess. Both German treaties entered into force on October 18, 2009.

57 For Example, Article 9 of the E.U.-U.S. Agreement, entitled "Limitations on use to protect personal and other data," provides that member states can impose conditions on use of information, but that "[g]eneric restrictions with respect to the legal standards of the requesting state for processing personal data may not be imposed by the requested State as a condition . . . to providing evidence or information."

58 *See e.g.* the Council of Europe's (COE) "Guidelines on Human Rights and the Fight Against Terrorism," July 11, 2002, [http://www.coe.int/t/dlapil/cahdi/Source/Docs2002/H\\_2002\\_4E.pdf](http://www.coe.int/t/dlapil/cahdi/Source/Docs2002/H_2002_4E.pdf) (laying down ground rules to be followed in fighting terrorism). *See also* the COE's Convention on Cybercrime of November 23, 2001, which aims at harmonizing national laws on cybercrime, improving national capabilities for investigating such crimes, and at increasing cooperation on investigations. A copy of the convention and an explanatory report are available at <http://conventions.coe.int/Treaty/en/Treaties/html/185.htm> and at <http://conventions.coe.int/treaty/en/reports/html/185.html>. *See also* Ian Walden, "Accessing Data in the Cloud: The Long Arm of the Law Enforcement Agent," November 14, 2011, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1781067](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1781067).

It is also notable that the EU generally places the specific fundamental human right to privacy above general counter terrorism objectives.<sup>59</sup> While European DPAs have sometimes sought enforcement audits of data processors in other countries,<sup>60</sup> such audits require a specific legal basis, as well as the consent of the State concerned – in conformity with the fundamental sovereign rights of European states.<sup>61</sup>

### *The United States Supreme Court's Aérospatiale Doctrine*

In contrast, the U.S. Supreme Court has held that U.S. courts may compel production of foreign evidence within the possession, custody, or control of an entity subject to U.S. jurisdiction, without following the procedures provided for in the Hague Evidence Convention. In *Société Nationale Industrielle Aérospatiale v. U.S. District Court for the Southern District of Iowa*, the Court held that use of the Convention is optional, not mandatory. The Supreme Court noted that the Hague Convention “doesn’t modify the law of any contracting state [including the Federal Rules of Criminal and Civil Procedure], require any contracting state to use its procedures either in requesting evidence or in responding to requests, nor compel any contracting state to change its own evidence gathering procedures.”<sup>62</sup> Despite this ruling, the Court in *Aérospatiale* noted the relevance of “comity” concerns in evaluating the scope and form of foreign discovery ordered by a U.S. court.<sup>63</sup> Applying this framework, U.S. courts have frequently held that significant U.S. government concerns may outweigh foreign interests in protection of private or confidential information.<sup>64</sup> Subpoenas and court orders have been issued even where disclosure is prohibited by law in the countries in which the information is located. The enforcement is not through a foreign court or treaty, but typically by a U.S. court through contempt proceedings, which can result in significant fines.<sup>65</sup> This threat of contempt penalties generally drives compliance and gives effect to subpoenas and orders outside the U.S., although other severe sanctions can include prosecution for obstruction of justice and dismissal of claims.<sup>66</sup>

Despite the general trend toward upholding U.S. interests against competing claims of foreign interests in privacy protection, some U.S. courts have streamlined, or even prohibited, U.S. disclosures in favor of protecting foreign interests.<sup>67</sup> In substance, the cases

59 As can be derived from ECtHR rulings post 9/11 (see Kim Lane Scheppel, *Other People's PATRIOT Act*, 139 et seq.) and the COE Convention and Guidelines (see footnote 58).

60 See Christopher Kuner, *Data Protection law and International Jurisdiction on the Internet (Part 2)*, 9 et seq.

61 See *supra* notes 53-55.

62 482 U.S. 522, 534 (1987).

63 See *Aerospatiale*, 482 U.S. 522, 544 (1987) (citing RESTATEMENT (THIRD) OF FOREIGN RELATIONS § 442(1)(c) (1987) (in deciding whether to issue an order directing production of information located abroad, and in framing such an order, a court or agency in the U.S. should take into account the importance to the investigation or litigation of the documents or other information requested; the degree of specificity of the request; whether the information originated in the U.S.; the availability of alternative means of securing the information; and the extent to which noncompliance with the request would undermine important interests of the U.S., or compliance with the request would undermine important interests of the state where the information is located).

64 See, e.g., *United States v. Bank of Nova Scotia*, 691 F.2d 1384 (11th Cir. 1982), cert. denied, 462 U.S. 1119 (1983) (interest of the U.S. in upholding grand jury's power to investigate crime outweighed interests of the Cayman Island and Bahamas in bank secrecy laws); *United States v. Vetco, Inc.*, 691 F.2d 1281 (9th Cir.), cert. denied, 454 U.S. 1098 (1981) (strong U.S. interest in collecting taxes and prosecuting tax fraud by U.S. nationals outweighed Switzerland's interest in preserving business secrets of Swiss subsidiaries of American corporations); *In re United States v. First National City Bank*, 396 F.2d 897 (2d cir. 1968) (risk of civil liability in Germany was “speculative” where a federal grand jury in New York issued a subpoena to a New York bank requiring production of documents relating to transactions of its customers located both at its head office in New York and at its branch in Frankfurt, West Germany; importance of U.S. antitrust enforcement was greater than German interest in bank secrecy).

65 In *In re Grand Jury Proceedings (Bank of Nova Scotia)*, 740 F.2d 817 (11th Cir. 1984), the Bank failed to comply with a grand jury subpoena and was subsequently fined \$1,825,00 for contempt of court.

66 Raul, *supra* note 18, at 120.

67 See, e.g., *Salerno v. Lecia*, 1999 U.S. Dist. LEXIS 7169 (W.D.N.Y., Mar. 23, 1999) (production of severance package information and personnel files precluded by EU Privacy Directive 95/46/EC and by German Act on Data Protection); *Volkswagen AG, Relator v. Valdez*, 909 S.W.2d 900, 902 n.14 (Tex. 1995) (denying request to produce company telephone book, as protected by German Federal Data Protection Act, because production would undermine interests of Germany while no U.S. interest would be undermined if it was not produced, particularly where alternative methods of discovery of same information were available).

and commentators suggest that a careful “balancing” of interests should address these kinds of conflicts.<sup>68</sup> The Restatement (Third) of Foreign Relations, which outlines the U.S. approach, lists several factors that a court will consider in determining whether to order disclosure from abroad: the importance to the investigation or litigation of the documents or other information requested; the degree of specificity of the request; whether the information originated in the United States; the availability of alternative means of securing the information; and the extent to which noncompliance with the request would undermine important interests of the U.S., or compliance with the request would undermine important interests of the state where the information is located.<sup>69</sup> Because of the subjective nature of the factors involved, it may be difficult to predict whether a court will grant access to information held abroad; nevertheless, if the U.S. government claims an interest in preventing terrorist activity and makes an effort to limit the request, a U.S. court will probably grant access.

### PRACTICAL IMPACT OF THE PATRIOT ACT

Because Patriot Act applications for warrants are not public, there is little available information regarding Patriot Act requests for U.S. based cloud service providers to disclose EU personal data. Even though the Patriot Act generally permits a party to challenge a subpoena or warrant for information in a court proceeding, research to date has failed to reveal any public challenges to Patriot Act requests on grounds of interference with the privacy of EU citizens.

Research reflects that from 2006-2009, 1755 “delayed-notice” search warrants were issued. Of those, 1619 (92%) were issued for drug-related investigations, 122 (about 7%) for fraud; and 15 (less than 1%) for terrorism related investigations.<sup>70</sup> These statistics suggest that the instances of U.S. government requests for EU citizen information pursuant to the Patriot Act are presumable quite rare.

Nevertheless, commentators generally agree that the “possession, custody, or control” standard, applied in the Patriot Act context, and with the imprimatur of the U.S. government’s interest in fighting crime and terrorism, could be used to obtain such information.<sup>71</sup> In practical terms, where a company is subject to jurisdiction in the U.S., and has the ability to obtain information from foreign affiliates and subsidiaries, the possibility of a successful Patriot Act Request for such information cannot be ruled out. Significantly, few commentators have focused on the opposite scenario: the possibility that an EU-based cloud service provider might itself become subject to a Patriot Act request for information regarding EU citizens. In that scenario, if the EU provider maintains an affiliate, subsidiary, parent, vendor, or other connection to the U.S. (sufficient to provide a U.S. court with jurisdiction over the related entity) and that U.S.-related entity has the practical “possession, custody, or control” of the EU information, it is theoretically possible that such information could be requested, under roughly the same principles as might apply to a U.S.-based cloud service provider.

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68 See generally The Sedona Conference®, “Framework for Analysis of Cross-Border Discovery Conflicts: A Practical Guide to Navigating the Competing Currents of International Data Privacy and e-Discovery,” Public Comment Version (August 2008), <http://www.thesedonaconference.org>.

69 Sec. 442(1)(c).

70 See Benjamin Wallace-Wells, “Patriot Act: The Kitchen-Sink Approach To National Security,” August 27, 2011, <http://www.nymag.com>.

71 See, e.g. “Analysis of Specific USA PATRIOT Act Provisions,” <http://epic.org> (stating that the “protected computer” definition in the act “includes effectively any computer”); Sean Gallagher, “PATRIOT ACT and Privacy Laws Take a Bite Out of US Cloud Business,” December 8, 2011, <http://arstechnica.com>.

Interestingly, at least one commentator has suggested that the concerns over the security of data stored in Europe by U.S.-based cloud service providers can be traced at least in part to early efforts at a sort of digital protectionism in the form of state efforts to promote European cloud companies over their U.S. competitors. The suggestion is that, for competitive purposes, European firms may call attention to purported insecurities of data stored with U.S.-based cloud providers flowing from the Patriot Act.<sup>72</sup> This suggestion was fueled by comments of German telecommunications giant, Deutsche Telekom, and other EU-based cloud providers who are marketing EU cloud services, “as a means to shield clients from government access such as that provided by the Patriot Act.”<sup>73</sup>

### COMPARISON TO LAW ENFORCEMENT REGIMES IN EUROPE AND OTHER JURISDICTIONS

Through the 1990s, European telecommunication surveillance steadily increased, as EU law enforcement recognized the importance of such information in combating drug offenses.<sup>74</sup> In the wake of the September 11, 2001 attacks in the U.S. (and additional major attacks in Madrid and London), many EU nations considered modifications to their law enforcement and national security laws to enhance their ability to fight terrorism.<sup>75</sup> These new EU laws, for example, often permit investigation of banking records related to the financing of terrorist activities and expand law enforcement ability to conduct surveillance of suspected terrorists.

Several EU nations, including Germany and the U.K., have enacted laws that permit government authorities to obtain access to personal data stored in data centers in connection with national security (and other) investigations, often without the knowledge or prior consent of the customer.<sup>76</sup> However, especially in Germany, data protection and the protection of privacy in general are aggressively defended. On February 27, 2008 the German *Bundesverfassungsgericht*, or German Federal Constitutional Court (similar to the U.S. Supreme Court), set high standards for the covert infiltration of IT systems by the state, namely that actual indication of a concrete danger for a legally protected interest of paramount importance exists.<sup>77</sup> With this decision, the *Bundesverfassungsgericht* ruled that Article 10 of the German constitution creates a right to confidentiality and integrity of IT systems, against which any intrusion by the state must be measured.<sup>78</sup> Still, most EU countries permit government entities access to data stored in the cloud, under certain conditions.<sup>79</sup> The Data Privacy Directive itself explicitly allows member states to exclude

72 See Kenneth Corbin, “Foreign Cloud Privacy Issues Dismissed by U.S. Officials,” *CIO Magazine*, January 19, 2012, [http://www.cio.com/article/698312/Foreign\\_Cloud\\_Privacy\\_Issues\\_Dismissed\\_by\\_U.S.\\_Officials](http://www.cio.com/article/698312/Foreign_Cloud_Privacy_Issues_Dismissed_by_U.S._Officials).

73 See Cornelius Rahn, “Deutsche Telekom Wants ‘German Cloud’ to Shield Data From U.S.,” *Bloomberg*, September 14, 2011, <http://www.bloomberg.com/news/2011-09-13/deutsche-telekom-wants-german-cloud-to-shield-data-from-u-s.html>.

74 See Paul M. Schwartz, “Evaluating Telecommunications Surveillance In Germany: The Lessons Of The Max Planck Institute’s Study,” 72 *Geo. Wash. L. Rev.* 1244 (2004): 1247.

75 See generally Kim Lane Schepel, “Other People’s PATRIOT Acts: Europe’s Response To September 11,” 50 *Loyala L. Rev.* 89 (2004) (discussing Germany and the UK, in particular); see also Elaine Cassel, “Patriot Act Spawns Similar Laws Across The Globe,” November 10, 2003, <http://www.counterpunch.org> (noting that UK, Canada, Australia, South Africa, and other nations all quickly enacted “versions” of the Patriot Act, in response to terrorist attacks).

76 See, e.g., sections 1 and 3 of the German Act on the Restriction of Privacy of Correspondence, Post and Telecommunication; U.K. Regulation of Investigatory Powers Act 2000 (“RIPA 2000”).

77 BVerfG, 1 BvR 370/07 on 27.2.2008.

78 This is in line with other leading decisions of the German Supreme Court in this area, namely the “Volkszaehlungsurteil” from December 15, 1983, which created the “basic right to informational self-determination” (BvR 209, 269, 362, 420, 440, 484/83) and the March 3, 2004 ruling regarding the “Grossen Lauschangriff” which demanded the high threshold of legal justification for acoustic observation of citizens and recognizes an indefeasible core basic right to the private sphere protected by Art. 1 of the German constitution (BVerfG, 1 BvR 2378/98). The most recent decision regarding the data retention directive as implemented into German law is discussed below.

79 See analysis in “A Global Reality: Governmental Access to Data in the Cloud,” A Hogan Lovells White Paper, Winston Maxwell, Paris France, Christopher Wolf, Washington, DC, 23 May 2012.

the application of its protective umbrella in cases of public security, defense, State security, and areas of criminal law.<sup>80</sup>

Sections 5 and 6 of the UK Intelligence Services Act 1994 provide for warrants authorizing surveillance acts outside the UK under certain circumstances.<sup>81</sup> Likewise, a recently enacted French statute permits investigating judges, with approval of the state prosecutor, to authorize police officers to use devices enabling them to access “in all places” computerized data in the form in which it appears on the screen of a user of an automated data processing system.<sup>82</sup> EU nations also have the power, under various mutual legal assistance agreements and treaties, to release data stored within their boundaries to U.S. authorities and vice versa, subject to conditions protecting confidentiality of personal information.<sup>83</sup> Thus, data stored by EU-based cloud service providers is not immune from law enforcement or intelligence surveillance by EU countries themselves.

A recent report suggests that similar law enforcement regimes apply in other countries, such as Japan and Canada.<sup>84</sup> Of the 10 countries studied, all 10 permit the government to require cloud providers to produce data in the course of an investigation, and 8 may do so in response to an informal request (U.S. and Japan being the exceptions).<sup>85</sup> Eight countries also do not require cloud providers to notify data subjects when the information is produced to government investigators, with the U.S. and Germany being the two countries that allow notification, with some exceptions.<sup>86</sup> Further, all 10 countries permit government investigators to monitor communications sent through the cloud, and 8 permit the government to compel cloud service providers to produce data held in other countries.<sup>87</sup> Additionally, the Belgian Code of Criminal Procedure provides for criminal sanctions when an electronic service provider is requested to divulge information that violates privacy rights in the course of a criminal investigation.<sup>88</sup>

Despite these findings, some experts still advise companies to hesitate in storing data with U.S. cloud service providers, as the U.S. is seen by many to have some of the most powerful data processing tools available and the U.S. government has generally been more aggressive than other jurisdictions in demanding data stored in other countries.<sup>89</sup>

Except in the case of Mutual Legal Assistance Treaties, EU countries generally confine the scope of search warrants to data within their geographic boundaries, or within

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80 Article 3.2 of the EU Data Protection Directive.

81 Intelligence Services Act (UK), 1994 Chapter 13, Sections 5 and 6, available at <http://www.legislation.gov.uk/ukpga/1994/13/contents>.

82 See law no. 2011-267 (March 14, 2011), referred to as LOOCSI 2, which relates to the “orientation and planning to achieve good results with respect to internal safety.” There is not yet any guidance available on the proper interpretation of “in all places,” but one plausible interpretation is that the statute covers data that can be accessed by a user in France even though the data is stored outside the country. The French Code of Criminal Procedure already allowed access to documents from a data processing system.

83 See footnote 38, *supra*. For example, Article 10 of the E.U.-U.S. Agreement requires requested states to use best efforts to maintain the confidentiality of requests for assistance if such confidentiality is requested by the requesting state.

84 Grant Gross, “Study: Patriot Act Gives US Government No Special Access to Cloud Data,” May 23, 2012, <http://www.pcworld.com/>.

85 *Id.*

86 *Id.*

87 *Id.*

88 Article 46bis Belgian Code of Criminal Procedure.

89 *Id.*

the possession of a party subject to jurisdiction in the country.<sup>90</sup> In 2007 a Belgian public prosecutor demanded U.S.-based company Yahoo!, for example, under the Belgian Code of Criminal Proceedings, provide user credentials of a number of webmail accounts. Yahoo! refused the request, arguing that the U.S. Electronic Communications Privacy Act prohibits this type of disclosure, absent a U.S. court order. After lengthy court proceedings<sup>91</sup> the Brussels Court of Appeals, in 2011, sided with Yahoo!, reasoning that the mere technical ability to access U.S. Yahoo! servers from Belgium does not establish criminal jurisdiction in Belgian territory.<sup>92</sup> The Yahoo! case illustrates the need for clear definitions as to who is deemed in control of (personal) data in the often complex supply chains of providers that make up cloud services.<sup>93</sup>

## EFFORTS AT RECONCILIATION OF CONFLICTING LAW

### *The Convention on Cybercrime*

Shortly after the September 11, 2001 attacks in the U.S., the Council of Europe adopted the Convention on Cybercrime.<sup>94</sup> The convention, conceived and drafted prior to the attacks, promotes a uniform global criminal policy against cybercrime. It takes into account the rapid rate of technology changes, which blur the traditional notions of physical “care, custody, and control” of information and similar existing legal frameworks.<sup>95</sup> To date, more than 47 nations have become signatories to the Convention. The U.S. ratified the Convention in January 2007.

### *The Data Retention Directive*

In 2006, the European Parliament and Council adopted Directive 2006/24/EC on the retention of data generated or processed in connection with the provision of publicly available electronic communications services of public communications networks (the “Data Retention Directive”).<sup>96</sup> This Directive requires all EU member states to enact regulations to compel private service providers to store basic telecommunications metadata (dates of communications, senders and recipients, IP address), for 6-24 months after it is required for business reasons. This obligation does not apply to the content of communications. The Data Retention Directive was justified as a “valuable tool in the prevention, investigation, detection, and prosecution of criminal offences, in particular

90 Convention on Cybercrime, Art. 18 and in particular explanatory note Art. 173, which requires that a law enforcement authority can “order a person in its territory to submit specified computer data stored in a computer system, or data storage medium that is in that person’s possession or control. The term ‘possession or control’ refers to physical possession of the data concerned in the ordering Party’s territory, and situations in which the data to be produced is outside of the person’s physical possession but the person can nonetheless freely control production of the data from within the ordering Party’s territory [...]” It also explicitly states that “a mere technical ability to access remotely stored data (e.g., the ability of a user to access through a network link remotely stored data not within his or her legitimate control) does not necessarily constitute ‘control’ within the meaning of this provision;” Ian Walden, “Accessing Data in the Cloud: The Long Arm of the Law Enforcement Agent,” Queen Mary University of London, School of Law, November 14, 2011, 5.

91 The public prosecutor opened proceedings against Yahoo! before a Belgian Criminal Court, which in 2009 ruled that Yahoo! was indeed in violation of the Belgian Code of Criminal Proceeding by failing to cooperate. This ruling was overturned in 2010 by the Court of Appeals in Ghent with the argument that the type of services Yahoo! provided did not actually fall under the definition of the Code of Criminal Proceedings in question. This in turn was toppled by the Belgian Supreme Court in 2011, arguing that the definition of the type service Yahoo! provided was in the scope of the applied criminal law, and referred back to the Brussels Court of Appeals.

92 Court of Appeal of Ghent of 30 June 2010; Ian Walden, “Accessing Data in the Cloud: The Long Arm of the Law Enforcement Agent,” 18; this case is still ongoing.

93 See also Renzo Marchini, *Cloud Computing*, 49; “Industry Recommendations to Vice President neelie Kroes on the Orientation of a European Cloud Computing Strategy,” November 2011, 7.

94 ETS 185 (November 8, 2011), <http://www.conventions.coe.int>; see also “Law Enforcement Agencies Access Rights to Your Cloud Data,” (July 22, 2011), <http://blogs.computerworlduk.com/cloud-vision/2011/07/law-enforcement-agencies-access-rights-to-your-cloud-data/index.htm>.

95 *Id.* at Art. 6.

96 Available at [www.eur-lex.europa.eu](http://www.eur-lex.europa.eu).



organised crime.”<sup>97</sup> In Germany, § 113a and 113b of the TKG and § 100g StPO were implemented to comply with the directive. Thereafter, almost 35,000 German citizens petitioned the German Supreme Court to repeal the Data Retention Directive as a violation of the fundamental human and constitutional right to privacy.<sup>98</sup>

On March 2, 2010 the German Supreme Court invalidated the Data Retention Directive,<sup>99</sup> ruling that it deeply invades the fundamental private sphere of a person.<sup>100</sup> Such an invasion can only be justified, said the German Supreme Court, under the strictest conditions which were not satisfied by the law in its current form.<sup>101</sup> This ruling left Germany in violation of the requirement to implement the Data Retention Directive by 2007. To date, Germany has still not complied with this requirement, giving rise to a lawsuit by the EU Commission filed on May 31, 2012, seeking sanctions of €300,000 per day. Ironically, the current Minister of Justice, Sabine Leutheusser-Schnarrenberger, was one of the plaintiffs in the appeal to the German Supreme Court which invalidated the law in Germany.

The Data Retention Directive is criticized because it requires retention of information, even if entirely irrelevant to any criminal investigation. In contrast, the Patriot Act has no comparable data retention provision and only requires retention of “specific information requested” by the U.S. government.<sup>102</sup> In 2011, an EU Commission investigation concluded that the Data Retention Directive is still a valuable tool, but that it needs modification “to ensure that high levels of respect for privacy and the protection of personal data are applied consistently.”<sup>103</sup>

*Work of The Sedona Conference® Working Group Six*

In 2008, The Sedona Conference® Working Group Six on International Electronic Information Management, Discovery, and Disclosure (WG6) – a private, non-profit U.S.-based think-tank with international participants – issued its initial guidance on how to manage the conflict between U.S. discovery obligations and EU privacy concerns.<sup>104</sup> The Sedona Conference® WG6 outlined a framework for analyzing and balancing “the needs, costs, and burdens of discovery with the interests of each jurisdiction in protecting the privacy rights and welfare of its citizens,”<sup>105</sup> which helped spawn a constructive dialogue with EU and other international DPAs.

In early 2009, the Article 29 Data Protection Working Party Issued its Working Document 1/2009 on pre-trial discovery for cross border civil litigation<sup>106</sup> suggesting that compliance with the U.S./EU “Safe Harbor” program, or equivalent data protections, would be required for any transfer of EU data to the U.S. for purposes of litigation. The Working Party noted that compliance with a request under the Hague Convention would always “provide a formal basis for a transfer of personal data” but observed that not all

97 *Id.*

98 BvR 256/08, BvR 263/08, BvR 586/08.

99 BVerfG, 1 BvR 256/08.

100 BVerfG, 1 BvR 256/08, 210 ff.

101 BVerfG, 1 BvR 256/08, 269ff.

102 See Kristina Ringland, “The European Union’s Data Retention Directive And The United States’ Data Preservation Laws: Finding The Better Model,” 5 *Shidler J. L. Comm. & Tech.* 13 (2009), <http://www.lctjournal.washington.edu>.

103 [http://ec.europa.eu/home-affairs/policies/police/police\\_data\\_en.htm](http://ec.europa.eu/home-affairs/policies/police/police_data_en.htm) see the full report at [http://ec.europa.eu/commission\\_2010-2014/malmstrom/archive/20110418\\_data\\_retention\\_evaluation\\_en.pdf](http://ec.europa.eu/commission_2010-2014/malmstrom/archive/20110418_data_retention_evaluation_en.pdf).

104 See The Sedona Conference®, “Framework for Analysis of Cross-Border Discovery Conflicts: A Practical Guide to Navigating the Competing Currents of International Data Privacy and e-Discovery,” Public Comment Version (August 2008), <http://www.thesedonaconference.org>.

105 *Id.* at 29.

106 00339/09/EN, WP 158 (February 11, 2009), <http://www.ec.europa.eu/justice>.

member states have signed the Convention, and that many who have signed it have entered a reservation against U.S. discovery rules.

Later in 2009, a French national privacy agency (Commission Nationale de l'Informatique et des Libertés, or "CNIL") recognized that all requests for transfer of information from France to the U.S. for purposes of litigation must comply with French data protection law.<sup>107</sup> The CNIL suggested that such requests should be processed exclusively through the Hague Convention system, and that data protection principles, including notice to data subjects and proportionality of scope, must apply to the transfers. In 2010, both the Federal Trade Commission and the U.S. Department of Commerce offered detailed reports on the need for a more comprehensive U.S. approach to privacy protection, among other things, to deal with the problem of international exchange of information.<sup>108</sup> Legislative hearings, and the introduction of bills for additional privacy protection, have followed in the wake of these reports.<sup>109</sup> The FTC recently issued a further report.<sup>110</sup>

In December 2011, The Sedona Conference® WG6 issued *The Sedona Conference® International Principles on Discovery, Disclosure and Data Protection: Best Practices, Recommendations & Principles for Addressing the Preservation & Discovery of Protected Data in U.S. Litigation (European Union Edition)*.<sup>111</sup>

In early 2012, Vice-President of the European Commission Neelie Kroes, responsible for the Digital Agenda, announced her intention to make Europe not just cloud friendly, but cloud active,<sup>112</sup> by updating the European Data Privacy regulations.<sup>113</sup> Similarly, the first U.S. Chief Information Officer, Vince Kundra, announced a "Cloud-First" policy, estimating that this strategy could save the U.S. approximately \$US5 billion per year.<sup>114</sup>

In addition to the above initiative, the U.S. and EU regulators have continued their efforts to improve coordination between in the law enforcement and counter-terrorism arena. Thus, for example, the U.S. Department of Justice and Belgian authorities recently signed The Agreement on Preventing and Combating Serious Crime, which will allow the exchange of biometric and biographic data on suspected criminals, to "bolster counterterrorism and law enforcement efforts while protecting individual privacy." The U.S. has entered into 20 such agreements with European and other nations, including Germany, the Netherlands, Finland, Spain, and Greece.<sup>115</sup>

These developments, reflecting a continuing need to balance law enforcement and national security against privacy protection concerns, have received the highest level of

107 Deliberation 2009-474 (August 19, 2009), <http://www.legifrance.gouv.fr>.

108 See Preliminary FTC Staff Report, "Protecting Consumer Privacy In An Era Of Rapid Change: A Proposed Framework for Businesses And Policymakers," December 2010, <http://www.ftc.gov>; Department of Commerce, Internet Policy Task Force, "Commercial Data Privacy In The Internet Economy: A Dynamic Policy Framework," December 2010, <http://www.ntia.doc.gov>.

109 See, e.g., McCain-Kerry Commercial Privacy "Bill of Rights" legislation, text available at <http://www.kerry.senate.gov>; Diane Bartz, "John McCain, John Kerry Introduce Contentious U.S. Privacy Bill," April 12, 2011, <http://www.reuters.com>.

110 "Protecting Consumer Privacy in an Era of Rapid Change: Recommendations For Businesses and Policymakers," <http://www.ftc.gov/os/2012/03/120326privacyreport.pdf>.

111 The Sedona Conference®, "International Principles on Discovery, Disclosure & Data Protection: Best Practices, Recommendations & Principles for Addressing the Preservation & Discovery of Protected Data in U.S. Litigation," European Union Edition, (December 2011).

112 Neelie Kroes speech in Davos, January 27, 2012, <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/38>; <http://blogs.ec.europa.eu/neelie-kroes/european-cloud-partnership/>.

113 [http://ec.europa.eu/information\\_society/activities/cloudcomputing/index\\_en.htm](http://ec.europa.eu/information_society/activities/cloudcomputing/index_en.htm).

114 Fran Foo, "US government's first chief information officer slams cloud computing excuses," *The Australian*, September 1, 2011.

115 See Department of Justice Press Release, September 20, 2011, <http://www.justice.gov>.

attention in the U.S. and in the EU. Recently, for example, a Dutch government minister suggested that the Dutch government should ban U.S. cloud service vendors from providing service to the government due to concerns that the Patriot Act could be used to invade the privacy of Dutch citizens.<sup>116</sup> Just two days later, the same official changed his position, noting that the issue “is a conflict of legislation that should initially be resolved between governments.”<sup>117</sup>

### *The Data Protection Regulation*

Most recently, on January 25, 2012, the EU Commission endorsed a new EU Regulation on Data Protection<sup>118</sup> intended to supersede the 1995 EU Data Directive.<sup>119</sup> Regarding the proposed EU Regulation, Peter Hustinx, EU Data Protection Supervisor, commented that : “*The proposed rules for data protection in the law enforcement area are unacceptably weak. In many instances there is no justification whatsoever for departing from the rules provided in the proposed Regulation. The law enforcement area requires some specific rules, but not a general lowering of the level of data protection.*”<sup>120</sup>

Among the other provisions of the pending Regulation – subject to modification during the ratification process in the EU Parliament and Council of Europe – is a strong endorsement of Privacy by Design (PbD) – a concept developed originally by Dr. Ann Cavoukian, Ph.D., former Canadian Information and Privacy Commissioner.<sup>121</sup> This concept calls for building in, by default, data privacy and protection controls in computer systems that store, process, manage, and transfer personal data. This Privacy by Design concept was also featured in the Article 29 Working Party Document 168 as the global cornerstone for the Working Party’s vision of “The Future of Privacy.”<sup>122</sup>

Barring a significant change in the direction of cross-border initiatives, including the new EU Regulation, Cloud Computing providers will likely need to build data privacy and data protection controls into Cloud Computing platforms in order to be compliant with “Privacy by Design” as well as Patriot Act requirements.<sup>123</sup>

### *Binding Safe Processor Rules*

The proposed EU Regulation introduce the concept of Binding Safe Processor Rules (“BSPRs”) which instructs data processors to take necessary steps to legitimize international transfers of data by putting in place BSPRs or appropriate contractual arrangements. In the Cloud Computing context, BSPRs will essentially require Cloud Computing providers working in the EU to agree to be legally liable for any data

116 See Zack Whitaker, “Dutch Government To Ban U.S. Providers Over Patriot Act Concerns,” September 19, 2011, <http://www.zdnet.com>.

117 See Loek Essers, “Dutch Minister Changes Patriot Act Stance,” September 21, 2011, <http://www.pcworld.com> (noting Dutch suggestion that the European Commission should “quickly resolve the Patriot Act cloud issue”).

118 See Christopher Kuner, “The European Commission’s Proposed Data Protection Regulation: A Copernican Revolution in European Data Protection Law,” *BNA Privacy and Security Law Report*, 11 PVLR 06, June 2, 2012; and see “EU Commission Press Release” and “Press Conference Recording,” available for download at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/46>.

119 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0010:FIN:EN:PDF>; see also Article 29 Working Party Document 191, “Opinion 01/2012 on the Data Protection Reform Proposals,” 00530/12/EN, 23 March 2012.

120 Available at

<http://europa.eu/rapid/pressReleasesAction.do?reference=EDPS/12/7&format=HTML&aged=0&language=EN&guiLanguage=en>.

121 A biography of Cavoukian is available on the Canadian IPC website at <http://www.ipc.on.ca/english/about-us/about-the-commissioner/>, and more information regarding the Privacy by Design concept can be found at <http://privacybydesign.ca/about/>.

122 See Article 29 Working Party Document 168, “The Future of Privacy,” 02356/09/EN, 1 December 2009, [http://ec.europa.eu/justice/policies/privacy/docs/wpdocs/2009/wp168\\_en.pdf](http://ec.europa.eu/justice/policies/privacy/docs/wpdocs/2009/wp168_en.pdf).

123 For a discussion of the impact of the Directive on cloud service providers, see Thor Olaverud, “Security: Prepared for the EU’s New Data Protection Regulation,” [www.cio.com](http://www.cio.com).

breaches or losses that occur at their data centers. It effectively sets up a kind of accreditation scheme for Cloud Computing providers; to get the accreditation, vendors would have to demonstrate the adequacy of their security controls. EU experts expect that BSPRs will serve somewhat as a “bridge” for expansion of EU-based cloud providers, but that the Patriot Act broader will hinder increase reliance on U.S.-based cloud providers and services.<sup>124</sup>

### *Cloud Contracting Best Practices*

Finally, as a best practice, Cloud Computing agreements must carefully be scrutinized to ensure that they provide consumers with appropriate data privacy and security protection, in accordance with applicable law. Such agreements should clearly define provisions relating to: (1) Service levels; (2) Data Security Breach Notification; (3) Legal Process Notification; (4) Use and Access to Customer Data; (5) Compliance with EU and other Applicable Data Protection Laws; (6) Limits of Liability; (7) Indemnity; (8) Representations and Warranties; (9) Termination and (1) Secure Destruction of Customer Data at Termination.<sup>125</sup>

## CONCLUSION

Some storm clouds do appear on the horizon for cross-border discovery and data privacy, in some part due to the extraterritorial reach of the Patriot Act to U.S.-based Cloud Computing providers. Cloud service providers have the ability to store personal and personal sensitive data of citizens worldwide, anywhere in the world. As a result, cloud service providers and their customers must carefully consider the law applicable to the jurisdictions in which they do business. Cloud Computing providers, particularly those located within or with significant contacts to the U.S. should carefully consider how the U.S.A. Patriot Act, the EU Directive, and the proposed EU Regulation impact the cross-border e-discovery/data privacy landscape, and should take steps now to mitigate additional risks of conflicting legal obligations.<sup>126</sup>

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124 Tom Brewster, “EU to legislate on Cloud Security,” IT News, Sept. 30, 2011, available at: <http://www.itnews.com.au/Tools/Print.aspx?CIID=275266>.

125 See Andrew Geyer and Melinda McLellan, “Strategies for Evaluating Cloud Computing Agreements,” Bloomberg Law Reports, August 5, 2011, available at: [http://www.nymity.com/Free\\_Privacy\\_Resources/Previews/MaskedReferencePreview.aspx?guid=e70bb8c5-0856-4fa5-86ae-1bb87cdf237a](http://www.nymity.com/Free_Privacy_Resources/Previews/MaskedReferencePreview.aspx?guid=e70bb8c5-0856-4fa5-86ae-1bb87cdf237a).

126 See: *New Model Clauses for Data Processors on Their Way?*, Privacy and Information Law Blog, April 25, 2012, available at: <http://privacylawblog.ffw.com/2012/new-model-clauses-for-data-processors-on-their-way.Footnotes 7/7>.

# CANADA'S PRIVACY REGIME AS IT RELATES TO LITIGATION AND TRANS-BORDER DATA FLOWS

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Canadian courts have a long tradition of protecting individual privacy rights. Privacy rights are entrenched in Canada's Constitution<sup>2</sup> and are reinforced by the courts. In the context of litigation, Canadian courts strive to respect the privacy rights of litigants and third parties while ensuring parties adhere to document production obligations. More recently, the globalization of information processing, and the reality that personal information is "both here and there,"<sup>3</sup> has challenged the Canadian courts, as it has the rest of the global community, to consider the privacy implications of information being indifferent to national boundaries.

In this paper, I begin with an introduction to Canada's privacy regime. Next, I discuss how Canadian courts have reconciled production requirements with privacy concerns when the personal information remains within Canada's boundaries. Finally, I explore recent Canadian jurisprudence dealing with the management of privacy concerns regarding the flow of personal information across national boundaries.

## **Canada's Privacy Regime, in Brief**

In the Canadian private sector, federal legislation, the *Personal Information Protection and Electronic Documents Act* ("PIPEDA"),<sup>4</sup> applies to federal works, undertakings and businesses, as well as to provincially regulated business in provinces that do not have adequately similar privacy legislation. To date, only three provinces have enacted private sector legislation which the Canadian government has recognized as being equivalent to PIPEDA: British Columbia, Alberta and Quebec.<sup>5</sup>

Privacy laws in Canada are based on two fundamental notions:

- An individual's personal information ought not to be used or disclosed without the person's consent or in contravention of the person's reasonable expectations; and

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<sup>1</sup> I am indebted to Sarah Willis, Summer Student in Davis LLP's Toronto office, for her assistance with the preparation of this paper.  
<sup>2</sup> *Canadian Charter of Rights and Freedoms*, Part I of the *Constitution Act*, 1982, being Schedule B to the *Canada Act 1982* (UK), 1982 c 11, s 8, protects privacy rights against unreasonable intrusions from the State ("Everyone has the right to be secure against unreasonable search or seizure").  
<sup>3</sup> *Society of Composers, Authors and Music Publishers of Canada v Canadian Associations of Internet Providers*, 2004 SCR 45 at para 59, Binnie J [SOCAM].  
<sup>4</sup> SC 2000, c 5 [PIPEDA].  
<sup>5</sup> *Personal Information Protection Act*, SBC 2003, c 63; *Personal Information Protection Act*, SA 2003, c P-6.5; *An Act respecting the Protection of personal information in the private sector*, RSQ c P-39.

- A proper balance should be struck between the protection of privacy, on the one hand, and access to information or a commercial organization's need to collect, use and disclose personal information, on the other hand.

This balancing act was discussed by the Federal Court of Appeal in *Englander v TELUS Communications Inc.*<sup>6</sup> The court held that an individual's right to privacy is not absolute, and the provisions of PIPEDA are meant to establish the circumstances in which collection, use and disclosure of information can appropriately occur.<sup>7</sup> The court stated that the wording of the Act pointed to the application of an overarching standard of reasonableness in determining disputes.<sup>8</sup>

### *Personal information*

Privacy laws protect an individual's "personal information." "Personal information" is defined similarly in most of the federal and provincial privacy statutes. In PIPEDA, personal information is defined as "information about an identifiable individual, but does not include the name, title or business address or telephone number of an employee of an organization."<sup>9</sup>

Canadian courts have given a generous interpretation to the definition of "personal information" in relation to privacy. In *Dagg v Canada (Minister of Finance)*,<sup>10</sup> the Supreme Court of Canada considered the definition of personal information in the context of the federal public sector privacy legislation. The court held that determining what constitutes personal information requires an analysis of the reasonable expectations of the individual. In this case, information regarding employee logs, specifically who was coming to work after hours, was found to be personal information for the purposes of the *Privacy Act*.<sup>11</sup> The Court found that it was a reasonable expectation of the employees that information regarding their whereabouts would be protected.<sup>12</sup>

Building off the *Dagg* decision, the Federal Court of Appeal further defined "personal information" in *Canada (Information Commissioner) v Canada (Transportation Accident Investigation and Safety Board)*.<sup>13</sup> The court focused mainly on whether it was personal information *about* an individual. The information at issue involved recordings of air traffic controllers. In determining that the communications at issue were of a professional nature, the court said that although they could help to identify an individual, they were not actually *about* the individual. The court also took into account that protection of this type of information was not consistent with the overall purpose of the *Privacy Act* and the values it was working to protect.<sup>14</sup>

A more recent case involving a Canadian furniture store, *Leon's*, had the Alberta courts interpreting "personal information" in the context of Alberta's private sector privacy legislation.<sup>15</sup> At issue in *Leon's* was the right of the company to record both driver's license and license plate numbers when third parties came to pick up furniture for a customer.

6 2004 FCA 387 [*Englander*].

7 *Ibid* at paras 38-40.

8 *Ibid* at para 102.

9 PIPEDA, *supra* note 4, s 2.

10 (1997), 2 SCR 403 [*Dagg*].

11 RSC 1985, c P-21.

12 *Dagg*, *supra* note 10 at paras 71-73.

13 2006 FCA 157 [*Transportation Accident Investigation and Safety Board*].

14 *Ibid* at para 54.

15 *Leon's Furniture Limited v Alberta (Information Privacy Commissioner)*, 2011 ABCA 94 [*Leon's*].

The court's decision arose out of two main issues: first, the definition of personal information and, second, the reasonableness of Leon's practices. Not unlike the courts in *Dagg* and *Transportation Accident Investigation and Safety Board*, the Alberta Court of Appeal in *Leon's* focused on whether the information at issue was about an individual. The court found that driver's license numbers fell under the definition of "personal information" because they are unique to each individual. With respect to license plates, the court determined that although license plates can be traced to individuals, they do not constitute information *about* the individual. The analysis addressed the reasonableness of Leon's decision to record driver's license and license plate numbers as a method of fraud prevention. The court felt that, when balancing between privacy and access, neither principle should be awarded paramountcy. As long as Leon's was acting reasonably, their actions were not contrary to the purpose of the statute.<sup>16</sup>

A recent Ontario Court of Appeal case can be contrasted with the *Leon's* decision. In *Citi Cards Canada v Pleasance*,<sup>17</sup> the Ontario Court of Appeal declined to order the production of a mortgage discharge statement. The court first held that information involving the amount owing on a mortgage constitutes information about an identifiable individual and, therefore, falls under the definition set out in PIPEDA. In coming to this determination, the court commented that the definition of personal information is an "elastic definition" and should be interpreted as such.<sup>18</sup> In *Citi Cards*, the court held that information about property owned by an individual constituted personal information. In *Leon's*, the court came to the opposite conclusion. The difference might be attributable to the nature of the property at issue. The balance owing on a mortgage is more intimately tied to the private affairs of an individual than the numbers attached to an individual's driving privileges.

### **Commercial activity**

PIPEDA applies to organizations which collect, use or disclose personal information in the course of "commercial activities" in all provinces, except organizations that collect, use or disclose personal information entirely within the provinces of Alberta, British Columbia or Quebec, as such organizations are governed by their provincial private sector privacy legislation.<sup>19</sup> Accordingly, an important determination in many privacy related disputes is the definition of "commercial activity."

PIPEDA defines "commercial activity" as follows:

Any particular transaction, act or conduct or any regular course of conduct that is of a commercial character, including the selling, bartering or leasing of donor, membership or other fundraising lists.<sup>20</sup>

The leading case on the interpretation of "commercial activity" involved a dispute over informal notes made by a doctor during an independent medical examination (IME) performed at the request of an insurance company.<sup>21</sup> The insured person, Mr. Rousseau,

<sup>16</sup> *Ibid* at para 39.

<sup>17</sup> 2011 ONCA 3 [*Citi Cards*].

<sup>18</sup> *Ibid* at paras 21-22.

<sup>19</sup> See footnote 5, *supra*. Further, health information collected, used or disclosed by health information custodians in Ontario is also not governed by PIPEDA, as it is governed by specific legislation, the *Personal Health Information Protection Act, 2004*, SO 2004, c 3.

<sup>20</sup> *Supra* note 4 at s 2(1).

<sup>21</sup> *Wyndowe v Rousseau*, 2008 FCA 39 [*Rousseau*].

was seeking access to the written notes after his insurance company terminated his long-term benefits. Whether the information collected by the doctor constituted personal information was not seriously disputed, therefore, one of the main issues was whether it was collected in the course of a commercial activity; in other words, was the IME transaction of a sufficient commercial nature to trigger PIPEDA? The Federal Court of Appeal found that the doctor was acting as an agent of the insurance company, which was engaged in a commercial relationship with Mr. Rousseau. This relationship established on the basis that it was governed by a contract whereby Mr. Rousseau paid the insurance company premiums.<sup>22</sup> Furthermore, the court found that it was the intention of Parliament to include transactions by insurance companies.<sup>23</sup>

With that brief introduction to some of the primary concepts in Canada's privacy regime, I turn to the special context of civil litigation.

### **Privacy Rights in Civil Litigation**

Consent to the collection, use and disclosure of one's personal information is a cornerstone of privacy law in Canada. Express or implied consent, or a prescribed exception to the consent requirement, must always be present in respect of any collection, use or disclosure of personal information in the course of commercial activities.<sup>24</sup>

#### ***Exceptions to the consent requirement***

The provincial private sector privacy Acts in Alberta, British Columbia and Quebec, as well as Ontario's *Personal Health Information Protection Act, 2004*, each include a provision specifically providing that nothing in the respective Acts shall be construed to interfere with information that is otherwise available by law to a party to a proceeding. PIPEDA does not contain a general exemption to the consent requirement in respect of litigation. Instead, PIPEDA contains several exceptions permitting the non-consensual collection, use or disclosure of personal information which may apply in the context of litigation proceedings. The most relevant exceptions in the litigation context are the following:

- An organization may collect personal information without consent if consent would compromise the availability or accuracy of the information and the collection is reasonable for purposes relating to investigating a breach of an agreement or a contravention of the laws of Canada or a province, including the common law.<sup>25</sup>
- An organization may use information without consent if it has reasonable grounds to believe the information could be useful in the investigation of a contravention of the laws of Canada and the information is used for the purpose of investigation.<sup>26</sup>

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<sup>22</sup> *Ibid* at para 35.

<sup>23</sup> *Ibid* at para 37.

<sup>24</sup> PIPEDA, *supra* note 4, sch 1, provides that "The knowledge and consent of the individual are required for the collection, use, or disclosure of personal information, except where inappropriate" (ss 4.3), and further that, "Personal information shall not be used or disclosed for purposes other than those for which it was collected, except with the consent of the individual or as required by law" (ss 4.5).

<sup>25</sup> *Ibid*, s 7(1)(b).

<sup>26</sup> *Ibid*, s 7(2)(a).



- Disclosure without consent is permitted if the disclosure is made to, in the Province of Quebec, an advocate or notary or, in any other province, a barrister or solicitor who is representing the organization.<sup>27</sup>

Disclosure without consent is permitted for the purpose of collecting a debt owned by an individual, where required to comply with a subpoena, warrant, court order or the rules of court relating to the production of records or when made to an investigative body on reasonable grounds to believe that the personal information relates to a breach of an agreement or contravention of the laws of Canada or of a province or a foreign jurisdiction.<sup>28</sup>

In *Lisozzi v Bell Distribution Inc.*,<sup>29</sup> the Ontario Supreme Court discussed these exceptions and stated as follows:

Section 7[(3)](c) in no way precludes the inspection of document No. 24 but instead mandates that the document can be produced or ordered to be produced to comply with the rules of court relating to inspection of documents. Section 7[(3)](a) complements that requirement by ensuring that disclosure can be made to the lawyer representing the party which then permits the solicitor to fulfill his or her duty vis-a-vis the necessity of full disclosure of all documents relating to any matter in issue in the action as required by Rule 30.03(4).<sup>30</sup>

### ***Publicly available information***

Publicly available information is also exempt from the consent requirement so long as the collection, use or disclosure relates directly to the purpose for which the personal information appears in the public record, document or registry, namely telephone books, professional or business directories, statutory registries, and documents of a judicial or quasi-judicial body that are available to the public.<sup>31</sup> In *Citi Cards*, the appellant argued that mortgage information fell under this exception because the amount of a mortgage is available from the Registry Office and the balance may be accessible from credit bureaus. The court rejected this argument, noting that mortgage information was not mentioned in the regulations, nor is the balance owing on a mortgage publicly available anywhere. The court clarified some aspects of section 7, saying that in order for information to fall under this exclusion, it must have been **collected** from a publically available source.<sup>32</sup>

### ***Implied consent***

Implied consent is also important in the litigation context. Not surprisingly, if one commences a lawsuit, he or she must expect to have some intrusions into their personal information. In *Ferency v MCI Medical Clinics*,<sup>33</sup> the court emphasized that a party

<sup>27</sup> *Ibid.*, s 7(3)(a).

<sup>28</sup> *Ibid.*, s 7(3)(c).

<sup>29</sup> [2001] OJ No 2378.

<sup>30</sup> *Ibid.* at para 11.

<sup>31</sup> PIPEDA, *supra* note 4, s 7(3)(h.1); *Regulations Specifying Publicly Available Information*, SOR/2001-7 s 1.

<sup>32</sup> *Supra* note 17 at para 27.

<sup>33</sup> [2004] OJ No 1775 [*Ferency*].

provides implied consent to the collection and use of relevant personal information when she commences a law suit:

The plaintiff has given implied consent to the defendant to collect, record and use her personal information insofar as it is related to defending himself against her lawsuit. A plaintiff must know that by commencing action against a defendant, rights and obligations will be accorded to the parties to both prosecute and defend.<sup>34</sup>

In *M(A) v Ryan*,<sup>35</sup> the Supreme Court of Canada grappled with whether to order the disclosure of notes taken during a counseling session between a sexual assault victim and a psychiatrist. In determining whether an order for disclosure should be made, the Court noted that a balance between the proper administration of justice and the protection of individual privacy was needed in the litigation context.<sup>36</sup> In that case, the Court ordered the disclosure of the notes, but only the necessary parts and only to a very limited number of individuals. The Court emphasized that implied consent is given to the use of a plaintiff's personal information only to the extent necessary to bring to light information necessary to the determination of the dispute:

...by commencing proceedings against the respondent Dr. Ryan, the appellant has forfeited her right to confidentiality. I accept that a litigant must accept such intrusions upon her privacy as necessary to enable the judge or jury to get to the truth....But I do not accept that by claiming such damages as the law allows, a litigant grants her opponent a license to delve into private aspects of her life which need not be probed for the proper disposition of the litigation.<sup>37</sup>

What if no exception applies, and no consent, implied or otherwise has been given?

### ***Admissibility of personal information without consent in litigation***

While a violation of PIPEDA during litigation will not necessarily render information inadmissible in civil litigation, disregarding individual privacy can be a factor considered by the courts in awarding costs and in determining whether to remove counsel from the record.<sup>38</sup> The court in *Ferency* dealt with the admissibility of videotape evidence in a medical malpractice claim. The plaintiff argued that the making and disclosure of the video were in contravention of PIPEDA. The court found that the evidence contained in the video was relevant and its probative value exceeded any prejudicial effects.<sup>39</sup> On the issue of privacy, the court provided valuable clarification on the applicability of PIPEDA in the litigation context. The defendant doctor had hired a private investigator to collect video evidence for use in the lawsuit. The plaintiff argued that the relationship was of a commercial nature and thus should be governed by PIPEDA. The court disagreed with this

<sup>34</sup> *Ibid* at para 31.

<sup>35</sup> (1997), 1 SCR 157 [*Ryan*].

<sup>36</sup> *Ibid* at para 10.

<sup>37</sup> *Ibid* at para 38.

<sup>38</sup> *Supra* note 31.

<sup>39</sup> *Ibid* at para 16.

argument, stating that the private investigator was simply acting as an agent for the doctor. The doctor was collecting the video evidence for a personal purpose – namely defending himself in a lawsuit, which is allowed under PIPEDA.<sup>40</sup> The presiding judge determined that the video tape evidence was not collected, used or disclosed in contravention of PIPEDA, but even if it had been, the evidence is relevant and admissible as a result of its probative value.<sup>41</sup>

A 2005 Ontario Superior Court decision further addressed admissibility of evidence when privacy concerns are raised.<sup>42</sup> The court stated that procedures for bringing complaints under PIPEDA are outlined in that Act, and therefore the court could not bypass these procedures and effectively override the Privacy Commissioner's jurisdiction to make an order regarding admissibility. The appropriate procedure would be for a complaint to be made under PIPEDA, and a report made by the Commissioner, and then potentially a hearing to be conducted in Federal court.<sup>43</sup>

Despite the requisite procedures, the Privacy Commissioner's report will not always govern. *Eastmond v Canadian Pacific Railway*<sup>44</sup> dealt with surveillance cameras placed around the worksite by Canadian Pacific Railway (CP). In that case, the Federal Court overruled the Privacy Commissioner's decision that the cameras were unreasonable and thus violated PIPEDA. In *Eastmond*, the court took a contextual approach saying that Parliament intended PIPEDA to be applied in a way that looks at why, how, when and where personal information is collected. Accordingly, in making a determination, the court should look at the appropriate circumstances surrounding collection, use and disclosure, noting that what is appropriate for collection may not be for use or disclosure and vice-versa.<sup>45</sup> The decision of the court turned, in part, on the fact that the recordings were never viewed unless there was a triggering event such as a theft. The court agreed with CP's argument that the collection of personal information did not actually occur until there was a triggering event, and at that point they were protected by the exemption under section 7(1)(b) of PIPEDA, which provides an exception if asking for consent would compromise the availability of the information for the purpose of an investigation.<sup>46</sup>

### ***Implied undertaking rule***

Prior to legislative protections for privacy interests in litigation, the “deemed undertaking rule”, also known as the “implied undertaking rule”, protected these interests, and continues to be invoked in the Canadian courtroom as a counterbalance to claims of intrusion on individual privacy. The implied undertaking rule is a common law rule developed as a response to concerns regarding the invasion of litigants' privacy that occurs in the course of a legal proceeding. The rule protects information obtained on discovery, preventing it from being used for purposes collateral to the proceedings in which it is disclosed.<sup>47</sup>

<sup>40</sup> *Ibid* at paras 25-30.

<sup>41</sup> *Ibid* at para 35.

<sup>42</sup> *Osiris Inc v 1444707 Ontario Ltd* (2005), OJ No 5527 [*Osiris*].

<sup>43</sup> *Ibid* at paras 83-84.

<sup>44</sup> *Eastmond v Canadian Pacific Railway* (2004), 2004 FC 852.

<sup>45</sup> *Ibid* at para 131.

<sup>46</sup> *Ibid* at paras 187-190.

<sup>47</sup> *Halsbury's Laws of Canada*, 1st ed, vol 2 (Markham, Ont: LexisNexis Canada, 2008) “Civil Procedure”, VIII.3(9). The common law deemed undertaking rule has been codified in many Canadian rules of court. See, for example, Ontario Rules of Civil Procedure, RRO 1990, reg 194, r 30.1.

A 2008 Ontario Court of Appeal case provided an extensive analysis of the deemed undertaking rule as it applied to videotape disclosure.<sup>48</sup> At issue in *Kitchenham* was whether a plaintiff was under an obligation to produce a surveillance video received through the disclosure process in a prior civil case. In the reasoning, the court quoted the following excerpt from a leading English discovery text addressing the implied undertaking rule:

The primary rationale... is the protection of privacy. Discovery is an invasion of the right of the individual to keep his own documents to himself. It is a matter of public interest to safeguard that right... it is in general wrong that one who is compelled by law to produce documents for the purpose of particular proceedings should be in peril of having those documents used by the other party for some purpose other than the purpose of the particular legal proceedings....<sup>49</sup>

The court then went on to conclude that the documents at issue were protected by the implied undertaking rule and therefore could only be produced upon consent of the affected party or a court order under the *Rules of Civil Procedure*.<sup>50</sup>

### ***Relevance and proportionality***

The concepts of relevance and proportionality are also be used to protect privacy interests in Canada. *The Sedona Canada Principles*<sup>51</sup> emphasize taking a broad, holistic approach to discovery, specifically stating that proceedings in a discovery process should focus on proportionality, taking into account:

(i) the nature and scope of the litigation, including the importance and complexity of the issues, interest and amounts at stake; (ii) the relevance of the available electronically stored information; (iii) its importance to the court's adjudication in a given case; and (iv) the costs, burden and delay that may be imposed on the parties to deal with electronically stored information.<sup>52</sup>

*The Sedona Canada Commentary on Proportionality in Electronic Disclosure and Discovery*<sup>53</sup> elaborates further by emphasizing the importance of considering non-monetary factors when analyzing the proportionality of evidence. Non-monetary costs, such as the invasion of privacy, are to be considered by judges when determining whether production of evidence should be restricted.<sup>54</sup> In making a determination, judges look to balance the relevance and importance of the requested information with the protection of privacy interests of the litigant or non-party.

48 *Kitchenham v AXA Insurance Canada* (2008), 94 OR (3d) 276 [*Kitchenham*].

49 Paul Matthews & Hodge Malek, *Discovery* (London: Sweet & Maxwell, 1992) at 253, cited in *Kitchenham*, *ibid* at para 31.

50 RRO 1990, reg 194, r 30.1.01(8).

51 *The Sedona Canada Principles Addressing Electronic Discovery*, 2008 at 11 [*The Sedona Canada Principles*], online: Sedona Conference <<https://thesedonaconference.org/>>.

52 *Ibid*.

53 *The Sedona Canada Commentary on Proportionality in Electronic Disclosure & Discovery*, 2010, online: Sedona Conference <<https://thesedonaconference.org/>>.

54 *The Sedona Canada Principles*, and the concept of proportionality, have explicitly been incorporated into the Rules of Civil Procedure in Ontario.

There are many examples in the Canadian courts of balancing production obligations with privacy concerns using the twin concepts of relevance and proportionality. In *Desgagne v Yuen*,<sup>55</sup> the plaintiff was severely injured in a collision while she was riding a bicycle. The defendants applied to the court for access to her hard drive, palm pilot, photos and video game console in the hopes that there would be evidence that she was exaggerating her injuries. The court likened disclosure of all of these documents to an electronic monitoring bracelet, noting that the former amounts to an even greater intrusion than the latter.<sup>56</sup> The court offered a valuable analysis on electronic discovery issues dealing with hard drives and metadata. The main concerns for the court were regarding the over-breadth of disclosure of this kind and the fact that potentially relevant data was only speculative in nature. There was no guarantee that production of the documents would end in relevant evidence. In this case, the intrusion far outweighed the probative value.<sup>57</sup>

The court in *Baldwin Janzen Insurance Services (2004) Ltd. v. Janzen* similarly dismissed an application to have a hard drive produced due to a lack of compelling reasons as to why it should be produced. There was nothing to suggest the defendant was lying or failing to disclose relevant documents, and so the court was loath to make the order.<sup>58</sup>

The court in *Vector Transportation Services Inc v Traffic Tech Inc*<sup>59</sup> came to a different conclusion than in the previous two cases, upholding an order for the production of the defendant's laptop to search for e-mails relevant to the claim. In coming to its conclusion, the court distinguished the facts from those in *Baldwin Janzen* and *Yuen*, saying that the former was a case where the plaintiff "simply did not justify the court making the intrusive order,"<sup>60</sup> and the latter involved a situation where the value of disclosure did not outweigh the values of privacy and the efficient use of judicial resources.<sup>61</sup> In *Vector Transport*, the documents to be produced were more carefully defined and there appeared to be evidence suggesting that relevant documents were in the defendant's possession.<sup>62</sup>

### **Redaction**

Finally, redaction and de-identification of personal information are recognized by Canadian courts as useful tools to balance privacy concerns with production needs. If the personal information is contained in a document that otherwise meets the thresholds of relevance and proportionality so as to be producible, but the personal information itself is not relevant and proportional, it might be possible for the personal information to be removed or neutralized. In *Andersen v. St. Jude Medical, Inc.*,<sup>63</sup> Master MacLeod of the Ontario Superior Court considered the production of a database containing personal health information. He set out a useful test for when personal information could be redacted from an otherwise producible dataset:

- a) The data produced must be substantially the same data as that which has been reviewed by the producing party's own experts. If not, then the parties' experts are being asked to draw conclusions based on different information.

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55 2006 BCSC 955 [*Desgagne*].

56 *Ibid* at para 14.

57 *Ibid* at para 20-23.

58 2006 BCSC 554 [*Baldwin Janzen*].

59 (2008), OJ No 1020 (Ont SCJ) [*Vector Transportation*].

60 *Ibid* at para 17.

61 *Ibid* at para 24.

62 *Ibid* at para 27.

63 (2008), OJ No 430 [*Anderson*].

- b) The forensic continuity of the data must be demonstrable such that any issues about authenticity or accuracy can be readily answered.
- c) The process of redaction must not leave the data less meaningful or useful.
- d) The process of redaction must not unduly delay production.<sup>64</sup>

As illustrate by the cases cited, the Canadian courts have much experience balancing production obligations with privacy rights as purely domestic issues.

### **International transfers and trans-border data flows**

Developments in data processing have resulted in a novel set of privacy-related issues for the international community. Protection of personal data has gone from a domestic issue, to one that transcends national and geographical boundaries. In 1980, the Organisation for Economic Co-operation and Development (OECD) was the first international organization to tackle the issue. The OECD's 1980 guidelines established a set of governing principles that numerous countries utilized in developing domestic laws addressing these issues.<sup>65</sup> Many other organizations continue to address the implications of, and best practices for, international data transfers, including Working Group 6 of The Sedona Conference<sup>®</sup>, which released in December 2011 a public comment version of its *International Principles of Discovery, Disclosure & Data Protection: Best Practices, Recommendation & Principles for Addressing the Preservation and Discovery of Protected Data in US Litigation (European Union Edition)*.<sup>66</sup>

PIPEDA does not prohibit organizations in Canada from transferring personal information to an organization in another jurisdiction for processing.<sup>67</sup> Under PIPEDA, a "transfer" of personal information is a use by the organization. When personal information is transferred, it can only be used for the purposes for which the information was originally created (and no additional consent for the transfer will be required).<sup>68</sup> "Processing" is interpreted to include any use of the information by the third party for a purpose for which the transferring organization can use it.<sup>69</sup> Under Canadian law, organizations are held accountable for the protection of personal information "transfers" under each individual outsourcing agreement. PIPEDA requires the organization to use contractual or other means to "provide a comparable level of protection while the information is being processed by the third party."<sup>70</sup>

Aside from contractual terms, the Office of the Privacy Commissioner of Canada requires organizations to take into account the nature of the foreign regime, including

<sup>64</sup> *Ibid* at para 31.

<sup>65</sup> *OECD Guidelines on the Protection of Privacy and Transborder Flows of Personal Data* (1980), online: OECD <[http://www.oecd.org/document/18/0,3746,en\\_2649\\_34223\\_1815186\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/18/0,3746,en_2649_34223_1815186_1_1_1_1,00.html)>.

<sup>66</sup> (2011), online: The Sedona Conference" <<https://thesedonaconference.org/>>.

<sup>67</sup> Canada's public sector privacy law, the *Privacy Act*, RSC 1985, c P-21, also does not prohibit transfers of personal information. Note, however, that British Columbia and Nova Scotia have enacted legislation that limit a public body's ability to outsource the processing of personal information outside of Canada. However, even in these provinces, there are no restrictions on third party service providers accessing the information in Canada. See *Freedom of Information and Protection of Privacy Act*, RSBC 1996, c 165 and *Personal Information International Disclosure Protection Act*, SNS 2006, c 3.

<sup>68</sup> PIPEDA, *supra* note 4, sch 1, ss 4.5; see also Office of the Privacy Commissioner of Canada, *Processing Personal Data Across Borders: Guidelines* (2009) at 5, online: Office of the Privacy Commissioner of Canada <[http://www.priv.gc.ca/information/guide/2009/gl\\_dab\\_090127\\_e.asp](http://www.priv.gc.ca/information/guide/2009/gl_dab_090127_e.asp)> [*Guidelines*].

<sup>69</sup> PIPEDA, *ibid*, ss 4.1.3; see also *Guidelines, ibid* at 5; see also Office of the Privacy Commissioner, *Bank's notification to customers triggers Patriot Act concerns* (2005), online: Office of the Privacy Commissioner <[http://29717.vws.primus.ca/cf-dc/2005/313\\_20051019\\_e.cfm](http://29717.vws.primus.ca/cf-dc/2005/313_20051019_e.cfm)>.

<sup>70</sup> PIPEDA, *ibid*, ss 4.1.3.

economic and social conditions to assess the risk to the integrity, security and confidentiality or customer personal information. In other words, an organization must ask itself “how likely is it that there will be access to the personal information by foreign courts, law enforcement and national security organizations?”<sup>71</sup>

While transfers of Canadian personal information outside the country is not prohibited, it is clear in Canada that the Office of the Privacy Commissioner of Canada has jurisdiction to regulate the transfers of personal data from Canada to other jurisdictions. This was confirmed in the 2007 case of *Lawson v Accusearch Inc.*<sup>72</sup> *Lawson* involved a judicial review of the Privacy Commissioner’s decision concerning the collection, use and disclosure of Canadian personal information by a US company. The Privacy Commissioner said that she had no extraterritorial effect and, therefore, lacked jurisdiction to compel the respondent to produce evidence necessary to conduct the investigation. The Federal Court disagreed and stated that the destination of the information was irrelevant, because the information had to have come from Canada at some point. Therefore, although the inability to identify the Canadian sources may frustrate the investigation, it does not mean the Privacy Commissioner has no jurisdiction to act.<sup>73</sup> In *Lawson*, the Federal Court relied on the Supreme Court of Canada decision in *SOCAN*.<sup>74</sup> The question on appeal before the Supreme Court of Canada was “who should compensate musical composers and artists for their Canadian copyright in music downloaded in Canada from a foreign country via the Internet?”<sup>75</sup> The court began by stating that the capacity of the internet to disseminate information and art around the world is highly valued, but it should not be facilitated unfairly at the expense of the creator of the works.<sup>76</sup> The Court then concluded that there was a sufficient connection for taking jurisdiction when Canada was either the country of transmission or reception.<sup>77</sup>

A complaint by a Canadian regarding cloud computing likely also comes under PIPEDA and under the jurisdiction of the Privacy Commissioner of Canada. The Privacy Commissioner has taken the position that where the Privacy Commissioner has jurisdiction over the subject matter of the complaint (i.e. collection, use, disclosure of Canadian personal information) but the complaint deals with cloud computing infrastructure that is not obviously located in Canada, “current jurisprudence is clear that the Privacy Commissioner may exert jurisdiction when assessment indicates that a real and substantial connection to Canada exists”.<sup>78</sup>

The case of *DataTreasury Corporation v Royal Bank of Canada*,<sup>79</sup> illustrates the Canadian courts’ approach to data transfers from Canada to the United States, and highlights key aspects of the Canadian privacy regime, including the implied undertaking rule and the specific exemptions to consent which allow for international transfers. *DataTreasury* took the form of a motion before a Prothonotary of the Federal Court of Canada to settle the terms of a protective order. *DataTreasury* and certain banks, the “Banking Group”, were engaged in patent infringement and patent impeachment proceedings. The parties contemplated a protective order to maintain the confidential aspects of the patented technology and other confidential information of the parties.

71 *Guidelines*, *supra* note 66 at 6-7.

72 (2007), 4 FCR 314 [*Lawson*].

73 *Ibid.*

74 *SOCAN*, *supra* note 3.

75 *Ibid* at para 1.

76 *Ibid* at para 40.

77 *Ibid* at paras 44-45 (This conclusion differed from the lower court’s views that only transmission amounted to a sufficient connection).

78 Office of the Privacy Commissioner, *Reaching for the Cloud(s): Privacy Issues Related to Cloud Computing* (2010), online: Office of the Privacy Commissioner <[http://www.priv.gc.ca/information/pub/cc\\_201003\\_e.asp](http://www.priv.gc.ca/information/pub/cc_201003_e.asp)>.

79 (2008), 2008 FC 955 [*DataTreasury*].

DataTreasury was headquartered in the United States and insisted that productions in the course of the proceedings would need to be sent to the United States because its central document database, document management consultants, United States counsel, witnesses and experts were all centralized in the United States. The Banking Group wanted a “Canada Only Clause” in the protective order that would have allowed the party producing information to serve and file a notice of motion to request an order preventing disclosure of the information outside of Canada. The receiving party would then be precluded from sending the information outside of Canada until after the final disposition of the motion, including any appeals.

The Banking Group expressed concerns about the transfer of its data to the United States which necessitated the “Canada Only Clause”, as follows:

- a) Canadian banks have been the subject of highly publicized privacy complaints relating to counter-terrorism laws;
- b) The potential that these proceedings could prompt similar complaints and cause serious harm to the goodwill of the Banking Group;
- c) The absence of the implied undertaking rule in the United States; and
- d) That the security of the Canadian banking system could be needlessly compromised if detailed information relating to the networks used by the Banking Group for processing financial documents were permitted to leave the country.<sup>80</sup>

The Federal Court acknowledged that once the information had left Canada, it could be subject to production in ways not contemplated by the parties. However, the court also found that the Canada Only Clause would result in endless motions and could limit the ability of counsel to show relevant documentation to its client located in the United States and to receive instructions. In its decision, the court attempted to address the Banking Group's concerns. The court noted that section 7(3) of PIPEDA specifically permits disclosure of personal information in these circumstances. That is, the knowledge or consent of the individual to whom the information relates is not required where disclosure is required to comply with rules of court relating to the production of records, in this case, the Federal Court Rules. Further, it stated that the personal information of customers of the Banking Group need not be produced and could be redacted. With respect to the use of the documents once they were in the United States, the court noted that the documents disclosed in this proceeding were in fact impressed with the implied undertaking that the documents and information would not be used for purposes other than these proceedings. As a precaution, the court ordered that the implied undertaking rule be explicitly set out in the protective order. While the Banking Group raised a concern about seizure of the productions by the U.S. Government under the PATRIOT Act, the court noted that this seizure concern was raised “as a possibility not an absolute reality” and that several members of the Banking Group routinely engage in outsourcing activities which permit personal information of customers to be sent to the United States.<sup>81</sup>

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<sup>80</sup> *Ibid* at para 4.

<sup>81</sup> *Ibid* at para 22.



The *DataTreasury* case illustrates several tools which the parties and the courts can use in the context of Canada-U.S. data transfers to maintain privacy rights and ensure production obligations are satisfied. A protective order can be used to limit access to documents and require those obtaining access to execute confidentiality agreements and to explicitly state the implied undertaking rule for the benefit of those U.S. parties who are unfamiliar with the implied undertaking rule. Further, redaction should always be considered as a means of ensuring irrelevant personal information does not get disclosed.

At The Sedona Conference® “4th Annual International Programme on Cross-Border Discovery and Data Privacy” held in Toronto in June 2012, the participants will consider whether such traditional tools to protect the privacy of Canadians, coupled with The Sedona Conference’s *International Principles of Discovery, Disclosure & Data Protection: Best Practices, Recommendation & Principles for Addressing the Preservation and Discovery of Protected Data in U.S. Litigation (European Union Edition)*, are appropriate and sufficient for protecting privacy in the context of Canada-U.S. transfers. It is hoped that a consensus will emerge as to best practices for managing data flows across the Canadian border for use in U.S. litigation.



# THE SEDONA CONFERENCE® COMMENTARY ON FINDING THE HIDDEN ROI IN INFORMATION ASSETS

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## PREFACE &amp; ACKNOWLEDGEMENTS

Welcome to a special publication in The Sedona Conference® Working Group Series (the “WGS”): *The Sedona Conference® Commentary on Finding the Hidden ROI in Information Assets*. The mission of The Sedona Conference® is to bring together lawyers, experts, and academics to discuss cutting edge legal issues, including those arising out of or affected by complex litigation. In furtherance of this mission, the present paper represents the work product of an interdisciplinary, diverse group of corporate officers, lawyers, information management professionals, representatives of legal services, and leading academics in the legal and business communities, who came together with a common interest in thinking strategically about how to improve knowledge-sharing in complex organizations, recognizing the asset value of information.

Against the backdrop of prior “e-discovery related” commentaries published as part of The Sedona Conference® Working Group Series by the Working Group on Electronic Document Retention and Production (WG1), a group of uniquely talented individuals met in December 2008 in Phoenix, Arizona, to discuss how to take the next step beyond merely managing e-discovery risk, to better leverage the enormous value of information caught up within firms and organizations of all types. These discussions led to consideration of a new approach to thinking about information management and information governance issues, based on consideration of the “option value” of information, at the suggestion of Professor Mark Cotteleer at Marquette University. The work of the group went through a series of drafts, and was aided by presentations given by group members at successive annual conferences of the ARMA International, in Orlando in 2009 and San Francisco in 2010.

The paper represents the collective efforts of many individual contributors. I especially want to acknowledge the contributions to the overall success of this project made by Jason R. Baron, Co-Chair of WG1 of The Sedona Conference®, as well as by Professor Steven S. Gensler, and Bennett B. Borden, each of whom supplied invaluable editorial assistance guidance at crucial junctures. The remaining contributing editors also substantially contributed in creating the initial text of the paper, in editing, and in participating in the group’s ongoing discussions. On behalf of The Sedona Conference®, I wish to thank everyone involved in devoting their time and attention during the drafting and editing process.

*Richard G. Braman*

Executive Director  
The Sedona Conference®  
February 2011

## EXECUTIVE SUMMARY

Since the advent of the Information Economy, we can create information in ways only dreamed of in prior periods. The amount of information existing in the world is almost unfathomable, and is growing exponentially. Today, firms, businesses, governmental organizations and non-profits (which we refer to generally as entities) create massive volumes of information. But it is much easier to create information than to effectively govern it in order to leverage its value beyond the short-term use for which it is created. Not only is its long-term use often untapped, but ungoverned information also can be a significant liability.

In this increasingly information-driven world, it has become all the more imperative that business entities make the effort to “know what they know.” The stark reality is that few such entities of any size have a real grasp of the full range of the information over which they are stewards, and fewer still have any institutional knowledge of where it is all located. This fundamental information governance problem is only exacerbated by corporate data environments that, largely by happenstance, discourage information sharing due to the diverse nature of the data repositories, their dispersion across the organization, and the unstructured nature of the information itself that is sorely in need of greater corporate governance.

Conventional wisdom says to manage the risk by adopting strict record retention plans and schedules, and sees information only in terms of its potential for liability. From that perspective, the urge to purge can be difficult to resist. But we all know that information is power. So why throw it away? Is it because the entity has made an informed determination that the risk of the information exceeds its potential benefit? Or is it because few entities have developed processes that allow them to know what they have, where it is kept, how it is being used, how it is *not* being used, and – most importantly – how it might *additionally* be used to be of benefit.

The solution does not lie in bigger and faster computing. In many ways, all of those new computers have caused the problem: generating and storing massive amounts of information sent to isolated silos and known to only a few. Rather, a possible solution lies in engaging the entity’s personnel – drawn from across a wide range of functions – to develop entity-specific methods for determining when information is not being used to its full potential. And, chances are, most of the assets an entity needs to do that are already in place.

The purpose of this paper is to provide an approach through which an entity can better identify, calculate and leverage the “hidden” value or return on investment (ROI) of the information it creates. We call this the *option value approach* to emphasize the importance of recognizing the long-term, strategic value of using or re-purposing an entity’s information in new and additional ways. We also provide a method whereby that value can be measured to help justify an investment in information governance schemes.

In Part One of this paper, we discuss how information systems typically develop within an entity, and how this development often results in an environment that works against information sharing and the leveraging of the long-term value of information.

Part Two of this paper makes the business case for adopting an option value approach to information governance. We examine how information systems are usually viewed contrasted with the option value approach. Information management systems and records management initiatives are often viewed from the actuarial perspective: they often are instituted in order to reduce an entity's risk of negative outcomes. Some of these outcomes include the substantial transactional costs of *ad hoc* processes for identifying and accessing information in response to regulatory or litigation requests; sanctions from courts or regulators for failing to properly identify and produce information; lost opportunities to adequately evidence present claims or defenses; and possible violations of statutory requirements regarding record retention and data privacy and security, among others.

In contrast, we propose an option value perspective of information. Effectively governing information not only keeps an entity out of trouble, it can provide greater ROI in information systems and the expense of instituting effective information governance policies and procedures. Information can be more effectively shared with other individuals and groups within an entity so that the value of that information can be extended beyond its original use. We go on to describe the benefits of re-purposing information, and provide several real world examples.

In Parts Three and Four, we describe the steps an entity can undertake to begin realizing the option value of its information assets. Information governance must be viewed as a value proposition, in which entities fully engage themselves in assessing the potential, untapped value of their information assets before making cost-based decisions about what to do with that information. A critical step in this process is the formation of an interdisciplinary team consisting of key players drawn from across the entity's functional groups to help identify its information assets, developing ways of leveraging their option value, and instituting policies and procedures to realize it. No single person knows everything about the entity's information assets, and no single person knows all of the ways in which existing information assets can be re-purposed to extract value.

In Part Five, we set out a framework describing the steps an entity can undertake to calculate the unrealized value of its information assets, and in Part Six, we discuss how an information governance scheme, focused on realizing value, can be implemented through the use of C-level champions and stakeholders, and various techniques including project management and active monitoring.

## INTRODUCTION

The world is awash in information, and is becoming increasingly so. Two professors at Berkeley estimated that between 1999 and 2002, the amount of electronic information doubled to five exabytes – the equivalent of adding half a million digital repositories the size of the Library of Congress.<sup>1</sup> In 2008, an IDC whitepaper<sup>2</sup> predicted that by 2011, the amount of digital information will be 10 times the size it was in 2006. This accelerated growth in electronic information is in part due to the ease by which electronic information is created, and the increasingly creative and diverse ways in which it is utilized. The world of email, simple documents and databases has been enriched (and complicated) by the introduction of collaborative technologies, social networking, interactive GPS applications, and the like. In short, organizations are accountable for an increasingly diverse and voluminous body of data,<sup>3</sup> and they are spending millions of dollars, and in some cases, billions,<sup>4</sup> on IT infrastructure and information management projects to understand and utilize this data. But, it is much easier to create electronic information than it is to effectively manage and govern it, let alone leverage it to the benefit of an organization.

As recognized in *The Sedona Guidelines: Best Practice Guidelines & Commentary for Managing Information & Records in the Electronic Age* (2d ed. 2007), “the fundamental transition to an electronic data environment in most organizations has resulted in an increased need for better information and records management controls and programs.”<sup>5</sup> The *Sedona Guidelines* went on to note that as a result of “several converging forces, the top management in many organizations,” including C-level executives, are “increasingly aware that identifying and managing information and records should be a business priority.”<sup>6</sup> However, the problem of optimizing the value of particular information assets goes much deeper than simply agreeing to the adoption of enhanced records management practices and procedures: it is rather a core issue of *information governance* that needs to be looked at in a new way.

Gartner defines the emerging discipline of “*information governance*” as including “the processes, roles, standards and metrics that ensure the effective and efficient use of information in enabling an organization to achieve its goals.”<sup>7</sup> Information governance is a broader concept than focusing alone on any one discipline, i.e., information management, information protection and security, records management, knowledge management, and/or electronic discovery practices and protocols – although each of these may play a vital constituent part in an organization’s overall information governance strategy or framework.

Organizations commonly become painfully aware of their looming information governance problem when they attempt to delve into their data to comply with regulatory or litigation requirements. Requests from shareholders or regulators, as well as e-discovery demands, often lead to frustrating and/or fervent efforts to understand where an organization’s data exists and what it contains. Organizations often see their stores of

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1 Peter Lyman and Hal R. Varian, “How Much Information?” (2003), <http://www.sims.berkeley.edu/how-much-info-2003>.  
 2 IDC, “The Diverse and Exploding Digital Universe: An Updated Forecast of Worldwide Information Growth through 2011.” (2008). <http://www.emc.com/collateral/analyst-reports/diverse-exploding-digital-universe.pdf>.  
 3 George L. Paul and Jason R. Baron, “Information Inflation: Can The Legal System Adapt?,” 13 RICHMOND J. LAW & TECH. 10 (2007), at ¶ 1 n.2 (“Organizations have thousands if not tens of thousands of times as much information within their boundaries as they did 20 years ago”).  
 4 See, e.g., Ben Bain, “NASA plans to spend billions for IT services,” *Federal Computer Week* (Sept. 18, 2009), <http://www.washingtontechnology.com/Articles/2009/09/18/Web-NASA-IT-Services.aspx>.  
 5 *Id.* at 11.  
 6 *Id.*  
 7 See [http://blogs.gartner.com/debra\\_logan/2010/01/11/what-is-information-governance-and-why-is-it-so-hard/](http://blogs.gartner.com/debra_logan/2010/01/11/what-is-information-governance-and-why-is-it-so-hard/).

electronic data through a glass darkly, and the infrastructure supporting it primarily as a costly means of managing and avoiding risk (i.e., staying out of trouble). Yet hidden within an organization's often siloed data stores lies valuable information assets that, when properly assessed and governed, can be leveraged to great benefit beyond mere risk avoidance.

In this paper, we introduce the concept of adopting an *option value approach* as one key to doing better in meeting the information governance challenge – by identifying, calculating and leveraging the option value of corporate information assets. Option value, as defined here, is simply the long-term strategic value of such assets. Organizations typically leverage information fairly effectively over the short-term: e.g., e-mail for current communications, financial data for the latest reporting periods. They are also better at leveraging structured data than over unstructured data.<sup>8</sup> But once the data's short-term use is expended, the data is often stored away and rarely reassessed for any long-term strategic value. Left ungoverned, this potentially valuable asset is not only wasted, it also may become a significant liability. Through proper information governance, however, organizations can realize additional benefit from their information assets, thus increasing the option value of those assets while reducing potential risk. This option value increases the return on investment (ROI) from the technological and human resources employed to create and manage an organization's information.

The option value approach can identify value for a wide range of organizations (public, private, non-profit or governmental), through which they can differentiate themselves. For instance, for-profit organizations can achieve competitive advantage and non-profit ones can increase funding potential and enhance service provision. Organizations can create opportunities to generate new products and services, increase market share, exceed customer expectations and increase the defensibility of their information governance practices.

It cannot be known in advance to what extent an organization's existing information governance practices are leaving value on the table, though in our experience it is often substantial. The only certainty is that organizations cannot know whether they are optimizing the value of their information assets until they go through the option value exercise, ask the right questions, and implement appropriate information governance practices. This paper suggests one method for accomplishing this goal.

### ***Part One: Current State of Information Governance from an Option Value Perspective***

Organizations exist to carry out certain purposes. They do so through the decisions and actions of their executives, managers and employees, and increasingly they make their decisions and perform actions by electronic means. If you want to thoroughly understand an organization, then you must thoroughly understand the information it creates. The stark reality is, however, that few organizations have a real grasp of the full range of information over which they are stewards, much less where it is all located.

Much of this is because of how an organization's informational needs, and the systems that support them, typically have developed over time. Organizations are usually divided into business unit segments tasked with fulfilling certain purposes. These segments,

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8 Structured data is data stored in a structured format, such as databases or data sets. Unstructured data refers to free form data which either does not have a data structure or one not easily read without use of a specific program, examples of which are word processing documents and slide presentations. See The Sedona Conference® Glossary: E-Discovery & Digital Information Management (3rd ed. 2010). It is often easier to query, analyze and understand structured data. Nassim Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable* (Random House 2007).



on the whole, create two kinds of information: that which is used internally within the segment (by far the largest in volume), and that which is communicated outside the segment as a deliverable product (such as financial or sales data, or internal audit reports). Because most of the segment's information is used within that segment, IT systems are often designed to focus on sharing information within a segment, and not in spreading it across an organization.

IT systems also tend to develop incrementally as an organization's needs evolve. Sometimes these needs are operational (a new accounting or human resources system is needed, or a new communications system is needed for a sales force). At other times, the needs are regulatory (to comply with Sarbanes-Oxley, FDA reporting requirements, the Health Insurance Portability and Accountability Act (HIPAA) or the Troubled Asset Relief Program (TARP)). Because these needs develop over time, organizations develop specific IT systems to address them, with (at best) only a secondary focus on how the IT system interacts with other systems, and how the information in one system can be leveraged for use across the organization. This piecemeal approach often leads to isolated and incompatible IT systems. Thus, information tends to become "siloed" across an organization.

Finally, because IT systems are expensive, management often requires tight budgets and hard ROI justifications for implementing them. Thus, IT systems tend to focus narrowly on fulfilling a specific information need, and not the larger value that can be leveraged from more integrated information asset management systems. In other words, rarely do organizations actually invest in broad-based approaches to solve the *general* problem of information asset management.

All of these factors contribute to an environment that is unintentionally "anti-information sharing." Yet to realize the full value of its information, and to increase its ROI in the creation of that information, an organization must know that information exists, where it exists, and how to access and leverage it. Only then can it determine its true option value. An organization that doesn't sufficiently understand and leverage its information is leaving money on the table and missing real business opportunities.

### ***Part Two: The Business Case for Adopting an Option Value Approach to Information Governance***

Sound information governance practices can rectify the problem of disparate, siloed information, can help an organization gain greater option value from the information it creates, and can realize a greater ROI from the resources it uses to create it. Typically, however, information or records management initiatives are perceived as a means of mitigating an organization's risk, a necessary cost that should be minimized over the long-term. Investment in these initiatives is perceived as representing an insurance policy. This investment perspective becomes *actuarial* in nature, focused on (i) understanding the probability that certain risks might come to pass; and (ii) estimating the potential value of investment based on the magnitude of those risks.

To be sure, an actuarial perspective plays a critical role in an organization's strategy. It is meant to protect the organization in the event of a (sometimes) unpredictable, consequential, and negative outcome (i.e., a so-called "Black Swan" event).<sup>9</sup> Failing to properly govern an organization's information can lead to the incurrence of

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<sup>9</sup> See, e.g., Shira A. Scheindlin and Kanchana Wangkeo, *Electronic Discovery Sanctions in the Twenty-First Century*, 11 Mich. Telecomm. Tech. L. Rev. 71 (2004), available at [www.mtlr.org/voleleven/scheindlin.pdf](http://www.mtlr.org/voleleven/scheindlin.pdf).

substantial transactional costs as a result of *ad hoc* processes for identifying and accessing information in response to discovery or regulatory requests; significant sanctions from courts or regulators for failing to properly preserve or produce relevant information; and, the inability to properly assert claims or defenses because the information supporting them is not readily available.<sup>10</sup>

We argue here for an enhanced perspective that recognizes that information has a value (usually untapped) beyond mere risk mitigation, i.e., that information likely has a use beyond that for which it was originally intended. The same data that should be “actuarially” managed to reduce risk can also generate important “options” for the generation of additional value and/or competitive advantage. For example, a technological application can be used in an electronic discovery process to analyze employees’ e-mail to discern what they knew (and when) concerning potential defects in an organization’s product. The proper use of this same technological application – and the data derived from it — might allow the organization to realize significant option value through the early detection of problems or defects to allow for modification of a product prior to it becoming a significant issue. It could also be used to identify creative customer service solutions in use by employees that could be leveraged and applied across the organization.

This simple example can be applied across a myriad of circumstances. Systems that collect and analyze the contents of stored information can be used to more readily share that information across business units. An employee who begins drafting a sales pitch should be able to find and use valuable content from similar documents created in other parts of the organization, resulting in increased efficiency, higher quality deliverables, and a decrease in the redundant (and thus wasted) use of resources. In short, when information originally created for one purpose can be re-purposed and re-used, i.e., when employees do not have to “re-invent the wheel” when doing their jobs, the result is additional value to the organization through increased efficiency.

Capitalizing on the option value of information requires a move away from mere information management to information governance. As described more fully below, this requires an organization to undertake an option value exercise to understand the information it creates and the purposes to which it is being put. It can then begin to understand what other valuable uses can be derived from it.

Consider these real-world examples:

- A large international company accumulated an incomplete, disjointed and often outdated conglomeration of information repositories related to customers, best practices, market data, tools, and training materials – all intended to support customers’ marketing and sales. Recognizing the option value of this information to multiple segments in the company, the company created a one-stop portal for customers to access all needed information. The audience using the portal is in excess of 7,000 individuals representing multiple groups, located in more than 120 countries. The use is more than had been anticipated and continues to grow beyond those who work directly with customers due to the ease and low cost of adding new repositories.

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<sup>10</sup> See *Supplemental Reading, infra*.

- A not-for-profit social service agency with a U.S.-based child adoption program generated documentation that prevented complete post-adoption service provision related to reunions between consenting birth parents and adult adoptees. Recognizing the option value of the adoption file in facilitating this service, it modified its file creation practice, thus facilitating reunions among consenting adults.
- A multi-national packaged food company used thousands of suppliers to provide the constituent ingredients for its products. Each food packaging plant used its own suppliers, and the records for each purchase from the suppliers were kept in a separate system for each plant. After the company centralized these supplier records, it identified extensive inefficiency and overlapping requirements. The company used this information to streamline its supply chain resulting in a 17% annual decrease in costs as well as a significant increase in profits.
- A major consumer electronics chain operated a customer support call center. Customer service representatives entered customer complaints into a database, but the database could only create basic summary reports. The company invested in an analytical application that scanned the contents of the complaint files to find trends and commonalities. The company used this information to improve certain of its products and to replace others with less problematic ones. It was also able to create standard help instructions for customer service representatives to use on calls related to similar issues.
- Here are some additional potential benefits in using an option value approach:
  - Enhancing retrieval for e-discovery and other purposes by identifying and incorporating additionally useful metadata.
  - Protecting and increasing market share by identifying patentable ideas and products, the need for trademarks and copyrights and the potential for expanding the uses of existing intellectual property.
  - Increasing competitive advantage and enhancing service provision by reviewing documents to identify gaps (e.g., missing functions that are critical to quality), and mitigating those gaps.
  - Creating new markets or increasing market share by identifying potential new markets.
  - Increasing customer satisfaction by ensuring that customer feedback is shared with business units that can initiate improvements in products or services.
  - Increasing product and service quality and efficiencies (e.g., reduced market cycles) by identifying opportunities for information sharing and enhanced workflow.
  - Achieving economies of scale by identifying cross-business requirements that could be solved at reduced cost in a centralized manner.

- Increasing product and service quality by identifying gaps that can be improved through work-flow redesign.
- Strengthening data security by evaluating process documentation to identify patterns in employee conduct or behavior.
- Enhancing business ethics by identifying opportunities for improvement.
- Leveraging the use of third party work product for use in aligned business areas.
- Enhancing the ability to be certified and hence improving reputation and marketability (e.g., creating documentation for activities that are practiced, but not properly documented). This can help to ensure consistent practice and facilitate certification, including for ISO, CARF (Rehabilitation Accreditation Commission) and others.

### ***Part Three: Using Interdisciplinary Teams & Processes***

Implementing effective information governance practices through an option value strategy requires a collaborative, enterprise-wide effort. No one person or discipline has all of the knowledge or skills necessary to analyze and determine the value of an organization's information. This is also true for the work that is needed to conduct the analysis (outlined in Part Four) to determine the option value of information assets. If not addressed properly, such information governance efforts can be duplicative, and at cross-purposes with one another, and ultimately wasted.

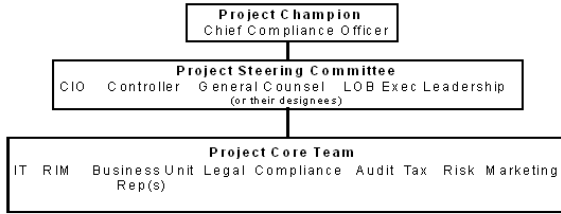
Finding the option value (i.e., the untapped strategic information value) in corporate information will require harnessing the efforts of a variety of disciplines, including data governance, business intelligence, enterprise content management, knowledge management and records and information management.

Interdisciplinary teams ("IDTs") can function in a variety of ways, depending on the needs of the organization. In most cases, an overarching multi-disciplinary governance infrastructure combined with project-based teams will significantly increase the probability of success of any information governance effort. They should bring together end users, subject matter experts, mid-level managers (to develop and refine strategy), and finally C-level executives (to allocate resources and act as advocates at a senior level).

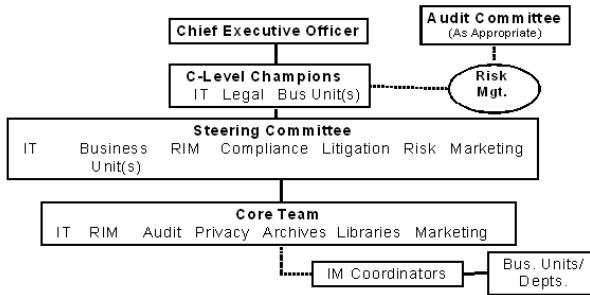
The question of whom to include in cross-disciplinary information governance teams will depend on the unique circumstances and readiness of each organization. Additionally, some organizations already may have existing governance structures that they can leverage for this purpose. Most option value IDTs should include at least the core participants of IT, Compliance, Legal, Records and Information Management, and a select number of Business Units. Each of these groups brings expertise that is essential to successful information asset management. Other disciplines that bring value to the option value initiative and should be considered for inclusion are: Marketing, Risk, Internal Control, Security, Privacy, Audit, Tax (Finance), Information Research, Libraries and Archives.

The following sample organization charts illustrate how an interdisciplinary team might be set up, either on a project basis or as a standing governance structure.

### Sample Information Asset Management Project Management Structure



### Sample Information Asset Management Governance Structure



These charts are intended only as examples; the exact makeup of the team will differ depending on the organization and the project.

#### *Part Four: Identifying & Assessing Option Value Opportunities*

How can organizations make informed choices about getting a greater ROI return, both as a short-term (tactical) and long-term (strategic) matter? Additionally, how much “hidden” value is being left on the table by an organization’s failure to even attempt to make such a calculation?

One known method of showing strategic value is by quantifying the estimated return on investment that would be generated by leveraging the untapped value of one’s corporate information assets. In this context, ROI means the return (profit or loss) on the investment in IT, records and information management and other initiatives (e.g., marketing) relative to the amount of money so invested to generate new value.

Once the IDT is assembled and the right members are at the table, its goal is to determine if option value has been considered and if there is any value that has not been recognized by past, current or planned information governance initiatives. This analysis ensures that all possible opportunities are uncovered so that the IDT can leverage the results.

**Key Team Focus**

- To identify the primary uses of content in information repositories (silos). This information may already exist or may need to be linked or gathered.
- To identify any situations in which existing information is not used to perform its primary function, such as where information is collected but is not adequately reported, or reported as required (e.g., information is gathered by a not-for-profit about client metrics, but not provided to funding agencies).
- To identify situations in which information can be utilized for a secondary purpose to provide additional ROI.
- To identify gaps in information capture and retention – i.e., information that does not currently exist, that could provide additional value to the organization.
- To leverage and quantify the option value related to the above areas.
- The following questions will help unearth the issues that need to be addressed.

**How well does the organization gather, share and use the data it already creates?**

This is the evaluation of: the source of the information; where does it come from; what is its intended purpose; and is there a need to share the information with others? Is the information created for only one, specific purpose, or could additional value be found in re-purposing or re-using all or part of the information for another reason? This can lead to assessing the levels of success or failure that each information system achieves in its role and function as information conduits. In order to define the option value of its information, an organization must understand the specific current purpose for the information, as well as where the information intersects with other information created for a different purpose.

**Where else might the organization extract or generate more value?**

Many organizations utilize distributed technology systems, including the use of third party providers for many of their technology applications. In many cases these applications are not utilized by other areas of the business and are considered to be siloed or inaccessible. As an example, one may have reports from a marketing group that breaks down the sales of a product by area that could be re-used to help the manufacturing group determine production levels. Siloed systems and applications often frustrate an organization's ability to mine the maximum value from information that may be useful to other areas of the business. This is where the IDT needs to analyze how the information is used, where it is captured and for what purpose, and how other segments of the business can re-purpose the information to create new value. Once the IDT understands this, the IDT can begin exploring the entire life-cycle of the

information assets when first developing or implementing applications. The ultimate goal, of course, is to determine if the information can be utilized by other areas of the business before the data is deleted or destroyed.

In organizations that do not exploit option value, information contained in separate segments or component parts sees little re-use. This is because retention and disposition policies usually relate only to the primary purpose of the information – typically the reason for which it was created. The potential for additional information sharing, re-purposing and re-use are not considered.

In many organizations, information tends to be over-retained (and mismanaged) when retention schedules are not consistently implemented and enforced. As an illustration, legal demands (such as subpoenas and other information requests related to litigation, regulatory investigation and inquiry) arise that require the preservation, collection, analysis and – if required – production of information. Often that information sought is located throughout and across the entire enterprise architecture, consisting of all data types, resources, security classifications and geographies.

Current practice is to segregate and collect this information for each and every new legal matter, and (hopefully) to solve any informational inconsistencies or gaps along the way. This process frequently also involves groups that are not a formal part of the organization, such as outside counsel, third party experts, and vendors. The steps are often repeated with each new legal demand that hits the organization resulting in numerous business interruptions and opportunities for errors. In some organizations, even once collected, the data (original or copies) is often kept in perpetuity without being re-used or – in the case of originals – recycled back into the enterprise architecture. This practice frustrates the existing information management practices within the organization and does not promote efficient use. In other organizations, originals remain in native repositories and copies are retained for preservation, review and production purposes. In both cases, information collected for one matter is not optimally leveraged for use in other cases, often requiring recollection.

Looking at the situation from an option value potential provides opportunities for efficiency and cost reduction. It also enables risk reduction, as organizations can be more secure in the knowledge that it is producing the same information in response to similar questions for the same time periods for the same matters.

Most information can be leveraged to achieve the greatest use when it is in a collaborative environment and allowed to flow in logical patterns, to relevant users, in a manner that is optimal for each specific purpose. Information that lacks visibility or access from other relevant areas of the organization may end up being recreated several times, using several different methods. This can provide inconsistent results, resulting in improperly informed stakeholders, as well as information that is used in an inefficient manner and that is being destroyed before maximum value can be extracted. For organizations within highly regulated industries (e.g., securities and investment banking) and/or with critical competitive interests (e.g., automotive manufacturing and pharmaceuticals), this collaboration must be driven by requirements related to proprietary and confidential information.

The two prior questions should help identify areas where the organization might be leaving value uncaptured. To do this, the IDT must first determine how value is currently assessed (e.g., if only related to the information's primary value) to determine if

there is value that it not currently leveraged. It then must determine not only the different ways in which suggested unleveraged value can be measured, but also the costs for executing the process for measuring and leveraging it. Realizing that this will demand continuing effort and dedicated resources, the organization will need to choose the best manner and timeframe in which to best achieve the outcome. Each organization embark on this in its own unique way, taking into account such things as the current financial strength of the company, competing demands for resources, and the overall environment of its culture and performance.

### ***Part Five: A Framework For Calculating the Option Value of Information Assets***

Once the IDT has addressed the high-level questions in Part Four, it can begin the process of determining the option value of an organization's information assets, through a multi-step process. For example, the following questions are useful:

- What additional revenue can be generated annually by applying a marketing strategy (using all relevant information assets) to a business unit or segment that could greatly benefit from it?
- How can the cycle time for certification be shortened by documenting information that up to now was only communicated verbally (e.g., ISO certification) in order to generate additional business (contracts, clients). How does that shortened cycle time translate to in terms of dollars generated through additional business?
- How much revenue can be generated (e.g., within the next five years) by applying patents generated in the US to identified opportunities in international markets?

The risks and costs associated with development and implementation must also be assessed and the opportunity costs of not proceeding with this new initiative must be calculated.

The following process is derived from writings in the information asset management field:<sup>11</sup>

**Step 1:** Map the sources of potential information asset value: The IDT needs to determine where the organization's most valuable information reside, and whether those assets add value from a strategic perspective (addressing a long-term vision or plan) or a tactical perspective (addressing short-term goals or objectives).

**Step 2:** Identify all of the different "loci" of value (i.e., locations where information resides), and "dimensions" of value (in terms of, e.g., service delivery, staffing, quality, inventory, cycle time) for the information assets: The IDT needs to identify where, how, and by whom each information asset is currently used, the current value placed on the information related to that use, and how it could be further leveraged to create additional value. The IDT needs to determine how much potential value can be quantified through leveraging the information asset for other purposes within the organization.

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<sup>11</sup> See *Supplemental Reading, infra*.



**Step 3:** Compute the perceived net potential value of the information assets: Based on the analysis conducted in Step 2, the IDT needs to estimate the costs associated with managing the assets that will be utilized when leveraging them to attain additional value, as well as any risks and contingencies associated with each information asset.

**Step 4:** Compute the option value currently being “left on the table” by the organization: For each information asset and each locus and/or dimension of value, the IDT must compute potential cost reduction opportunities, “misperceptions” of risk, and opportunities to minimize contingency costs. By subtracting the sum of those costs from the figure calculated in Step 3, the IDT can identify the value being “left on the table” by the organization. Actual value being left of the table consists of that figure, minus the costs associated with leveraging resources to attain the actual value.

### ***Part Six: Implementing an Option Value Governance Initiative Within the Organization***

Executive sponsorship from the CEO, CIO, CFO and other C-level champions drives implementation and execution. No matter where initiatives or ideas come from within an organization, conventional and proven wisdom shows that without leadership from the executive level, most initiatives are either doomed to fail or fall short of expectations. This effort is no different, especially since it seeks to reach all organizational levels across all business units. Successful implementation demands that executive leadership not only champion and drive the effort but also maintain a strong role in measuring success and keeping the focus on core goals. Additionally, in this case, a critical success factor will be that C-Level management views having an information sharing culture as a high priority. From executive leadership comes the foundation for successful execution and accountability.

Once executive sponsorship has been secured, it is incumbent upon the leadership to identify all stakeholders (including the IDT, lines of business, and other relevant parties). It will be imperative to communicate the process and goals to them, along with executive leadership’s expectations, to ensure buy-in and execution from each stakeholder.

Finally, a plan must be created that incorporates processes and tools for project management, status reporting, communication, training and audit. Successful execution plans encompass iterative stages and clearly identify the tasks to be accomplished in each stage. For example, the initiative can begin in one business unit, and then roll out to additional units as success is demonstrated. The information acquired, experience gained, and lessons learned in one stage can be leveraged for use in the next (and in other projects and initiatives across the enterprise).

Monitoring the process and measuring outcomes are critical to sustained success. Once the initial stages of implementation take place, the IDT should transition into a standing governance group to oversee the ongoing measurement and monitoring of outcomes and results. This will also allow for change management of the process when necessary as systems, practices or business needs of the organization change. Creating a permanent governance body that includes a focus on the option value concept, will provide a clear message in the organization that maintaining and further seeking the option value of the organization’s information is important.

## CONCLUSION

This paper has provided a business case for C-level executives to take an integrated value approach to finding hidden ROI in organizational information assets. They can do so by strategically thinking about and championing efforts to identify the option value of information, i.e., the additional value that information assets can generate for the organization. An interdisciplinary team led by a C-level champion should be used to identify and quantify opportunities and related risk and cost. By gathering information and asking a series of questions related to core information assets, the team will be able to identify untapped strategic value in the entity's information assets that can be used to accomplish a variety of objectives. For-profits will be able to identify opportunities to increase revenue through increased market share, customer base, products, services and customer satisfaction. Not-for-profits will be able to increase their funding base and enhance client service provision. Government entities will be able to improve service provision to its citizenry. All organizations can add to the bottom line by uncovering new potential for economies and efficiencies in information management. This approach to information governance – based on a focus on *option value* – may also reap secondary benefits, including but not limited to the entity getting a better handle on short-term risk due to the presence of current, ongoing legal and compliance demands.

One mission of The Sedona Conference® has been to foster new ways of thinking about the digital world we find ourselves in, with its exponentially increasing volume of information for institutions and individuals to confront across many disciplines. Just as lawyers and judges are confronting a new reality in litigation with respect to the presence of electronically stored information in a myriad of new formats and applications, C-level executives also increasingly realize that this new environment demands new approaches, including strategically thinking about information governance issues of all kinds. The option value concept presented in this paper has the potential to significantly contribute to efforts in this arena. As the subject is so closely tied to the concerns of the legal community, we intend to continue to work with organizations and institutions of all kinds in advancing new methods and approaches in the area of information asset management and governance.

## SUPPLEMENTAL READING

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