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Starr v. SONY BMG Music Entertainment: The Second Circuit's Misapplication of Twombly in a Section 1 Sherman Act Conspiracy Case Alleging Parallel Conduct

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I. INTRODUCTION

On January 13, 2010, in *Starr v. SONY BMG Music Entertainment*² (“*Starr*”), a panel of the United States Court of Appeals for the Second Circuit reversed the October 9, 2008 opinion and order of the Honorable Loretta A. Preska, United States District Judge for the Southern District of New York.³ In *Starr*, Judge Preska had found that plaintiffs’ second amended complaint fell short of the standards set forth by the Supreme Court in *Twombly*.⁴ The panel found that the amended complaint attempts to allege a Section 1 Sherman Act conspiracy claim was based on no more than conclusory descriptions of parallel conduct among defendants.

In reversing Judge Preska, we submit that the Second Circuit’s decision in *Starr* undermines and cannot be reconciled with a fundamental tenet of the Supreme Court’s instructions in *Twombly* that allegations of parallel business behavior resulting from independent action, including interdependent conscious parallelism, do not state a Section 1 Sherman Act conspiracy claim. The Second Circuit’s misapplication of *Twombly* in *Starr* muddles the standard for pleading antitrust claims in the Second Circuit and beyond. The decision conflicts with the Supreme Court’s decision in *Twombly*, as clarified by the Court in *Iqbal*,⁵ as well as other post-*Twombly* appellate opinions.

This article provides an overview of plaintiffs’ allegations, Judge Preska’s opinion, the Second Circuit’s decision, and outlines the authors’ views on the Second Circuit’s errors and the implications *Starr* will have on antitrust pleading standards in the Second Circuit and elsewhere.

II. THE RACE TO THE COURTHOUSE AND PLAINTIFFS’ ALLEGATIONS

By way of background, in December 2005, prompted by a press report that the Antitrust Bureau of the New York State Attorney General’s Office was conducting an investigation into the

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² 592 F.3d 314 (2d Cir. 2010).

³ In re Digital Music Antitrust Litig., 592 F. Supp. 2d 435 (S.D.N.Y. 2008) (“*Digital Music*”). On January 27, 2010, defendants petitioned the Second Circuit to rehear *Starr en banc*. On February 19, the Panel amended its opinion based on one of the many errors raised in our petition for rehearing and discussed in this article. When this article was drafted, defendants’ petition for rehearing *en banc* remained pending before the Second Circuit and thus the time to petition the Supreme Court for a writ of certiorari had yet to run. If and when this case is remanded to the District Court, there are issues raised in defendants’ motion to dismiss that the District Court did not need to reach and those issues likely will be the first matters considered upon remand.

⁴ Bell Atlantic Corp. v. Twombly, 550 U.S. 544 (2007).

⁵ Ashcroft v. Iqbal, 129 S. Ct. 1937 (2009).

terms upon which recorded music was being made available for digital distribution, various plaintiffs' counsel raced to file over thirty class action complaints in courts throughout the United States. The complaints contained conclusory allegations of a purported conspiracy to fix the prices for "Internet Music" and compact discs. The first complaints filed in connection with this matter began to appear within days of newspaper articles published on Christmas Eve 2005. According to these articles, Apple was charging 99 cents for every song it sold on its "iTunes" website, but major music companies were advocating adoption of "variable pricing," by which the most popular recordings could sell for more and lesser-known music could sell for less.

In August 2006, the over thirty class action complaints were transferred by the Judicial Panel on Multidistrict Litigation to the United States District Judge for the Southern District of New York and assigned to Judge Preska. After plaintiffs filed a First Consolidated Amended Complaint, Judge Preska ordered defendants to provide plaintiffs with letters—in substance a first motion to dismiss—detailing that complaint's deficiencies. In June 2007, with defendants' detailed letters in hand—as well as the standards established by the Supreme Court in *Twombly* (which was issued by the Court during the letter writing process)—plaintiffs decided to recast their allegations and file the operative Second Consolidated Amended Complaint rather than stand on their deficient pleading.

It is important to note that the Second Amended Complaint does not allege facts suggesting that an actual agreement among defendants existed, and the complaint also does not allege the most basic facts about the nature of an alleged conspiracy, including which specific defendants were part of any alleged agreement, what supposedly was agreed upon, by whom, and when. Rather, the allegations in Second Amended Complaint can be categorized largely into two main theories of conspiracy: (1) the existence of competing, government-cleared joint ventures among certain defendants, and (2) speculation concerning the distribution costs of digital music and how one might expect prices to change even though oligopolistic entities, such as the defendants here, facing a dominant buyer, like Apple, often have similar price structures.

Plaintiffs' first main theory of conspiracy rests upon two competing joint ventures ("MusicNet," organized by Warner Music, Bertelsmann, and EMI, and "pressplay," organized by Sony and Universal Music). Each was launched in late 2001 in an effort to distribute digital music to consumers in a lawful manner and to compete with rampant unauthorized downloading that was battering Defendants' businesses. These joint ventures were thoroughly investigated by the Antitrust Division of the United States Department of Justice between 2001 and 2003. In December 2003, after a lengthy review into the issues that are now the core allegations in the operative *Starr* complaint, the Antitrust Division closed its inquiry and publicly announced that its "substantial investigation" had "uncovered no evidence that the major record labels' joint ventures have harmed competition or consumers of digital music." In light of this context, plaintiffs' invitation to infer a conspiracy from the existence and practices of the very same joint ventures whose existence and practices were considered and cleared by the Department of Justice is anything but reasonable.

Plaintiffs' second main theory of conspiracy asserts that "in or about May 2005" defendants raised prices from 65 cents to 70 cents per song "despite the fact that by [early 2005] Defendants' costs of providing Internet Music had been substantially reduced." Allegations of parallel price increases standing alone are neutral facts and do not establish a conspiracy. Judge Preska agreed, finding that: "There is no agreement . . . merely because an oligopolist charges an inflated price knowing (or even hoping) that other oligopolists will match his high price. Such is bald conscious

parallelism” As the Supreme Court explained in *Twombly*, there is no general rule that, absent a conspiracy, it is in the individual interest of a company to ignite price wars every chance it gets.

In sum, plaintiffs’ Second Amended Complaint at best alleges that the music companies all allegedly charged about the same prices, belonged to the same trade association, and formed joint ventures to sell their music, which was being widely downloaded without authorization.

III. JUDGE PRESKA’S ANALYSIS IN *STARR*

After conducting a careful analysis of *Twombly*, Judge Preska found that the “facts alleged by Plaintiffs, considered alone or collectively, do not place Defendants’ conduct ‘in a context that raises a suggestion of a preceding agreement.’”⁶ Instead, Judge Preska concluded that plaintiffs allege exactly what *Twombly* forecloses—“bald conscious parallelism” which “does not allege the further facts required by *Twombly* to state a § 1 claim based upon parallel conduct.” Judge Preska understood and followed the critical lesson of *Twombly*: “[A]llegation[s] of parallel conduct and a bare assertion of conspiracy will not suffice.”⁸ Rather, plaintiffs must allege sufficient “factual matter” (taken as true) to “plausibly suggest[]” that parallel conduct among competitors was the product of a “preceding agreement,” and “not merely parallel conduct that could just as well be independent action.”⁹

Furthermore, Judge Preska properly “reject[ed] as unreasonable Plaintiffs’ invitation to infer that Defendants’ subsequent adoption of parallel prices and use restrictions resulted from agreement based on their creation of or membership in the unchallenged joint ventures.”¹⁰ Judge Preska’s repeated statement throughout her opinion that these joint ventures were “unchallenged” was supported by the record as plaintiffs unequivocally conceded during oral argument, in response to questions from Judge Preska, that they did not challenge the joint ventures themselves (or as shams) but, instead, suggested that they created opportunities to collude. It is beyond dispute that the opportunity to conspire is not sufficient to state an antitrust conspiracy claim.¹¹

Judge Preska also concluded that the investigations alleged are probative of nothing: “[T]he investigations alleged here do not support the inference Plaintiffs urge: the DOJ closed its investigation after it ‘uncovered no evidence that the major record labels’ joint ventures have harmed competition or consumers of digital music’”¹²

IV. THE SECOND CIRCUIT’S DECISION IN *STARR*

The Second Circuit panel recognized in *Starr* that an allegation of parallel business behavior does not itself constitute a violation of the Sherman Act because, as the Supreme Court explained in *Twombly*, it can be “just as much in line with a wide swath of rational and competitive

⁶ *Digital Music*, 592 F. Supp. 2d at 441–42.

⁷ *Id.* at 444, 447.

⁸ *Twombly*, 550 U.S. at 556.

⁹ *Id.* at 555, 557 (instructing that parallel conduct allegations “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”). Judge Preska found no such “context” here.

¹⁰ *Digital Music*, 592 F. Supp. 2d at 444.

¹¹ See, e.g., *Capital Imaging Assocs., P.C. v. Mohawk Valley Medical Assocs.*, 996 F.2d 537, 545 (2d Cir. 1993) (“The mere opportunity to conspire does not by itself support the inference that such an illegal combination actually occurred.”).

¹² *Digital Music*, 592 F. Supp. 2d at 444.

business strategy unilaterally prompted by common perceptions of the market.”¹³ The Panel also properly explained that parallel conduct allegations “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.”¹⁴ Although noting these well-settled standards established in *Twombly*, the Second Circuit misapplied the standards in *Starr* by equating independent action and interdependent conscious parallelism with conduct suggestive of a preceding agreement.

After cataloging the litany of mere parallel conduct allegations found in the Second Amended Complaint, the Second Circuit concluded that the complaint “alleges specific facts sufficient to plausibly suggest that the parallel conduct alleged was the result of an agreement among defendants.”¹⁵ In the Second Circuit’s view, the following allegations placed the parallel conduct allegations “in a context that raises a suggestion of a preceding agreement, not merely parallel conduct that could just as well be independent action.”¹⁶

1. Industry concentration, which is simply indicative of an oligopoly where parallelism is expected;
2. The bald and conclusory opinion, not fact and also hearsay, attributed to one person described by the Panel as “an industry commentator” noting that no sane person would use MusicNet or pressplay;
3. A single sound bite from an industry executive that is repeated out of context regarding the formation of a lawful joint venture;
4. An additional conclusory and erroneous opinion, again not a fact and also hearsay, from one customer representative as to whether the most favored nations clauses (“MFNs”) are anticompetitive;
5. A comparison to prices charged by eMusic, a product used to distribute of digital music which is not alleged to be comparable with defendants’ products;
6. A mistaken reference to pending investigations by the government when, in fact, all the investigations were closed with no suggestion that any antitrust violation had occurred; and
7. The failure to reduce prices in response to lower costs—which is no more than an allegation of parallelism in a concentrated market that is insufficient to state a claim; no inference can be drawn from the lack of price wars among defendants.

In the Panel’s view, it would not be in each defendant’s self-interest to sell digital music at prices and with downloading protections that were so unpopular “unless the defendant’s rivals were doing the same.”¹⁷ But these allegations do not constitute plausible grounds to infer an agreement. Rather, they are equally, if not more, consistent with conscious parallelism.

V. SECOND CIRCUIT’S MATERIAL ERRORS IN *STARR*

We submit that the *Starr* decision contains certain material errors that must be addressed by either the Second Circuit sitting en banc or, if not, by the Supreme Court upon petition for a writ of certiorari. As a threshold matter, Judge Newman’s concurring opinion in *Starr* is directly at odds with and undercuts the basic principles of *Twombly* as it suggests that allegations of mere parallelism are sufficient at the pleading stage, at least in some “contexts,” which neither the Panel

¹³ *Starr*, 592 F.3d at 321 (quoting *Twombly*, 550 U.S. at 553–54).

¹⁴ *Id.* at 322 (quoting *Twombly*, 550 U.S. at 557).

¹⁵ *Id.* at 323.

¹⁶ *Id.* at 323–24.

¹⁷ *Id.* at 327.

decision nor Judge Newman define. Judge Newman also suggests that the Supreme Court's analysis in *Twombly*, which he calls "perplexing," conflated the directed verdict standard with the motion to dismiss standard in addressing allegations of parallel conduct.

Some of the other material errors found in *Starr* decision can be summarized accordingly:

First, the Second Circuit does not consider the significance of an important industry context that explains defendants' independent, rational business decisions; specifically, efforts to overcome rampant unauthorized downloading of music over the Internet. Unlike Judge Preska, the Second Circuit ignores the most prominent and pervasive "context" surrounding the allegations of parallel conduct: widespread unauthorized downloading of music from the Internet. Rather, the Second Circuit treats these actions as suggestive of conspiratorial conduct.

Second, instead of considering this critical industry context, the Second Circuit relies heavily on the reported statement of a single "industry commentator," noting that no sane person would use MusicNet or pressplay, which is hearsay, and is at best a conclusory opinion and not "fact" suggestive of an antecedent conspiracy. Such a bald comment is of no weight or moment.

Third, the Second Circuit's decision in *Starr* also misapplies the Supreme Court's decision in *Dagher*,¹⁸ by overlooking critical facts and adopting new arguments that the plaintiffs expressly disavowed before Judge Preska. Contrary to the Second Circuit's conclusions: (i) the joint ventures were, like the Texaco-Shell joint venture in *Dagher*, reviewed and cleared by governmental authorities and (ii) in response to a question from Judge Preska during oral argument, plaintiffs' counsel represented to Judge Preska that they were not challenging the legality of the joint ventures nor arguing that they were shams. Thus, the Second Circuit's analysis rests upon inferences that cannot be squared with *Dagher* or even with the plaintiffs' own stated position before Judge Preska.

Fourth, although other courts have held that investigations, by themselves, are not suggestive of conspiratorial conduct, the Second Circuit draws improper inferences from the closed government antitrust investigations referenced in the Amended Complaint. Significantly, the Panel in *Starr* was specifically advised, in response to a question during oral argument, that every one of these investigations has been closed without any suggestion that any antitrust violations of any kind had occurred. Even if these investigations were still pending, pleading the existence of an investigation is not pleading a fact that, if true, would plausibly suggest the existence of an antecedent conspiracy. Investigations are probative of nothing.¹⁹ Furthermore, the Second Circuit compounded one of their mistakes, which it later corrected in its February 19, 2010 errata opinion. Initially the Panel stated, incorrectly, that the Antitrust Division undertook a "criminal investigation" of the joint ventures that closed in December 2003. Rather, and as the Panel subsequently acknowledged by amending its opinion, there was a lengthy civil investigation that found no anticompetitive conduct and ended with a public statement by the Antitrust Division detailing the basis for its conclusion.

Finally, the Second Circuit's *Starr* decision conflates interdependence with acts against self-interest by misapprehending what constitutes an act against self-interest and then pointing to conduct that is suggestive of no more than interdependent conscious parallelism. Indeed, Areeda

¹⁸ *Texaco Inc. v. Dagher*, 547 U.S. 1 (2006).

¹⁹ See, e.g., *Hinds County v. Wachovia Bank*, 620 F. Supp. 2d 499, 514 (S.D.N.Y. 2009); *In re Graphics Processing Units Antitrust Litig.*, 527 F. Supp. 2d 1011, 1024 (N.D. Cal. 2007).

& Hovenkamp's treatise, *Antitrust Law*—a well-respected treatise cited by the Panel in *Starr*—warns that conduct couched as an act against self-interest is often synonymous with interdependence and, as such, adds nothing.²⁰ Even if a rational business decision may depend upon a rival's reaction, Areeda & Hovenkamp caution that it is an error for courts to employ this economic reality in an oligopoly “to equate interdependence with conspiracy.”²¹

VI. IMPLICATIONS OF THE *STARR* DECISION IN THE SECOND CIRCUIT AND BEYOND

Absent rehearing, the material errors and general misapplication of *Twombly* found in the Panel decision, and the concurring opinion, will have considerable consequences for future parallel conduct antitrust cases. The *Starr* decision will confuse antitrust pleading standards, in the Second Circuit and beyond, and call into question and weaken the weight of post-*Twombly* authority limiting the import of parallel conduct allegations on antitrust claims. For example, the *Starr* decision conflicts not only with *Twombly* itself, but also with the Second Circuit's prior parallel conduct antitrust decision applying *Twombly*, *Elevator Antitrust Litigation*,²² and decisions of other appellate courts applying *Twombly*, such as *In re Travel Agent Comm'n Antitrust Litig.*²³

More importantly, the *Starr* decision represents a significant departure from the Supreme Court's cautionary instruction in *Twombly* that “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’ to support a § 1 claim.”²⁴ If the *Starr* decision is left undisturbed, it undoubtedly will invite putative antitrust claimants with no more than allegations of parallel conduct disguised as “context” to commence costly, coercive litigation in the Second Circuit and elsewhere of the type the Supreme Court in *Twombly* expressly foreclosed.

²⁰ See 6 PHILIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW, ¶¶ 1434c1; 1434c2 (2d ed. 2003).

²¹ *Id.* ¶ 1434c2.

²² *In re Elevator Antitrust Litig.*, 502 F.3d 47 (2d Cir. 2007).

²³ *In re Travel Agent Comm'n Antitrust Litig.*, 583 F.3d 896 (6th Cir. 2009).

²⁴ 550 U.S. at 559.