

The Implications Of Twombly And PeaceHealth

Friday, Apr 25, 2008 --- Despite hundreds of citations to, and reliance upon, the U.S. Supreme Court's decision in *Bell Atlantic Corp. v. Twombly*, 127 S.Ct. 1955 (2007), addressing pleading standards, the lower courts have not yet elaborated on how the Twombly-articulated "plausibility" standard should be applied to specific allegations of Sherman Act Section 2 claims, including bundling cases.

Recently, in *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883 (9th Cir. 2008), the Ninth Circuit adopted a substantial change to the standard for proving a Section 2 bundling claim, arguably also heightening the standard for such a claim.

This brief article summarizes the relevant case law and invites antitrust practitioners to consider the potential implications to bundling cases if Twombly and PeaceHealth were combined and applied to such cases.

Less than a year ago, in Twombly, the U.S. Supreme Court ruled that to survive a Federal Rule 12(b)(6) motion to dismiss, a Sherman Act Section 1 plaintiff must plead facts sufficient "to state a claim to relief that is plausible on its face." 127 S.Ct. at 1960.

Rejecting the prior test of *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957), that "a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief," the Twombly Court dismissed the complaint because the complaint failed to meet requirements not normally considered until the summary judgment phase of the case. 127 S.Ct. at 1964.

Twombly held that "stating a [Section 1] claim requires a complaint with enough factual matter (taken as true) to suggest that an agreement was made.

Asking for plausible grounds to infer an agreement does not impose a probability requirement at the pleading stage; it simply calls for enough facts to raise a reasonable expectation that discovery will reveal evidence of illegal agreement." *Id.* at 1965.

The Court explained that "[a]n allegation of parallel conduct is thus much like a naked assertion of conspiracy in a [Section 1] complaint: it gets the complaint close to stating a claim, but without some further factual enhancement it stops short of the line between possibility and plausibility of 'entitle[ment] to relief.'" *Id.* at 1966.

The Court reasoned that “it is only by taking care to require allegations that reach the level of 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 [Section 1] claim.” *Id.* at 1967.

Many have taken the Court’s holding and admonitions about the burdensome expense of discovery in antitrust cases as a nod to dismiss antitrust, as well as non-antitrust, cases at the pleading stage unless the plaintiff can allege a plausible claim for relief.

Specifically, with respect to Sherman Act Section 2 claims, *Twombly* has been cited as the standard to be applied in motions to dismiss, to specific elements of a Section 2 claim and to the issue of standing.

On the standard to plead a Section 2 claim, the Third Circuit in *Broadcom Corp. v. Qualcomm Inc.*, 501 F.3d 297, 317 (3rd Cir. 2007), for example, cited generally to *Twombly* for the principle that antitrust claims, including Section 2, must “allege facts sufficient to raise a right to relief above the speculative level”.

And, in *W.B. New England, Inc. v. R.A.B. Food Group, LLC*, No. 06 Civ. 15357, 2008 WL 540091 at *3 (S.D.N.Y. Feb. 27, 2008) the court stated that “*Twombly* requires that a plaintiff satisfy a flexible plausibility standard which obliges a pleader to amplify a claim with some factual allegations in those contexts where such amplification is needed to render the claim plausible.”

With respect to application of *Twombly*’s plausibility standard to particular elements of a Section 2 claim, the Second Circuit, in *Port Dock & Stone Corp. v. Oldcastle Northeast, Inc.*, 507 F.3d 117, 125 (2d Cir. 2007), upheld the district court’s dismissal, explaining that the plaintiff needed to plead “further facts ‘plausibly suggesting’ an anti-competitive aspect to the refusal to deal.”

In *Garmin Ltd. v. TomTom, Inc.*, No. 2:06-cv-338, 2007 WL 2903843 (E.D. Tex. Oct. 3, 2007), the court analyzed a Section 2 attempt to monopolize counterclaim applying *Twombly*’s plausibility standard and found that allegations in the counterclaim were sufficient to provide for a plausible relevant market, dangerous probability of monopolization and harm to competition.

And, in *Stand Energy Corp. v. Columbia Gas Transmission Corp.*, 521 F.Supp.2d 537, 539-40 (S.D. W. Va. 2007), the court explained that “[i]narguably, *Twombly* imposes a more demanding standard for pleading antitrust claims” and in this instance the “factual averments which support a claim of agreement for a vertical conspiracy do not suffice to describe an agreement to monopolize.”

See also *In Re Hypodermic Products Antitrust Litigation*, No. 05-cv-1602,

2007 WL 1959224, at *12 (D.N.J. June 29, 2007) (the court denied a motion to dismiss, in part, because the plaintiff alleged a plausible relevant market).

And, on the issue of standing, the Sixth Circuit relied upon *Twombly* as a basis for affirming the district court's dismissal of a Section 2 case for lack of standing. See *NicSand, Inc. v. 3M Co.*, 507 F.3d 442, 450 (6th Cir. 2007).

The court reasoned that “antitrust standing is a threshold, pleading-stage inquiry and when a complaint by its terms fails to establish this requirement we must dismiss it as a matter of law — lest the antitrust laws become a treble-damages sword rather than the shield against competition-destroying conduct that Congress meant them to be.” *Id.*

The court explained that *Twombly* tried to “eliminate this kind of loose antitrust pleading. Just as in [*Twombly*], where the Court held that ‘without more, parallel conduct does not suggest conspiracy,’ so here: a price increase by retailers, without more, does not suggest anticompetitive behavior by suppliers.” *Id.* at 458 (citing *Twombly*, 127 S.Ct. at 1966).

The court concluded that the plaintiff failed to meet the necessary requirement that it suffered antitrust injury, “as opposed to the ill effects of price competition, which understandably ‘hurts.’” *Id.* at 459.

At the same time courts have been grappling with *Twombly*, the Antitrust Modernization Commission (“AMC”) and the lower courts have continued to grapple with defining a better test to assess when bundled arrangements violate the antitrust laws.

To assess whether bundling is illegal, in 2007, the AMC proposed that courts should adopt a three-part test to determine whether bundled discounts or rebates violate Section 2 of the Sherman Act.

To prove a violation of Section 2, A plaintiff should be required to show each one of the following elements (as well as other elements of a Section 2 claim): (1) after allocating all discounts and rebates attributable to the entire bundle of products to the competitive product, the defendant sold the competitive product below its incremental cost for the competitive product; (2) the defendant is likely to recoup these short-term losses; and (3) the bundled discount or rebate program has had or is likely to have an adverse effect on competition.

PeaceHealth, F.2d 895, 905 (9th Cir. 2007). In its reasoning, the AMC concluded that “the first element would (1) subject bundled discounts to antitrust scrutiny only if they could exclude a hypothetical equally efficient competitor and (2) provide sufficient clarity for businesses to determine whether their bundled discounting practices run afoul of [Section] 2.” *Id.*

Before *PeaceHealth*, a prominent test for judging the legality of a bundle was set forth in *Ortho Diagnostic Sys. Inc. v. Abbott Labs. Inc.*, 920 F. Supp. 455 (S.D.N.Y. 1996).

In *Ortho*, the court analyzed “whether a firm that enjoys a monopoly on one or more of a group of complementary products, but which faces competition on others, can price all of its products above average variable cost and yet still drive an equally efficient competitor out of the market.” *Id.* at 467.

The court concluded that such a situation could indeed occur and provided a two-product example where one competitor sold shampoo and one competitor sold conditioner along with shampoo. *Id.*

The court demonstrated that the monopolist of conditioner selling a shampoo-conditioner bundle at a price above the total cost of manufacturing both products could make it impossible for the competitor solely selling shampoo to compete. *Id.*

The court held: [A] Section 2 plaintiff in a case like this – a case in which a monopolist (1) faces competition on only part of a complementary group of products, (2) offers the products both as a package and individually, and (3) effectively forces its competitors to absorb the differential between the bundled and unbundled prices of the product in which the monopolist has market power – must allege and prove either that (a) the monopolist has priced below its average variable cost or (b) the plaintiff is at least as efficient a producer of the competitive product as the defendant, but that the defendant’s pricing makes it unprofitable for the plaintiff to continue to produce. *Id.* at 469.

In *PeaceHealth*, in addressing a jury verdict in favor of a bundling plaintiff, the Ninth Circuit declined to adopt the standard set forth in *Ortho* because “the standard looks to the costs of the actual plaintiff” and in doing so “could require multiple suits to determine the legality of a single bundled discount.” 502 F.3d at 916.

The Ninth Circuit found the *Ortho* approach to “be unduly cumbersome for sellers to assess and thus might chill pro-competitive bundled discounts.” *Id.*

Rather than adopting the *Ortho* standard, the Ninth Circuit adopted what it referred to as its “discount attribution” standard.

“Under [this] standard, the full amount of the discounts given by the defendant on the bundle are allocated to the competitive product or products. If the resulting price of the competitive product or products is below the defendant’s incremental cost to produce them, the trier of fact may find that the bundled discount is exclusionary for the purpose of [Section] 2.” *Id.*

The Ninth Circuit reasoned that this “standard makes the defendant’s bundled discounts legal unless the discounts have the potential to exclude a hypothetical equally efficient producer of the competitive product.” *Id.*

The discount attribution standard adopted by the Ninth Circuit echoes the first part of the AMC’s proposed three-part test. The Ninth Circuit, however,

rejected the second and third parts of the AMC's test. *Id.* at 916.

The court reasoned that the recoupment requirement (the second part) is not proper in the bundling context because there is not necessarily a loss associated with a bundled product.

The bundled discounter could, as explained in the shampoo-conditioner example in *Ortho*, be able to bundle the products above the incremental cost to produce them. The Ninth Circuit also rejected the AMC's requirement of a likelihood of an adverse effect on competition (the third part) as they felt it to be "superfluous in light of the general and pre-existing requirement of antitrust injury under *Brunswick*." *Id.* at 921

Notably, *PeaceHealth* cited *Twombly* in stating, "[w]e decline to adopt a rule that might encourage more antitrust litigation than is reasonably necessary to ferret out anti-competitive practices." *Id.* at 916.

If combined, *Twombly* and *PeaceHealth* potentially have altered the framework in which courts may determine whether a plaintiff has adequately pled a bundling case.

Under the bundling test of *Ortho*, a plaintiff could determine whether defendant priced its product below the average variable/incremental cost of plaintiff's product and thus could adequately plead a bundling case with facts available to the plaintiff without additional discovery.

However, the standards in *Twombly* and *PeaceHealth*, if combined, potentially require a bundling plaintiff to assert factual allegations regarding a defendant's incremental costs. Such plaintiffs, however, likely would not be in a position to have such information before discovery occurs.

Thus, applying both *Twombly* and *PeaceHealth* at the pleading stage in bundling cases raises new questions for litigants and courts to resolve.

Some important considerations would include what a bundling plaintiff must plead to survive a motion to dismiss and whether it is appropriate to apply a plausibility standard when a defendant's detailed cost information is unavailable to the plaintiff.

Often, an intense economic analysis is required to meet the *PeaceHealth* test for determining whether bundling may constitute a violation of the antitrust laws.

Given that plaintiffs continue to challenge the legality of bundles, how the courts address the *PeaceHealth* discount attribution test in combination with *Twombly*'s plausibility pleading standard remains to be seen.

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