SULLIVAN & CROMWELL LLP

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In Landmark Digital Antitrust Ruling, Ninth Circuit Largely Affirms *Epic* v. *Apple* Decision

Apple Wins Some, and Loses Some

SUMMARY

On April 24, 2023, the Ninth Circuit handed down its decision, available here, in the appeal of the trial court's decision in *Epic Games, Inc.* v. *Apple Inc.* Epic's lawsuit challenged Apple's App Store restrictions that (i) prohibit app distribution outside of the App Store; (ii) require developers exclusively to use Apple's In-App Purchase ("IAP") payment system for purchases within an app, on which Apple collects a commission of either 15% or 30%; and (iii) contain anti-steering provisions that restrict app developers from informing users about other payment mechanisms.

The Ninth Circuit affirmed the trial court's conclusion that Epic had failed to prove its federal antitrust claims challenging Apple's prohibition on alternate app stores and requirement to use IAP. While the Ninth Circuit found that the trial court committed certain legal errors, it concluded that those errors were harmless in light of Epic's failure to prove other elements of its claims. The Ninth Circuit, however, affirmed the trial court's holding that Apple's anti-steering provisions violate California's Unfair Competition Law ("UCL"), handing Epic a win with potentially far-reaching consequences for all app developers.

The implications of the decision for future antitrust plaintiffs are mixed. The Ninth Circuit clarified the test for establishing single-brand aftermarkets, apparently placing a somewhat higher burden on plaintiffs, but also adopted a fairly narrow reading of the Supreme Court's recent *Amex* decision that commentators had speculated would pose a major obstacle to suits involving multisided transaction platforms. The Ninth Circuit's ruling for Epic on its UCL claim is perhaps the most surprising part of the decision, and creates uncertainty about the extent of the UCL's reach beyond the scope of federal antitrust laws.

For more details on the case, see our September 13, 2021 memo discussing the trial court's decision, available here.

I. BACKGROUND AND PROCEDURAL HISTORY

In 2020, Epic brought suit against Apple in the U.S. District Court for the Northern District of California alleging violations of federal and California antitrust and unfair competition laws. Epic challenged Apple's App Store restrictions that (1) prohibit distribution of iOS applications ("apps") for Apple's iPhone and iPad devices outside Apple's App Store; (2) require app purchases and in-app transactions for digital content to exclusively use Apple's In-App Purchase ("IAP") payment system, on which Apple collects a commission of either 15% or 30%; and (3) contain anti-steering provisions that restrict app developers from informing users about alternate payment mechanisms that are not subject to Apple's commission.

Following a bench trial presided over by the Honorable Yvonne Gonzalez Rogers, the court found that Apple's restrictions have anticompetitive effects and reduce innovation in mobile game distribution. Nonetheless, the court denied Epic's federal antitrust claims, finding that Apple had presented non-pretextual, procompetitive rationales for its prohibition on alternate app stores and the requirement to use IAP, and that Epic had failed to prove a less restrictive alternative existed that was equally effective at achieving those objectives. The district court did hold, however, that Apple's anti-steering provisions violate California's Unfair Competition Law ("UCL") and issued a permanent nationwide injunction preventing Apple from enforcing these provisions. Both parties appealed the district court's ruling, and the Ninth Circuit stayed the district court's injunction pending appeal.

On April 24, 2023, a panel for the Ninth Circuit issued a 91-page opinion, reversing certain legal conclusions by the district court, but finding each error to be harmless and affirming as to all of the district court's ultimate holdings on Epic's antitrust and unfair competition claims. The panel was made up of Circuit Judges Sidney R. Thomas and Milan D. Smith, who authored the opinion, and District Judge Michael J. McShane (sitting by designation). Judge Thomas authored a partial concurrence and partial dissent—discussed in more detail below—in which he disagreed with the majority's conclusions that certain errors relating to market definition were harmless and stated that he would have remanded the case to the district court to re-evaluate Epic's antitrust claims in the context of a properly-defined relevant market.

II. THE COURT'S REASONING

A. FEDERAL ANTITRUST CLAIMS

1. Defining the Relevant Market

A significant point of contention between Epic and Apple at trial was how to define the relevant market. Epic proposed "two single-brand markets: the aftermarkets for iOS app distribution and iOS in-app payment

solutions, derived from a foremarket for smartphone operating systems."[1] Apple, on the other hand, argued that the relevant market was "the market for all video game transactions."[2] The district court did not accept either of those definitions, instead categorizing the relevant market as "mobile-game transactions—i.e., game transactions on iOS and Android smartphones and tablets."[3] On appeal, Epic raised four arguments regarding its single-brand market theory that the district court rejected; Epic argued "that the district court committed legal error when it (1) held a market can never be defined around a product that the defendant does not license or sell, (2) required lack of consumer awareness to establish a *Kodak*-style market, (3) purportedly required a change in policy to establish a *Kodak*-style market, and (4) required Epic to establish the 'magnitude' of switching costs."[4]

The Ninth Circuit agreed with Epic's first argument, finding that "the district court erred by imposing a categorical rule that an antitrust market can never relate to a product that is not licensed or sold."[5] It also agreed with Epic's third argument that a plaintiff can establish a single-brand aftermarket without needing to show that the defendant adopted aftermarket restrictions *after* consumers purchased goods in the foremarket (although the panel found that the district court did not actually impose such a requirement).[6] However, two of the three members of the panel concluded that any errors were harmless because the district court had properly concluded that Epic had failed to make out at least two other elements necessary to establish a valid single brand market. Specifically, the Ninth Circuit upheld the district court's findings that "Epic failed to show a lack of general consumer awareness regarding Apple's restrictions on iOS distribution and payment processing," and that "Epic failed to show significant switching costs."[7] The Ninth Circuit reasoned that if a user consents to the challenged aftermarket restrictions when they purchase their iPhone, or can freely switch to an Android phone if they find the aftermarket restrictions too onerous, those restrictions would not be unlawful. Thus, in clarifying that the Supreme Court's decision in *Kodak*[8] and the Ninth Circuit's decision in *Newcal*[9] require a plaintiff to show both a lack of consumer knowledge about aftermarket restrictions *and* high switching costs, the Ninth Circuit appears to impose a more stringent standard on antitrust plaintiffs to establish a single-brand market.

Judge Thomas concurred with the panel's conclusion that the district court erred in several aspects of its market definition analysis, but dissented as to the remainder of the majority opinion, arguing that the panel should have remanded the case to the district court to reevaluate the remainder of Epic's antitrust claims under a properly-defined relevant market.

2. Sherman Act Section 1 – "Rule of Reason" Analysis

The Ninth Circuit reversed the district court's threshold determination that Apple's Developer Program License Agreement was not an agreement within the meaning of Sherman Act Section 1, finding that this conclusion "plainly contradicts Section l's text, which reaches '[e]very contract, combination . . . , or conspiracy' that unreasonably restrains trade."[10] The Ninth Circuit also rejected Apple's contention that Epic had failed to prove that the challenged restrictions had an anticompetitive effect, crediting the district court's

findings that Apple had "extraordinarily high" operating margins and a high market share of 52% to 57%, and that it did not change its 30% commission in response to competitive pressures.[11]

The remainder of the Ninth Circuit's holdings relating to the Section I claim favored Apple. The court endorsed both of Apple's procompetitive justifications for the challenged restrictions—(1) "improv[ing] device security and user privacy" and (2) "compensat[ing] [Apple] for its IP investment"—finding that "IP-compensation is a cognizable procompetitive rationale" and that, "by improving security and privacy features, [Apple] is tapping into consumer demand and differentiating its products from those of its competitors," thereby increasing interbrand competition between iPhone and Android devices.[12] In so holding, the Ninth Circuit rejected Epic's and its *amici*'s argument that "Apple's security and privacy rationales are *social*, not procompetitive, rationales and therefore fall outside the purview of antitrust law."[13] Having credited Apple's procompetitive justifications, the Ninth Circuit went on to find "that Epic failed to prove the existence of substantially less restrictive alternatives (LRAs)" that would be "virtually as effective" in accomplishing those goals.[14] It agreed with the district court's rejection of Epic's proposed alternative for the app distribution restrictions—a notarization model (similar to that Apple employs for its macOS computers) whereby Apple would "notarize" as safe apps that are distributed through other app stores—finding that it lacked the benefits of Apple's current human review model for the App Store and that Epic failed to show how Apple would be compensated under this model for the use of its IP.[15] The panel also agreed with the district court that, "in a world where Apple maintains its distribution restriction but payment processing is opened up, Apple would still be contractually entitled to its 30% commission," and the court concluded that Epic failed to prove that permitting other payment processors to collect the commission would be as efficient as mandating the use of IAP.[16]

Interestingly, the Ninth's Circuit's analysis of the rule of reason claim did not end there. At the urging of Epic and "several *amici*, including the United States and thirty-four state attorneys general," the panel went on to hold that, where "the plaintiff fails to carry its . . . burden of establishing viable less restrictive alternatives," Ninth Circuit precedent requires the court then to undertake a "balancing [of] the anticompetitive effects . . . against [the conduct's] procompetitive benefits."[17] While the Supreme Court has never endorsed this fourth step of the rule-of-reason analysis and Apple had argued that it is not required, the panel clarified that Ninth Circuit precedent did require this final balancing step. But in any case, the Ninth Circuit concluded that "the district court's failure to explicitly reach the fourth step was harmless" because it had "'carefully considered the evidence in the record and . . . determined, based on the rule of reason,' that the distribution and IAP restrictions 'have procompetitive effects that offset their anticompetitive effects.'"[18]

3. Sherman Act Section 1 – Tying

In ruling on Epic's Section 1 tying claim, which alleged that Apple unlawfully tied app distribution and payment processing, the Ninth Circuit disagreed with the district court's finding that these services are not separate products—a threshold requirement for any tying claim.[19] The panel nevertheless agreed with the

district court's ultimate conclusion that Epic had failed to prove the tie was unlawful, first joining with the D.C. Circuit's *Microsoft* decision in holding that "*per se* condemnation is inappropriate for ties 'involv[ing] software that serves as a platform for third-party applications,'" and then concluding that the tying claim failed under the rule of reason for the same reasons discussed above.[20]

4. Sherman Act Section 2 – Monopoly Maintenance

Having rejected Epic's proposed market definition, the Ninth Circuit affirmed the dismissal of Epic's monopoly maintenance claim in light of the district court's findings that Apple lacked durable monopoly power in the mobile games transaction market and that Epic had failed to show the conduct was anticompetitive under the rule of reason.[21]

B. CALIFORNIA UCL CLAIMS

The one tangible victory for Epic in the Ninth Circuit's decision was the panel's affirmation of the district court's finding that Apple's anti-steering provisions violated the UCL. On appeal, Apple challenged the district court's ruling on three grounds. *First*, Apple argued that Epic lacked constitutional standing to seek injunctive relief under the UCL because Apple had terminated Epic's developer account. The Ninth Circuit rejected this argument because Epic's subsidiaries still had developer accounts that were affected by the rule, and because the rules indirectly harmed Epic by steering users away from Epic's competing store. *Second*, turning to the merits, Apple argued that Epic's claim was precluded by the so-called "safe harbor doctrine," which "bars a UCL action where California or federal statutory law 'absolutely preclude[s] private causes of action or clearly permit[s] the defendant's conduct.'"[22] The Ninth Circuit rejected this argument, drawing a distinction (discussed in more detail below) between "categorical legal bar[s]" under the Sherman Act—which are exempt from UCL liability—and cases involving a mere failure of proof—which can be subject to UCL liability.[23] *Third*, Apple argued that "two principles from Sherman Act case law" should be imported into the UCL and preclude liability: (i) the requirement to define a relevant market and conduct a formal rule-of-reason balancing, and (ii) the Supreme Court's decision in *Amex*, which (Apple argued) barred liability stemming from anti-steering provisions in a two-sided market. The court rejected the latter argument based on *Amex*, finding that the *Amex* Court rejected the plaintiff's claims in that case based on a failure of proof and did not give "blanket approval of anti-steering provisions."[24] The panel also held that requiring formal rule-of-reason analysis for UCL claims would be inconsistent with the flexible test for liability laid down by the California Supreme Court.[25] Finally, the Ninth Circuit upheld the broad permanent injunction that the district court issued as a remedy for Apple's UCL violation.

IMPLICATIONS

Perhaps the most surprising aspect of the Ninth Circuit's opinion is its affirmation of the district court's UCL ruling. Upholding the district court's broad injunction gives a significant win to all app developers (not just Epic) because it applies to all app categories (not just games) and applies nationwide. Unless Apple seeks

en banc review—a prospect that seems likely[26]—or succeeds in convincing the district court to modify the injunction's terms, developers may be able to avoid Apple's 30% IAP commission on in-app purchases simply by directing users to external, web-based payment options once the injunction goes into effect.[27]

More generally, the Ninth Circuit's UCL ruling creates uncertainty about what exactly the UCL prohibits. The California Supreme Court has long held that the UCL is broader than federal antitrust laws, prohibiting conduct that "threatens an incipient violation of an antitrust law, or violates the policy or spirit of one of those laws because its effects are comparable to or the same as a violation of the law."[28] But the few cases that apply the UCL do not provide much clarity about exactly how far beyond federal law it extends. The Ninth Circuit's opinion attempts to provide some clarity by suggesting that any categorical legal rule prohibiting a claim under the Sherman Act would also bar a claim under the UCL, whereas a claim may be viable under the UCL where a mere "proof deficiency" defeated liability under the Sherman Act. Some ambiguity remains, however, because the Ninth Circuit's decision does not lay down any standard explaining what legal rules are sufficiently "categorical" so as to bar a UCL claim and does not explain what sorts of "proof deficiency" under federal law are nevertheless tolerable under the UCL.

The Ninth Circuit's resolution of the Sherman Act claims was less surprising. At bottom, many of the panel's holdings on Epic's antitrust claims rested on Epic's failure to prove all elements of its claim at trial. In this sense, the ramifications of the decision for future antitrust claims against Apple and similar platforms will be relatively limited. For example, while Epic failed to offer up and adequately support a less restrictive alternative to the app distribution restrictions, the opinion seems to leave open the possibility that such an alternative could exist. Nevertheless, at least two aspects of the court's holdings relating to Epic's antitrust claims warrant attention.

First, the Ninth Circuit clarified the test for establishing single-brand aftermarkets. While the new four-part test announced by the panel more clearly defines what a plaintiff must show, it also appears to place a higher burden on plaintiffs than the tests that the district court and other courts had applied in the wake of *Newcal*.[29] In particular, the Ninth Circuit made clear that a plaintiff must show both that "information costs prevent accurate life-cycle pricing" by consumers *and* that there are significant barriers to switching in the foremarket.[30]

Second, the Ninth Circuit appeared quite skeptical of Apple's arguments, based on the Supreme Court's *Amex* decision,[31] that the App Store is a two-sided market and that Epic failed to demonstrate harm on the consumer side of that market. In rejecting this claim, the Ninth Circuit reasoned that "Amex does not require a plaintiff to [show] harm to participants on both sides of the market" but only that a plaintiff must show "anticompetitive impact on the 'market as a whole.'"[32] While this holding was based largely on a prior Ninth Circuit case from 2022, it nevertheless tempers the prediction by many commentators at the time *Amex* was handed down that it would pose a major obstacle to antitrust plaintiffs.[33]

Finally, one less-obvious winner from the decision is the United States Department of Justice. The DOJ has reportedly been ramping up the pace of its investigation into Apple's App Store restrictions in preparation for filing its own antitrust lawsuit against Apple.[34] The amicus brief that the DOJ filed in the Ninth Circuit did not support either party, instead identifying a handful of specific errors made by the district court. The panel adopted the views advocated by the DOJ on almost all of those issues, including whether the Developer Program License Agreement is a contract under Sherman Act Section 1, whether rule-of-reason analysis requires a final balancing step, and whether Apple's app distribution services and IAP are separate products.[35] While Apple will certainly rely on some of the Ninth Circuit's findings to defend against any antitrust claims asserted by the DOJ—including, for example, the panel's decision to credit Apple's privacy and security justifications for its App Store requirement and IAP restrictions—most of those holdings rest on Epic's failure to introduce sufficient evidence to support its claims, rather than more fundamental deficiencies in Epic's legal theories.

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ENDNOTES

1 Opinion at 18.

2 *Id.*

3 *Id.*

4 *Id.* at 34.

5 *Id.* at 35.

6 *Id.* at 37-38.

7 *Id.* at 38-39.

8 *Eastman Kodak Co.* v. *Image Tech. Servs*., 504 U.S. 451 (1992).

9 *Newcal Indus., Inc.* v. *Ikon Off. Sol.*, 513 F.3d 1038 (9th Cir. 2008).

10 *Id.* at 42 (quoting 15 U.S.C. § 1). This aspect of the decision is unsurprising; several *amicus* briefs, including one by the United States Department of Justice, criticized this holding by the district court. *See, e.g.*, Brief For the United States of America as Amicus Curiae in Support of Neither Party ("DOJ Amicus Brief"), at 10-14, *Epic Games Inc.* v. *Apple Inc.*, Nos. 21-16506 (Ninth Cir. Jan. 27, 2022), *available at* https://cdn.ca9.uscourts.gov/datastore/general/2022/10/20/21-16506-Amicus-brief-by-United-States-of-America.pdf.

11 Opinion at 46-49.

12 *Id.* at 50-53.

13 *Id.* at 52-56.

14 *Id.* at 58.

15 *Id.*at 61-62.

16 *Id.* at 62-63.

17 *Id.* at 64-65.

18 *Id.* at 67.

19 *Id.* at 70-72.

20 *Id.* at 72.

21 *Id.* at 76. Notably, the panel emphasized that Epic did not challenge the district court's conclusion that Apple lacks monopoly power in the market for mobile games transactions.

22 *Id.* at 80 (quoting *Zhang* v. *Sup. Ct*., 57 Cal. 4th 364, 379–80 (2013)).

23 *Id.* at 81-82.

24 *Id.* at 82.

25 *Id.* at 82-83.

26 Epic and Apple jointly requested—and the Ninth Circuit granted—a one-month extension of the time to seek *en banc* review, strongly indicating that both parties intend to seek such review.

27 There is some ambiguity in the scope of the district court's injunction. For a discussion of these ambiguities, refer to our earlier memo discussing the district court's decision, available here.

28 *Cel-Tech Commc'ns, Inc.* v. *L.A. Cellular Tel. Co*., 20 Cal. 4th 163, 180 (1999).

29 Under the old test, a plaintiff was required to show that "(1) the aftermarket is wholly derivative from the primary market; (2) illegal restraints of trade relate only to the aftermarket; (3) the defendant

ENDNOTES CONTINUED

did not achieve market power in the aftermarket through contractual provisions that it obtains in the initial market; and (4) competition in the initial market does not suffice to discipline anticompetitive practices in the aftermarket." *AliveCor, Inc*. v. *Apple Inc*., 592 F. Supp. 3d 904, 916 (N.D. Cal. Mar. 21, 2022). In a footnote, the Ninth Circuit explained that this test derived from a misreading of *Newcal* and that these four factors related only to whether the complaint had "plausibly alleged lack of consumer awareness." (Opinion at 33 n.8.)

30 Opinion at 33.

31 *Ohio* v. *Am. Express Co*., 138 S. Ct. 2274 (2018).

32 Opinion at 49-50 (quoting *PLS.Com, LLC* v. *Nat'l Ass'n of Realtors*, 32 F.4th 824, 838 (9th Cir. 2022)).

33 *See, e.g.*, Herbert Hovenkamp, *Antitrust and Platform Monopoly*, 130 Yale L.J. 1952, 1960 (2021) ("*Amex* casts a pall over enforcement against digital platforms . . . ."); Steven C. Salop, *Dominant Digital Platforms: Is Antitrust Up to the Task?*, Yale L.J. Forum, 563, 575 (2021) ("Potential cases against the dominant digital platforms will need to contend with [*Amex*] and the noninterventionist antitrust approach it supports.").

34 *See* Aaron Tilley et al., *U.S. Escalates Apple Probe, Looks to Involve Antitrust Chief*, WALL STREET JOURNAL (Feb. 15, 2023), https://www.wsj.com/articles/u-s-escalates-apple-probe-looks-to-involve-antitrust-chief-2fa86ddf.

35 *See* DOJ Amicus Brief, *supra* note 10. In fact, the only position advanced by the DOJ that was not adopted by the Ninth Circuit was the district court's conclusion that Apple lacked monopoly power in the market for mobile game transactions. However, the Ninth Circuit's decision to affirm on this point is hardly surprising given that Epic itself did not challenge that conclusion.

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