

CPI's North America Column Presents:

"Bright Line" *Apple v. Pepper* Invites Further Economic Analysis

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While *Apple v. Pepper* may have offered clarity on which entities have standing to recover antitrust damages in cases where a platform operator facilitates transactions between buyers and sellers but does not set prices, the decision also appears to create a more rigorous standard for economic analysis at the class certification stage for these specific types of direct purchaser class actions.

Background

In *Apple v. Pepper*, the U.S. Supreme Court concluded that purchasers of apps from Apple's App Store have standing to sue Apple for alleged antitrust violations even though third-party developers (as opposed to Apple) set the prices at which apps are sold.² The Court based its decision on a "bright line" rule established under *Illinois Brick* that limits antitrust standing to those who suffered direct harm as a result of alleged anticompetitive conduct.³ *Illinois Brick* further ruled that purchasers who suffered injury as a result of overcharges being "passed through" by non-defendant intermediaries do not have legal standing.⁴

The Court rejected Apple's argument that the economics of a transaction on Apple's App Store implies that any antitrust harm suffered by app purchasers was necessarily *indirect* in nature. According to Apple, any impact must be indirect because — given that app developers set prices — app purchasers could only be harmed if app developers passed on any allegedly anticompetitive overcharge that Apple imposed on the developers.⁵

In rejecting Apple's argument, the Court referred to the "statutory text and precedent," which it indicated "was not based on an economic theory about who set the price."⁶ The Court concluded that "[i]t is undisputed that the iPhone owners bought the apps directly from Apple ... [and therefore] were direct purchasers who may sue Apple for alleged monopolization."⁷ The Court further noted that "[t]here is no intermediary in the distribution chain between Apple and the consumer": app purchasers buy "directly from the retailer Apple" and "pay the alleged overcharge directly to Apple."⁸

While rejecting Apple's standing arguments, the Court, along with the dissent, acknowledged the complicated economics of App Store transactions and the need to analyze pricing decisions of upstream app developers to determine impact and calculate damages. If an upstream app developer elects not to pass through any alleged commission overcharge, then purchasers of the developer's product will not be harmed.

Thus, in putative class actions in which plaintiffs allege a platform operator that does not set prices engaged in anticompetitive conduct, the incentives and pricing decisions of the third-party sellers that set the prices at which the platform sells products will need to be analyzed. This analysis — and in particular whether third-party sellers passed through any alleged overcharge — will be necessary to determine if common methods and evidence can be used to demonstrate that all putative class members were impacted by the alleged anticompetitive

conduct. Such cases will require additional economic analysis beyond what is typically necessary at the class certification stage for direct purchaser plaintiffs.

Economic Analysis of Pass-Through When Third-Party Sellers Set Prices

Both the majority opinion and the dissent (written by Justice Gorsuch) appear to recognize that an analysis of pass-through will be required. Writing for the majority, Justice Kavanaugh stated:

[If] Apple could prove that app developers in a ... [competitive] system would always set a higher price such that consumers would pay the same retail price regardless of ... Apple's commission ... then the consumers' damages would presumably be zero.⁹

Similarly, Justice Gorsuch, in dissent, stated:

Plaintiffs can be injured *only* if the developers are able and choose to pass on the overcharge to them in the form of higher app prices that the developers alone control.¹⁰

Thus, in cases where third parties set the prices at which the alleged platform monopolist sells products, an economic analysis of how the third parties set prices and whether they pass through any alleged overcharge will be required. Consequently, two questions become relevant for class certification that are not considered in traditional direct putative class actions:¹¹

- 1) "would every class member be ... subjected to an overcharge through pass-on"; and
- 2) "can common evidence be used to prove that ... all class members were subjected to the overcharge through pass-on"?¹²

Economic theory predicts that under a stylized model in which all intermediaries operate in a perfectly competitive market where price equals marginal cost and all firms are subject to the same cost increase, then the entire cost increase will be passed through to consumers.¹³ However, economists recognize that, outside this simplistic setting, pass-through rates can and do vary across different firms and that, in certain circumstances, a firm may elect *not* to pass through a cost increase.¹⁴ Moreover, empirical evidence demonstrates that there is, in fact, variation in pass-through rates and that cost increases are not always passed through by every seller to each of the seller's customers.¹⁵ Thus, determining whether any given third-party seller increased its price to any given customer will require a fact-specific inquiry into *that* seller's pricing practices to that customer.

To illustrate the ideas in the rest of this article, consider a hypothetical platform that offers online distribution services to a diverse set of sellers. The platform could sell everything from

physical products like toilet paper and luxury handbags to digital products such as movies and computer games. Suppose this platform retains a certain percentage of the purchase price of each sale as a commission, but the purchase price is determined by the upstream seller. Finally, suppose the platform is alleged to have engaged in anticompetitive practices that allowed it to obtain a higher commission than it could have absent the alleged conduct.

In general, a firm's incentive to pass through a cost increase will depend, in part, on the extent to which the quantity the firm sells will fall in response to a price increase (i.e. the elasticity of demand that the firm faces).¹⁶ All else equal, a firm will elect to pass through less of a cost increase if purchasers are very sensitive to prices changes. In the hypothetical example of the retailer platform, it is therefore necessary to consider the elasticity of demand facing the different upstream firms that sell products on the platform.

What is unique in the setting of a platform is that the platform sells numerous categories of products; thus, it will be necessary to consider the elasticity of demand that the different upstream sellers face for each type of product on the platform. A seller of toilet paper, which may be viewed more as a commodity product, may face very elastic demand; thus, an increase in price is likely to cause consumers to elect to purchase a different brand of toilet paper or to purchase toilet paper from a different retailer. Consequently, the toilet paper seller may elect not to pass through any of the alleged overcharge to consumers who purchase on the platform at issue. A seller of branded luxury handbags, on the other hand, may face less elastic demand and consequently may elect to pass through almost all of the overcharge.

In real-world settings, even firms that face similarly elastic demand may have different pricing strategies that result in different pass-through decisions. Consequently, an analysis of different sellers' pricing strategies may be required to determine whether the firm has an incentive to pass through an alleged overcharge from the platform. In the hypothetical example, sellers of digital products on the retail platform, such as computer games, may have complex pricing strategies that consider the revenue the seller makes from advertising as well as game sales. These sellers may elect to respond to the alleged overcharge by the retail platform not by raising the price of the product but by instead increasing the amount of third-party advertising shown to users of the product. In this instance, the alleged overcharge would not be passed through by the seller to the consumer.

Sellers may employ other pricing strategies that influence whether a particular seller passes a potential overcharge to purchasers on the retail platform. For example, many sellers engage in "focal point pricing" by setting prices at "focal points" ending in 99 cents or 99 dollars.¹⁷ Depending on the size of the overcharge by the retail platform, some sellers in the hypothetical example may choose not to pass along a small overcharge in order to maintain the focal point pricing. For instance, if a seller sets a price of \$99 for a product sold on the retail platform and the overcharge by the retail platform is 5 percent of the purchase price, then absent the

overcharge, the seller may have still set a price of \$99 rather than \$94.50. In this case, the alleged 5 percent overcharge would not be passed on by the seller to the consumer.

Sellers on the retail platform could also adopt different pricing strategies at different points in time due to changes for a variety of reasons. For example, the introduction of a new seller that competes directly with an existing seller on the retail platform could influence the ability of the seller to pass through the alleged overcharge. In another example, a seller may offer periodic or seasonal discounts; the seller may find it more difficult (or may not want) to pass through an alleged overcharge from the retail platform in periods when the seller is discounting the product. Thus, just because a seller passes through an alleged overcharge in one period does not mean it passes through the overcharge in other periods.

The examples above demonstrate that many factors may affect whether a seller on a platform elects to pass through any alleged overcharge. Consequently, a factual analysis of the relevant economic factors (e.g. elasticity of demand across products, pricing strategies) and an empirical analysis of actual pricing behavior is required to determine whether pass-through of the overcharge occurs at different points in time for each seller. Ultimately, the Court's "bright line" decision in *Apple v. Pepper* necessitates such additional economic analysis at the class certification stage in these types of antitrust direct purchaser class actions.

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- ² Apple’s App Store provides distribution services to app developers who set the prices for their apps. App developers sell apps through the App Store in exchange for a yearly fixed fee and a per transaction commission that is paid to Apple. Simultaneously, Apple’s App Store sells these apps to consumers who own iPhones and purchase apps.
- ³ *Illinois Brick Co. v. Illinois*, 431 U.S. 720, 745-746 (1977); *Apple Inc. v. Pepper*, 139 S. Ct. 1514, 1520 (2019).
- ⁴ *Illinois Brick*, 431 U.S. at 741.
- ⁵ Brief of Petitioner at 24-30, *Apple Inc. v. Pepper*, 139 S. Ct. 1514 (Aug. 10, 2018) (No. 17-204).
- ⁶ *Apple Inc. v. Robert Pepper*, 139 S. Ct. at 1522.
- ⁷ *Id.* at 1520.
- ⁸ *Id.* at 1521.
- ⁹ *Id.* at 1523.
- ¹⁰ *Id.* at 1528 (emphasis in original).
- ¹¹ This need to analyze pass-through differentiates cases in which prices are set by upstream developers from cases involving more traditional distribution chains. A pass-through analysis is generally not required because the Supreme Court ruled in *Hanover Shoe* that an antitrust defendant could not use a “pass-through” defense. That is, a defendant cannot argue that a direct purchaser was not damaged because the purchaser “passed on” any overcharge to its own customers. *Hanover Shoe* therefore makes analyzing pass-through and pricing decisions of parties other than the alleged antitrust violator unnecessary in cases involving more traditional distribution chains.
- ¹² ABA Section of Antitrust Law, *Indirect Purchaser Litigation Handbook* (2007), at 169.
- ¹³ *Id.* at 132–33.
- ¹⁴ Joseph E. Stiglitz, *Economics of the Public Sector* (2001), chap. 18; E. Glen Weyl & Michal Fabinger, *Pass-Through as an Economic Tool: Principles of Incidence under Imperfect Competition*, 121 J. Pol. Econ. 528 (2013); Gee Hee Hong & Nicholas Li, *Market Structure and Cost Pass-Through in Retail*, 99 Rev. Econ. & Stat. 151 (2017).
- ¹⁵ Timothy Besley & Harvey S. Rosen, *Sales Taxes and Prices: An Empirical Analysis*, 52 Nat’l Tax J. 157 (1999); David Besanko et al., *Own-Brand and Cross-Brand Retail Pass-Through*, 24 Marketing Sci. 123 (2005); Gee Hee Hong & Nicholas Li, *Market Structure and Cost Pass-Through in Retail*, 99 Rev. Econ. & Stat. 151 (2017).
- ¹⁶ ABA Section of Antitrust Law, *Indirect Purchaser Litigation Handbook* (2007), at 132–33.
- ¹⁷ Kenneth C. Manning & David E. Sprott, *Price Endings, Left-Digit Effects, and Choice*, 36 J. Consumer Res. 328 (2009); Eric T. Anderson et al., *Effects of \$9 Price Endings on Retail Sales: Evidence from Field Experiments*, 1 Quantitative Marketing & Econ. 93 (2003).