

Blog Post

Discovery Sanctions Affirmed Despite Dwarfing Potential Value of Entire Case

February 8, 2018

In *Klipsch v. ePRO*, the Second Circuit affirmed discovery sanctions commensurate with the costs incurred by the moving party in addressing the sanctionable conduct (\$2.68 million), as well as security for the sanctions, potential damages and potential attorneys' fees; and held that such sanctions are not unduly punitive even if the likely ultimate value of the case (perhaps as low as \$20,000) is considerably less than or even grossly disproportionate to the sanctions and security.

ePRO sold counterfeit and infringing headphones bearing the Klipsch trademark. The parties disputed the total amount of ePRO's sales of the infringing products: Klipsch maintained that ePRO had sold at least \$5 million of such products, while ePRO claimed that its total sales of the infringing products was no more than \$8,000 world-wide. The district court initially was persuaded by ePRO's sales records until it became increasingly apparent that ePRO had, among other things, failed to impose a written litigation hold and seemed to be withholding substantial amounts of potentially relevant documents.

As a result, the magistrate judge permitted Klipsch to hire a forensic investigator, iDiscovery Services ("iDS") to conduct additional discovery into ePRO's electronically stored data ("ESI"). iDS found that ePRO had engaged in various forms of spoliation,

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including allowing data-wiping software to be run after the litigation had commenced, manually deleting and editing various unstructured ESI, and failing to preserve backups. ePRO also blocked the investigator's access to more than 30 email accounts. On Klipsch's *ex parte* motion, the district court increased the \$20,000 hold that had been placed on ePRO's assets (for security) to \$5 million and ordered ePRO to show cause why a default judgment should not be entered against it.

After a four-day evidentiary hearing, the district court concluded that, although iDS uncovered nothing to contradict ePRO's evidence that world-wide sales of the infringing products were relatively modest, ePRO's spoliation of evidence – which the court presumed to be relevant – was prejudicial to Klipsch. The district court awarded Klipsch a total of \$2.68 million as compensation for the cost of the additional discovery efforts necessitated by ePRO's misconduct, rejecting ePRO's arguments that this amount was punitive either (i) when compared to the likely value of the case (around \$25,000), or (ii) in view of Klipsch's failure to find that the structured ESI (*i.e.*, the sales records) had been tampered with or that there had been additional infringing sales.

The district court initially reduced the \$5 million hold back to \$20,000. However, on Klipsch's motion for reconsideration, the district court, exercising its inherent equitable powers, upheld the \$5 million asset hold. The \$5 million asset hold covered both the discovery sanction of \$2.68 million and an additional \$2.3 million in order to preserve Klipsch's ability to recover treble damages and attorneys' fees to which it could be entitled under the Lanham Act for willful infringement. The court allowed ePRO to address the \$5 million restraint by an asset restraint, a bond, or a combination of the two.

This asset hold, as a form of injunctive relief, provided the vehicle for Klipsch's interlocutory appeal pursuant to 28 U.S.C. § 1292(a)(1), and the Second Circuit resolved all disputes raised by the

parties inextricably bound up with the validity of the injunction. The Second Circuit affirmed the factual findings of the district court that ePRO had engaged in willful spoliation and rejected ePRO's arguments that the sanctions award and asset freeze were (i) disproportionate to the likely value of the case, (ii) punitive and/or (iii) a violation of due process.

The Second Circuit explained that, although "superficially sympathetic given the amount of the sanction," ePRO's position overlooked the substantial costs that ePRO caused Klipsch to accrue by failing to comply with its discovery obligations. The sanction was not a reward to Klipsch for its success or lack thereof, but rather, just compensation for costs it should not have had to bear. As the Court explained, "we see no reason why the party required to undertake those [additional discovery] efforts should not be compensated simply because it eventually turned out that the obstructive conduct had hidden nothing of real value to the case. Those costs must be placed on the uncooperative opponent in order to deter recalcitrant parties from the cavalier destruction or concealment of materials that the law requires them to retain and disclose."

On the question of the validity of the \$5 million asset restraint, the Second Circuit concluded that the district court clearly had authority to exercise its inherent equitable power to impose the \$5 million restraint to cover the sanctions, as well as the potential damages award and attorneys' fees.

It is interesting to note that the district court did not rely on Rule 37 to impose the sanctions, but rather on its inherent equitable power. Therefore, ePRO's argument that the sanctions exceeded the amount allowable under Rule 37 were unavailing. The Second Circuit also rejected ePRO's attempt to analogize discovery sanctions to awards for attorneys' fees which are sometimes (but not always, as the Court pointed out) made proportional to the success of the outcome, noting "[d]iscovery sanctions are different."

Klipsch serves as a reminder that small-value cases require the very same diligence with respect to litigation holds and other discovery obligations as large-value cases. Courts will not hesitate to award even seemingly disproportionate discovery sanctions if additional discovery efforts appear to be warranted in light of a party's recalcitrance, regardless of whether those efforts ultimately uncover a smoking gun or information that contradicts the recalcitrant party's central contentions.

In *Klipsch*, no such information was uncovered. The Second Circuit acknowledged that "[i]f it turns out, as the district court has estimated, that the amount of actual damages in this case is modest in relation to the costs spent on the litigation, that would be a highly regrettable outcome." But, as the Court emphasized, "the question before the district court, and before us, is which party should be held responsible for those costs." Counsel beware of precipitating such a regrettable result.

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