Legal Backgrounder

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SECOND CIRCUIT APPLIES *TWOMBLY* TO REVERSE DISMISSAL OF PRIVATE ANTITRUST SUIT

by

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In a notable recent decision, *Starr v. Sony BMG Entertainment*, 592 F.3d 314 (2d Cir. 2010), the United States Court of Appeals for the Second Circuit addressed the pleading standard a plaintiff must satisfy to survive a motion to dismiss an antitrust conspiracy claim under § 1 of the Sherman Act based on alleged parallel conduct. In vacating the district court's dismissal, the Second Circuit made clear that (at least in the Second Circuit) the Supreme Court's decision in *Bell Atlantic Corporation v. Twombly*, 550 U.S. 544 (2007), does not require a plaintiff to "allege facts tending to exclude independent self-interested conduct as an explanation for the defendants' alleged parallel behavior." *Starr*, F.3d at 323-24. Nor does it necessarily require the plaintiff to "identify the specific time, place or person related to each conspiracy allegation" when asserting a § 1 conspiracy based on alleged parallel conduct. *Id*. at 325. In the Second Circuit's view, *Twombly* merely held that such a plaintiff must plead facts placing the "allegations of parallel conduct . . . in a context that raises a suggestion of preceding agreement." *Id*. at 322 (quoting *Twombly*, 550 U.S. at 557). Finally, *Starr* held that the Supreme Court's ruling in *Texaco, Inc. v. Dagher*, 547 U.S. 1 (2006), did not preclude a court from considering allegations that the defendants' participation in a joint venture facilitated their purported anticompetitive conduct, at least in cases like *Starr* where the plaintiffs have challenged the joint venture as a "sham." *Starr*, 592 F.3d at 326.

Background: The Alleged Conspiracy. *Starr* involves an alleged conspiracy that began as early as December 2001 to restrain competition in the U.S. market for music sold as digital files ("Digital Music"), including music delivered online via the Internet ("Internet Music") and as files stored on compact discs ("CDs"). The plaintiffs, who are individual music consumers, sued "the four largest music labels," which allegedly controlled more than 80 percent of the Digital Music market in the United States. In short, the plaintiffs alleged these four music labels conspired to fix prices and "restrain the availability of Internet Music, which, in turn, buoyed the price of CDs, 'despite declining costs of production associated with the introduction of new technologies.'" *In re Digital Music Antitrust Litig*., 592 F. Supp. 2d 435, 437 (S.D.N.Y. 2008) (quoting Second Consolidated Amended Complaint ("Complaint")).

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The conspiracy alleged by the plaintiffs divides into two phases. During the first, the four music labels allegedly formed, and entered into distribution agreements with, two joint ventures to sell music directly to consumers over the Internet through two subscription services called MusicNet and Duet (later renamed pressplay). In this first phase, a consumer seeking to buy Internet Music from the four music labels had to subscribe to both MusicNet and pressplay at a cost of $240 per year and agree to unpopular Digital Rights Management terms ("DRMs") that severely restricted access to any music files purchased. Under the DRMs, a subscriber could copy no more than two songs by any particular artist onto a CD, and a subscriber's music files would "expire" unless repurchased annually. In addition, neither service allowed a customer to copy songs to any portable digital music players. In the Complaint, the plaintiffs quoted one industry commentator as saying the services did not offer "reasonable prices," and a leading computer industry magazine as concluding "nobody in their right mind" would want to use them.

In the alleged second phase, the four music labels began to sell Internet Music to consumers through third-party entities, but only if those entities contracted with MusicNet to sell the music to consumers at the same prices and with the same restrictions as MusicNet. Each of the four music labels allegedly enforced these restrictions by demanding Most Favored Nation clauses ("MFNs") in its licensing agreements with the joint ventures and other third-party retailers that guaranteed the music label would receive no less favorable terms than the terms offered to other licensors (*i.e.*, the other three music labels).

The plaintiffs alleged that although the costs associated with the production and sale of Internet Music fell "dramatic[ally]" over the course of the conspiracy as compared with CDs, they "were not accompanied by dramatic price reductions for Internet Music, as would be expected in a competitive market." *Starr*, 592 F.3d at 318. In addition, the plaintiffs alleged that when third-party retailers began to sell the music-label defendants' Internet Music during the second phase of the alleged conspiracy, the music labels agreed to a "wholesale price floor" of 70 cents per song, nearly three times the price smaller independent labels charged to consumers for their Internet Music. The plaintiffs also alleged that: (i) the four music labels attempted to hide their protective MFNs in "secret side letters" to avoid "antitrust scrutiny;" (ii) the "wholesale price floor" reflected a 5 cent price increase effected in 2005 while the cost of providing Internet Music had continued to drop "substantially;" (iii) each of the four music labels refused to do business with eMusic, the second largest Internet Music retailer, which sold Internet Music to consumers at only 25 cents a song and without restrictive DRMs; and (iv) the alleged price fixing was the subject of a pending state and two separate pending federal investigations.

The District Court's Dismissal. The district court applied *Twombly* and dismissed the plaintiffs' Section 1 conspiracy claim, holding the alleged actions of the four music labels constituted only "parallel conduct," and the "further facts" alleged by the plaintiffs "considered alone and collectively, d[id] not place Defendants' conduct 'in a context that raises a suggestion of a preceding agreement.'" *In re Digital Music Antitrust Litig.*, 592 F. Supp. 2d 435, 441-42 (S.D.N.Y. 2008). The district court reasoned inter alia that (i) the alleged operation itself of the two joint ventures by the music label defendants could not yield a plausible inference of improper agreement because the plaintiffs had not challenged the existence of the joint ventures or their creation by the four music labels, *see id*. at 442-43, and (ii) the other factors alleged, such as acts of the music labels against their own economic self interest, suspicious price increases, the "antitrust record" of the four music labels and the joint ventures, and certain economic conditions favorable to collusion, were "equivocal" and did not supply sufficient "factual enhancements" to justify a plausible inference of agreement, *see id*. at 444-46.

The Second Circuit's Opinion. The Second Circuit disagreed and vacated the district court's order of dismissal, holding the complaint "succeed[ed] where *Twombly*'s failed" because the plaintiffs had pleaded "specific facts sufficient to plausibly suggest that the parallel conduct" alleged was the result of an illegal agreement. *Starr*, 592 F.3d at 323. Among other things, the Second Circuit held the

district court incorrectly found that the plaintiffs had not directly challenged the alleged joint ventures formed by the four music labels, and, as a result, erroneously concluded that their alleged operations, including selling Internet Music at "unreasonably high prices" and subject to "unpopular" DRMs, would not support any reasonable inference of agreement. *Id*. at 320, 325-26. In addition, the Second Circuit held the district court committed error by refusing to consider the plaintiffs' proposed amendment to the Complaint, which included the additional allegations that the music-label defendants effected an increase of the "wholesale price floor" charged to Internet Music retailers in 2005 despite that Internet Music costs continued to drop at that time. *Id*. at 323 & n.3.

Analysis. Several aspects of the Second Circuit's opinion warrant careful scrutiny by antitrust litigators. *First*, the ruling might be read to suggest that defendants moving to dismiss a Section 1 conspiracy claim will not succeed merely by arguing that the complaint fails to allege facts tending to exclude independent self interest as an explanation for the defendants' alleged parallel conduct. *Starr*, 592 F.3d at 325. The Second Circuit observed that even though *Twombly* began its analysis by noting that a Section 1 plaintiff must offer affirmative evidence tending to rule out the possibility of independent action to survive a motion for summary judgment, *Twombly* did not adopt that standard as the threshold for evaluating allegations of an anticompetitive conspiracy on a motion to dismiss. *Starr*, 592 F.3d at 325. Instead, the Supreme Court "specifically held … plaintiffs need only" couple their allegations of parallel conduct with "'enough factual matter (taken as true) to suggest an agreement was made.'" *Id*. (quoting *Twombly*, 550 U.S. at 556).

On the other hand, *Starr* should not be read as rendering irrelevant on a motion to dismiss arguments that independent self interest (not unlawful conspiracy) can explain the defendants' alleged parallel conduct. Indeed, *Starr* repeatedly quotes *Twombly* for the principle that "allegations of parallel conduct that could 'just as well be independent action'" are insufficient to state a Section 1 conspiracy claim. *Starr*, 592 F.3d at 327 (quoting *Twombly*, 550 U.S. at 557); *see also id*. at 322 and 323. Nevertheless, on the particular allegations in *Starr*, the Second Circuit concluded the plaintiffs had overcome this obstacle by alleging parallel conduct by the four music labels – *e.g*., adoption of a common, inflated pricing structure and use of similar restrictive DRMs – "that would plausibly contravene each defendant's self-interest in the absence of similar behavior by rivals." *Starr*, 592 F.3d at 327 (quotation marks and citations omitted). The Second Circuit reasoned that each of the four music labels would have been acting against its own "self interest to sell Internet Music at prices, and with DRMs, that were so unpopular as to ensure that 'nobody in their right mind' would want to purchase the music, unless [all the labels] were doing the same." *Id.*

Notably, this analysis all but ignores the district court's reasoning on this point, in which the district court evaluated the alleged parallel actions of the four music labels in the context of the existing "environment of widespread unauthorized downloading of Internet Music." *Digital Music*, 592 F. Supp. 2d at 442. In so doing, the district court concluded that, given the well-known "circumstances of widespread pirating" plaguing the music industry, the mere unpopularity with consumers of the alleged Internet Music use restrictions hardly established that each four music label defendants would have acted against its economic self-interest in adopting them independently. *Id*. at 445. As the district court observed, "[s]urely, any Defendant who decided to give its product away for free would have been popular with consumers, but refusing to do so is hardly the economically-irrational decision Plaintiffs portray it to be." *Id*.

It is important to note that the Second Circuit's differences with the district court on this point appear to be driven at least in part by the degree to which it believed the alleged actions of the music-label defendants cut against their own self-interest. The Second Circuit arguably rejected the contention that the alleged anticompetitive conduct of the defendants "would be entirely consistent with independent, though parallel, action" not merely because it could be viewed as "contraven[ing] each

defendants' self interest," *Starr*, 592 F.3d at 327, but because of the significant extent of that contravention.

Second, the court in *Starr* found that the plaintiff could rely on allegations of parallel conduct to assert a Section 1 conspiracy claim under *Twombly* even though the complaint failed to "identify the specific time, place, or person related to each conspiracy allegation." *Starr*, 592 F.3d at 325. The Second Circuit explained the suggestion in *Twombly* that a complaint without such particulars would not provide adequate notice under Rule 8 of the Federal Rules of Civil Procedure is merely "dicta," and in any event would not apply as in *Starr* to a claim of agreement resting on allegations of parallel conduct. *Id*.

Third, the court in *Starr* considered the impact of the Supreme Court's ruling in *Texaco, Inc. v. Dagher*, 547 U.S. 1 (2006), on the inferences that might be drawn from the plaintiffs' allegations that the defendants' participation in an otherwise lawful joint venture facilitated their alleged anticompetitive conspiracy. *Starr*, 592 F.3d at 326. In *Dagher*, the Supreme Court held that, where two competitors had formed a lawful joint venture approved by federal and state regulators (and which the plaintiffs did not challenge as a sham), a decision by that joint venture to price similarly two comparable products it now sold (but which the two competitors separately had sold prior to the joint venture) did not on its face constitute an illegal price-fixing agreement subject to the per se rule. *Dagher*, 547 U.S. at 5-8. Because the competitors no longer competed in the same market, but participated jointly "as investors" in a legitimate joint venture, the Supreme Court held that a challenge to the joint venture's pricing decision should be reviewed under the rule of reason. *Id*. at 6-7.

In *Starr*, the Second Circuit rejected the music-label defendants' argument that, on the facts alleged, *Dagher* supported dismissal of the plaintiffs' Section 1 conspiracy claim. *Starr*, 592 F.3d at 326-27. To start, the court held *Dagher* inapplicable because (i) the plaintiffs in *Starr* had in fact challenged the joint ventures as "shams" that were "mere puppets of the defendants," and (ii) the defendants did not contend the joint ventures were "explicitly approved by state or federal regulators." *Id*. at 326. Moreover, the Second Circuit held that, even if *Dagher* required the conduct of the joint ventures to be evaluated under the rule of reason, the complaint alleged that the activities of the joint ventures, including the sale and distribution of the defendants' Internet Music through the MusicNet and pressplay services, were "anticompetitive and unreasonable." *Id*. at 327.