# Corporations

## Twombly: Naked (Alleged) Conspiracy Does not Strip Freedom of Unilateral Action

*By John Thorne**

When the Supreme Court hears *Bell Atlantic Corp. v. Twombly* this fall, it will confront both a fundamental issue of pleading law in an antitrust context and an important question of substantive antitrust law at the pleading stage. The case could throw open the door to vexatious litigation, or the Court could affirm district courts' authority to dismiss abusive lawsuits—before plaintiffs have the opportunity to impose massive discovery costs—by insisting that plaintiffs plead facts that demonstrate an entitlement to relief. The case could impose a tax on ubiquitous business conduct by turning all "parallel" conduct into fair game for enterprising plaintiffs' lawyers, or the Court could protect the important antitrust principle that parallel but unilateral conduct is lawful, thereby reinforcing a trend of antitrust decisions that preserve individual economic actors' freedom to behave in ways that are efficient without concern about baseless but costly litigation.

The case began when plaintiffs—representatives of a purported class of virtually everyone in the United States—filed a complaint alleging that the major local telephone companies "conspired" to suppress competition. That complaint— prepared by the Milberg, Weiss law firm— rested on two sets of allegations. First, plaintiffs alleged that defendants had refused to render sufficient assistance to new competitors, failing to live up fully to the expansive regulatory obligations imposed by the FCC under the Telecommunications Act of 1996 (and later vacated by the courts). Second, plaintiffs alleged that defendants had refrained from "meaningful" competition in one another's traditional service territories, even though such entry opportunities were supposedly attractive business opportunities.

The district judge—Gerard Lynch, a former prosecutor, Columbia Law School professor, and highly respected jurist —dismissed the complaint. The district court noted that antitrust laws draw a basic distinction between lawful unilateral action and conspiratorial conduct. Accordingly, when a complaint seeks to draw an inference of agreement from allegations of otherwise lawful parallel conduct "the basic requirement that plaintiffs must fulfill is to allege facts that, given the nature of the market, render the defendants' parallel conduct, and the resultant state of the market, suspicious enough to suggest that defendants are acting pursuant to a mutual agreement rather than their own individual self-interest."[1] Judge Lynch carefully explained why the allegations in the *Twombly* complaint failed to meet that standard: rational businesses are expected to resist demands that they share assets with rivals, and *non*-entry—particularly in a new business that plaintiffs themselves alleged was fraught with risk—is a perfectly reasonable exercise of self-interest on entirely unilateral grounds.

The Second Circuit reversed, finding that Judge Lynch's careful analysis was simply unnecessary. Instead, it held that allegations of parallel conduct (that is, the claim that rivals or potential rivals acted in a similar way), combined with a conclusory allegation of "conspiracy," will almost always suffice to state a claim under Section 1 of the Sherman Act. Thus, "to rule that allegations of parallel anti-competitive conduct fail to support a plausible conspiracy claim, a court would have to conclude that there is *no set of facts* that would permit a plaintiff to demonstrate that the particular parallelism asserted was the product of collusion rather than coincidence."[2] That standard, which relies not on the facts alleged but on un-alleged facts that might be proved, would allow virtually any allegation of parallel conduct to proceed to discovery, because it is almost always true that parallel behavior *could* have been the product of agreement. The Second Circuit quickly decided that Twombly's claims could proceed, without examining whether the facts alleged supported to any extent an inference of conspiracy.

The Supreme Court granted certiorari in June.

### Giving Courts Tools To Control Abusive Litigation

As a case about pleading standards, *Twombly* will clarify the authority of district judges to insist that plaintiffs plead sufficient facts to show that they have a genuine claim before allowing a potentially massive factual controversy to proceed. For half a century, since *Conley v. Gibson*,[3] the Court has made clear that Rule 8's requirement of a "short and plain statement" showing "that the pleader is entitled to relief" does not demand *evidentiary* detail. At the same time, legal conclusions—that is, bare allegations that the law has been violated—are insufficient. Under Rule 12, a court accepts well-pleaded facts as true in evaluating the sufficiency of the complaint. But it need not accept the inferences that plaintiffs seek to draw from well-pleaded facts. Drawing these lines is critical to ensuring that a complaint serves its basic functions under the Civil Rules. First, only by disregarding merely conclusory allegations and rejecting unwarranted inferences can the district court ensure that the plaintiff has a *factual* basis for some cognizable legal claim: nothing is easier than claiming that a defendant violated some legal standard if the underlying facts are not revealed. Second, only by insisting on pleading of the key material facts can the district court ensure that the complaint

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provides a defendant notice of the nature of the claim against it.

The threshold question in *Twombly* is whether plaintiffs' allegation that defendants "conspired"—combined with allegations of otherwise lawful parallel conduct—is enough to satisfy Rule 8. It is long settled that, under Section 1 of the Sherman Act, parallel but unilateral conduct is lawful, while concerted action is subject to scrutiny if it unreasonably restrains trade. The complaint in *Twombly* alleges in so many words that defendants conspired, but it includes no *direct* allegations that support that claim: it does not identify the time, place, participants, form, or mechanism of the conspiracy. The Second Circuit held that the bare allegation of conspiracy was enough. That puts the line between conclusory allegation and well-pleaded fact in the wrong place. As Judge Michael Boudin of the First Circuit has observed, an allegation of "conspiracy" is "border-line": standing alone—that is, without more specific facts to support it—such an allegation, even if it is "factual" in form, is actually a warning sign that the plaintiff has launched a baseless complaint—a "fishing expedition." For that reason, the court should treat such an allegation as a mere legal conclusion, the invocation of the governing standard that need not, without more, be accepted as true for purposes of evaluating the sufficiency of the complaint. The court can then consider whether the *facts* are sufficient to meet Rule 8.

In all legal contexts, the need for courts to distinguish between factual allegations, on the one hand, and legal conclusions and unwarranted inferences, on the other, is prompted by the most fundamental policies underlying our system of private civil litigation. The aspiration of the Federal Rules is (as Rule 1 says) "to secure the just, speedy, and inexpensive determination of every action." In keeping with that goal, Rule 8(f) directs that "all pleadings shall be so construed as to do substantial justice." Fifty years ago, in *Conley v. Gibson*, the Supreme Court elaborated that pleading should not be treated as a "game of skill" but instead should "facilitate a proper decision on the merits."

These principles do not favor plaintiffs in every case. In *Twombly*, it is the plaintiffs that are treating pleading as a game of skill in which they seek to impose massive discovery costs on defendants through artful pleading. The basis for cases like *Twombly* is not a reasonably grounded actual suspicion of wrongdoing or expectation that a trial on the merits will yield success, but a bet that the thinnest of allegations, with the greatest of legal consequences, will survive motions to dismiss and begin to put pressure on defendants to settle complex litigation—what Judge Henry Friendly, in his book *Federal Jurisdiction*, called "blackmail settlement."[4] Consumer class-action litigation can impose particularly strong pressure in this regard. In such cases, discovery costs are borne disproportionately by defendants, particularly in the early stages of litigation, when compliance with massive document requests can cost a large corporation millions of dollars and distract employees from more productive tasks. And, if a class is certified, even a very low probability of recovery may be enough to force a settlement that is not only unjust, but benefits consumers not at all, serving only to make a few lawyers rich.

The federal rules do not require district courts to countenance such harmful litigation. To the contrary, district judges are authorized, and should be encouraged, to apply pleading standards with sensitivity to the underlying legal standards and policies and practical litigation realities. Yet the Second Circuit in *Twombly* repudiated that approach, even while acknowledging the deleterious consequences.

### Protecting Efficient Unilateral Action

What has been said so far is largely independent of the antitrust context, but the *Twombly* case implicates specific antitrust policy issues as well. The Second Circuit's opinion, in recognizing that the "conspiracy" charge in the case is an entirely conclusory label that any plaintiff could attach, effectively treated mere pleading that defendants engaged in parallel conduct as enough to merit discovery. The Second Circuit thus seemed to suggest that there is something inherently suspicious about parallel conduct. That is wrong as a matter of basic economics; and the Second Circuit's mistaken approach threatens to inflict substantial costs on the economy by distorting unilateral business judgments.

The Supreme Court has made clear that, to support a claim of conspiracy under Section 1, a plaintiff must do more than show that conspiracy is one possible explanation for parallel conduct: rather, the Supreme Court held in *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*[5] that a plaintiff seeking to prove a conspiracy through circumstantial evidence must "present evidence that tends to exclude the possibility that the alleged conspirators acted independently." Parallel conduct does not, in general, provide a sound basis to infer that defendants are engaged in concerted action. As the district court in *Twombly* correctly noted, "parallel action is a common and often legitimate phenomenon, because similar market actors with similar information and economic interests will often reach the same business decisions."[6] In perfectly competitive markets, economists expect that competing firms will routinely act in parallel with each other, responding similarly to similar market-affecting phenomena. In imperfectly competitive markets as well, firms that are all seeking to maximize profits subject to similar constraints tend to make similar decisions. Of course, firms may also engage in parallel behavior as a result of a conspiracy. But because there are other more common sources of parallel behavior, mere allegations of parallel behavior do not, as a matter of logic, tend to exclude the possibility that defendants acted unilaterally.

Nevertheless to allow mere allegations of parallel conduct to proceed to discovery would impose significant costs on the economy and, thus, on consumers. Plaintiffs could pursue class action cases against companies based only on garden-variety economic behavior such as raising prices in response to higher demand or reducing capacity in response to shrinking demand. The cost of litigating (and settling) such cases is likely to be substantial in the aggregate. But such costs could be just the tip of the iceberg. Expected litigation and settlement costs are one of the factors that businesses consider in making decisions. If allegations of parallel conduct are allowed to proceed to discovery,

businesses will face an effective litigation "tax" in making the same efficient decisions as their competitors. At the margin, this tax will deter businesses from responding efficiently to changes in costs, demand, or technology.

The district court in *Twombly* recognized that in addition to allegations of parallel action, a plaintiff must allege facts that tend to exclude the possibility of unilateral action. In particular, the question is whether the alleged actions would be contrary to the individual self-interest of the defendant *absent* agreement: if it would not be, then, unless there are other facts, there is no reason to think that the defendants' conduct was the result of conspiracy rather than individual self-interest. Courts can draw on the common-law-like development of antitrust in evaluating such allegations. For example, antitrust law recognizes that failure to enter new markets (thus preserving an existing pattern of distribution) is hardly ever suspicious, because new ventures are always risky, capital is scarce, and a business can pursue only a small fraction of available business opportunities. Twombly's allegation that the local telephone companies' failure to compete "meaningfully" as new entrants (relying on a new, unstable, and ultimately fruitless business model) must be evaluated against that backdrop.

The need to protect parallel but unilateral conduct from attack by plaintiffs raising frivolous claims reflects a fundamental trend in the Supreme Court's antitrust jurisprudence, a trend towards protecting freedom of unilateral action. In *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*,[7] the Court adopted a rule that was strongly protective of firms' ability to cut prices, even if such price cuts make it more difficult for competitors to survive. In *NYNEX Corp. v. Discon, Inc.*,[8] the Court refused to impose limitations on monopolists' ability to switch suppliers. Most recently, in *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP*,[9] the Court emphasized the positive antitrust importance of allowing firms to invest without facing later obligations to share assets with rivals. These decisions are *categorical*. As the Seventh Circuit, speaking through Judge Easterbrook, recently explained in *Schor v. Abbott Laboratories*,[10] clever economists can always construct models showing potential market harms, but if the circumstances are too rare, it is important to have categorical per se rules of legality anyway. The *Twombly* case fits that mold: by allowing allegations of parallel conduct to proceed under Section 1, the Second Circuit standard risks distorting business judgments and deterring efficient conduct. Such a standard would thus disserve basic antitrust policies, and the Supreme Court should reject it.

**Footnotes**

[1] Twombly v. Bell Atlantic Corp., 313 F. Supp. 2d 174, 182 (S.D.N.Y. 2003).

[2] Twombly v. Bell Atlantic Corp., 425 F.3d 99, 114 (2d Cir. 2005).

[3] 355 U.S. 41 (1957).

[4] Henry Friendly, Federal Jurisdiction: A General View 120 (1973).

[5] 475 U.S. 574, 588 (1986).

[6] 313 F. Supp. 2d at 179.

[7] 509 U.S. 209 (1993).

[8] 525 U.S. 128 (1998).

[9] 540 U.S. 398 (2004).

[10] 457 F.3d 608, 612-13 (7th Cir. 2006).