Robert A. Mittelstaedt #60359
ramittelstaedt@jonesday.com
Craig E. Stewart #129530
cestewart@jonesday.com
Michael Scott #255282
michaelscott@jonesday.com
JONES DAY
555 California Street, 26th Floor
San Francisco, CA 94104
Telephone: (415) 626-3939
Facsimile: (415) 875-5700

Attorneys for Defendant
APPLE INC.

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN JOSE DIVISION

THE APPLE iPOD iTUNES ANTI-TRUST LITIGATION.

Case No. C 05-00037 JW
C 06-04457 JW

DEFENDANT'S REPLY MEMORANDUM IN SUPPORT OF MOTION FOR JUDGMENT ON THE PLEADINGS AS TO PLAINTIFFS' RULE OF REASON TYING CLAIM

Date: October 5, 2009
Time: 9:00 A.M.
Place: Courtroom 8, 4th floor

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INTRODUCTION

Plaintiffs' opposition rests on the fallacy that the threshold requirement for a tying claim—namely, that two products have been tied together—differs depending on whether the *per se* or rule of reason test is applied. That argument is contrary to logic and precedent, and is unsupported by any case.

As plaintiffs admit (Opp. 8), the predicate for any tying claim, whether the claim is analyzed under the *per se* or rule of reason tests, is that the seller agree "to sell one product but only on the condition that the buyer also purchases a different (or tied product), or at least agrees that he will not purchase that product from any other supplier." *Eastman Kodak Co. v. Image Tech. Servs.*, 504 U.S. 451, 461 (1992) (quoting *N. Pac. Ry. Co. v. United States,* 356 U.S. 1, 5-6 (1958)). Here, this Court has ruled that this predicate is absent. As the Court explained, the alleged "tying and tied products are separately available." Dkt. 80 (No. 07-06507), p. 5. This separate availability is fatal to any antitrust scrutiny, whether *per se* or rule of reason. Without an underlying tying arrangement, there is nothing to which either analysis may be applied.

Plaintiffs cite no contrary authority. In each case they cite, there was an underlying restraint to which the rule of reason could be applied. Rule of reason treatment was proper in those cases because the court denied *per se* treatment on a ground other than the absence of the underlying restraint itself. Here, however, the underlying restraint is missing. Plaintiffs identify no case in which rule of reason analysis was applied to a tying arrangement after the Court found there was no tie.

Faced with this fatal defect in their position, plaintiffs resort to repeating their earlier argument that this is a technological tie. This, however, is precisely the argument the Ninth Circuit rejected in *Foremost Pro Color, Inc. v. Eastman Kodak Co.*, 703 F.2d 534 (9th Cir. 1983)—and that this Court rejected in following *Foremost Pro* to dismiss plaintiffs' *per se* claim. As the Ninth Circuit ruled, when two products are separately available and the only allegation is that one is required for the "practical and effective" use of the other, the coercion essential to establish a tie is missing. *Id.* at 542. Contrary to plaintiffs' assertion, the required coercion does not differ depending on whether *per se* or rule of reason treatment is sought. Coercion goes to whether the seller is refusing to sell the products separately, which determines whether a tie exists at all, not whether *per se* or rule of reason treatment is proper. Because Apple has never refused to sell its products separately, tying law is simply inapplicable here and judgment on the tying claim should be granted.

ARGUMENT

I. SECTION 1 DOES NOT APPLY BECAUSE THE ALLEGED TIE DOES NOT INVOLVE ANY CONCERTED ACTION.

Plaintiffs do not dispute that Sherman Act section 1—the statute under which they assert their tying claim—requires a "contract, combination or conspiracy" between separate entities. Nor do they dispute that the basis of their tying claim—the alleged incompatibility between iTS files and competing portable players—resulted from Apple's own unilateral product design decisions and not from any agreement with another entity. These facts are fatal to any claim under section 1.

Plaintiffs cite no authority holding that a company's unilateral product design decisions fall within section 1. To the contrary, as shown in our opening memorandum (and as plaintiffs do not dispute), in each case alleging a so-called technological tie, the claim was either brought under section 2 or the court rejected the section 1 claim on other grounds without reaching the question whether concerted action was present. Thus, far from being a matter of "settled antitrust jurisprudence" (Opp. 13), plaintiffs' assertion that section 1 applies here is unsupported by any decision. And it is rejected by the leading antitrust treatise which states that, in the case of an alleged technological tie, "neither a § 1 'agreement' nor a Clayton § 3 'condition or understanding' is involved, so any incremental liability that attaches to tying claims does not apply here." 3A P. Areeda, H. Hovenkamp & E. Elhauge, *Antitrust Law*, ¶ 776c, at p. 254 (2d ed. 2004).[1]

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[1] Citing another section of the treatise, plaintiffs assert (Opp. 15, n.9) that the treatise "analyze[s] in detail" how technological ties should be treated under section 1. In fact, that section of the treatise says nothing about applying section 1. And the cases it cites are either section 2 cases or section 1 cases in which no tie was found. 10 P. Areeda, H. Hovenkamp & E. Elhauge, *Antitrust Law*, ¶ 1757a, at p. 317 (2d ed. 2004).

Rather than citing any cases holding that section 1 governs alleged technological ties, plaintiffs rely on cases in which the defendant coerced an actual agreement from a buyer to purchase two products together (or not to buy from a competitor). In *N. Pac. Ry.*, for example, the defendant railroad entered into contracts with purchasers of land in which the purchasers explicitly agreed to ship commodities only over the defendants' railroad lines. 356 U.S. at 5-6. Similarly, in *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2 (1984), the tying arrangement was a "contract between the hospital and its patients" that the patients would use only the hospital's anesthesiology services. *Id.* at 19 n.28. These cases are inapposite here because plaintiffs allege no such agreement.[2]

Plaintiffs' fallback position is that an agreement exists here because Apple supposedly "forced iTMS purchasers to agree not to purchase a portable digital player from anyone other than Apple." Opp. 14. The allegations to which they point, however (Cmplt. ¶¶ 41-44, 50) describe only Apple's decision to adopt its own DRM, not any agreement between Apple and any customer.

Contrary to plaintiffs' argument (Opp. 14), holding that section 1 does not apply here does not give "special treatment" to technology companies. Rather, it is simply applying to technology companies the same antitrust rules that govern every other industry. Section 1 applies only to concerted action between separate entities, not to a single company's design of its own products, whether those products are software or nuts and bolts.

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[2] *County of Tuolumne v. Sonora Cmty. Hosp.*, 236 F.3d 1148, 1152 (9th Cir. 2001) (hospital required obstetrical patients to purchase cesarean section services from specified doctors); *Datagate, Inc. v. Hewlett-Packard Co.*, 60 F.3d 1421, 1427 (9th Cir. 1995) (Hewlett-Packard expressly required purchasers of software service to also purchase hardware service); *United States v. Microsoft Corp.*, 253 F.3d 34, 84 (D.C. Cir. 2001) (Microsoft contractually required licensees of Windows to also license Internet Explorer); *Systemcare, Inc. v. Wang Labs. Corp.*, 117 F.3d 1137, 1139 (10th Cir. 1997) ("[U]nder the WSS contract, a customer must subscribe to Wang's hardware support program in order to obtain Wang's software support services."); *Nobel Scientific Indus., Inc. v. Beckman Instruments, Inc.*, 670 F. Supp. 1313, 1324 (D. Md. 1986) (defendant allegedly coerced agreement to buy related software applications as a package—finding no tie because products were in fact made separately available).

Plaintiffs' tying claim thus fails at the threshold. Absent an actual agreement between separate entities, section 1 is inapplicable and the tying claim must be dismissed.

II. PLAINTIFFS' RULE OF REASON TYING CLAIM INDEPENDENTLY FAILS BECAUSE THEY HAVE NOT ALLEGED A TIE.

A. The Absence of a Tying Arrangement is Fatal to Plaintiffs' Rule of Reason Claim.

Plaintiffs' argument that their rule of reason treatment is proper here rests on a misunderstanding of why their *per se* claim failed. They assert that *per se* analysis applies only to a "subset" of antitrust claims, and thus that "[t]ying arrangements that are not suitable for *per se* prohibition may still be addressed under a rule of reason test." Opp. 3. But this begs the question whether plaintiffs have alleged a tying arrangement in the first place. The predicate for antitrust scrutiny of a tying arrangement—whether *per se* or rule of reason—is that a tying arrangement actually exist. Without such a tie, there is nothing to which the rule of reason can be applied.

The cases plaintiffs cite as applying the rule of reason demonstrate the point. In each case, *per se* treatment was denied for some reason other than the absence of the predicate conduct itself. In *Jefferson Parish*, for example, the court rejected *per se* treatment because the defendant hospital lacked market power in the tying product market, not because it found that the hospital had not tied together its hospital and anesthesiology services. 466 U.S. at 26-29. Similarly, in *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001), there was no dispute that Microsoft had contractually tied its Windows and Internet Explorer software products together. *See id.* at 84 ("Microsoft required licensees of Windows 95 and 98 also to license IE as a bundle at a single price."). Microsoft admitted as much. *Id.* at 85. Thus, *per se* treatment was rejected not for lack of a tie, but because the court concluded it lacked sufficient familiarity with the software tying arrangement at issue there to apply *per se* treatment.[3]

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[3] Similarly, in *Broad. Music, Inc. v. Columbia Broad. Sys., Inc.*, 441 U.S. 1 (1979), the defendants admittedly had fixed the price of the blanket music licenses they sold. Thus, even though the Court concluded that *per se* treatment was inappropriate because the licenses could not exist at all without some price being set for them, the underlying price-fixing agreement remained to be evaluated under the rule of reason.

That is not the situation here. The Ninth Circuit rejected *per se* treatment in *Foremost Pro*—and this Court rejected it in this case—because it found no tying arrangement at all, not because of any defect peculiar to *per se* treatment. The Ninth Circuit ruled that no tie existed because plaintiff had not alleged that "the purchase of the alleged tied products was required as a condition of sale of the alleged tying products." *Foremost Pro*, 703 F.2d at 542. The only allegation was that one product was a "prerequisite to practical and effective use of the" other product. *Id.* As the Ninth Circuit concluded, an alleged "technological interrelationship among complementary products" does not constitute the coercion required to state a tying claim. *Id.*

This ruling is equally fatal to a rule of reason claim because coercion is required not simply for *per se* tying claim, but to state any tying claim at all. As shown in Apple's opening memorandum (at 5-6), and as plaintiffs themselves admit (Opp. 5), the difference between *per se* and rule of reason treatment in tying cases is not that coercion is required for one and not for the other. Rather, the *per se* rule requires proof that the defendant has market power over the tying product, whereas the rule of reason requires no such proof. Thus, had the Ninth Circuit denied *per se* treatment in *Foremost Pro* because Kodak lacked market power, that would not have disposed of a rule of reason claim against the same alleged tying arrangement. But the Court's ruling that plaintiffs had failed to allege coercion was fatal to any tying claim because, in the absence of coercion, no tying arrangement exists at all.

Plaintiffs try to avoid this result by suggesting that the coercion required for a *per se* claim differs from that required for a rule of reason claim. However, they cite no authority supporting this assertion. They rely only on *Foremost Pro*'s holding that the plaintiff there had not alleged "the coercion essential to a *per se* unlawful tying arrangement." Opp. 9 (quoting *Foremost Pro*, 703 F.2d at 542). Plaintiffs read into this reference to *per se* treatment that coercion has some other meaning in rule of reason cases. *Foremost Pro* spoke in terms of *per se* treatment only because that was the theory asserted in the case. There is no suggestion whatsoever that coercion means one thing for *per se* purposes and another thing for rule of reason analysis. And no other court has held or even suggested that.

Equally meritless is plaintiffs' related suggestion (Opp. 9) that rule of reason treatment applies when "coercion is not demonstrated in the usual way"—*i.e.*, by an "express condition." No case holds that choosing between *per se* or rule of reason analysis turns on how coercion is proved. Plaintiffs are confusing the test for deciding whether a tie exists in the first place with the test for determining—***if*** a tie is found—whether that tie should be evaluated under *per se* or rule of reason analysis. Coercion goes to whether a tie exists at all—*i.e.*, whether the defendant has conditioned, by express contract provision or otherwise, the sale of one product on the purchase of another. Absent such conditioning, there is no tying arrangement to be evaluated because "where the buyer is free to take either product by itself there is no tying problem." *Jefferson Parish*, 466 U.S. at 12 n.17 (quoting *N. Pac. Ry. Co.*, 356 U.S. at 6 n.4). The fatal flaw in plaintiffs' claim is not that they have proved some coercion other than an express condition. They have failed to prove any conditioned sale at all, which defeats their rule of reason claim just as much as their *per se* claim.[4]

Nor is there any merit to plaintiffs' assertion that the Ninth Circuit held that Foremost had stated a tying claim when the Court described Foremost's claim as "basically involv[ing] the so-called technological tie." 703 F.2d at 542. As this Court recognized, that was not a holding that the alleged "so-called technological tie" constituted a tying arrangement within the meaning of the antitrust laws. Instead, the Ninth Circuit was simply describing the framework, or (or as this Court described it) the "model for liability" (Dkt. 213, p. 8), into which plaintiffs were trying to squeeze themselves. The Ninth Circuit's actual holding was that the so-called technological tie

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[4] Plaintiffs try to distinguish *Advanced Computer Servs. of Mich., Inc. v. MAI Sys. Corp.*, 845 F. Supp. 356, 369 (E.D. Va. 1994), by asserting that the court found no tie because the defendant had not expressly or implicitly conditioned the sale of one product on another. That, however, is exactly the point. The absence of conditioned sale was equally fatal to both the *per se* and the rule of reason claim in that case. The same is true here because the alleged technological relationship between iTS content and iPods is neither an explicit nor an implicit tie.

Webb v. Primo's Inc., 706 F. Supp. 863 (N.D. Ga. 1988), does not help plaintiffs. The court rejected the tying claim there because the plaintiff had not shown any coercion at all and because, even if the plaintiff had shown coercion, the plaintiff failed to show either market power or any actual anticompetitive effect. The court did not suggest that rule of reason treatment would have been proper even absent coercion.

plaintiffs asserted was not an actionable tying arrangement at all because it lacked the required element of coercion.

Plaintiffs' assertion (Opp. 6) that "[o]ther courts" have recognized the existence of technological ties is also groundless. They cite *Microsoft*, but that case involved an express contractual tie. *See supra*, p. 4. It did not find a tie simply because two products were technologically interrelated or worked better together than with competing products. The only other authority plaintiffs cite is the Areeda treatise. But, as noted (*supra*, p. 2 & n.1), that treatise makes clear that so-called technological ties do not involve any concerted action and that the alleged conduct is subject to antitrust scrutiny, if at all, only under the monopolization standard of section 2, not as a section 1 tying claim.

Plaintiffs' remaining efforts to distinguish *Foremost Pro* are similarly groundless. They assert (Opp. 7) that a technological tie can be found when one product is "less effective" without the other. But that is precisely the argument that *Foremost Pro* rejected. As this Court recognized, the claim in *Foremost Pro* was that Kodak's film "was incapable of being processed" without Kodak's processing chemicals. Dkt. 213, p. 6. Thus, customers "necessarily" had to purchase one with the other. 703 F.2d at 540. Despite this, the Ninth Circuit held that no tying arrangement existed. Plaintiffs' claim here is even weaker because they do not—and cannot—allege that iTS files are "incapable" of being used without iPods or that customers "necessarily" must purchase one with the other. *Foremost Pro*'s ruling thus applies *a fortiori*.

Likewise mistaken is plaintiffs' assertion that *Foremost Pro* is distinguishable because it concluded that a technological relationship between two products does not foreclose competition. The Ninth Circuit found that, rather than foreclosing competition, creating technologically related products "increases competition by providing consumers with a choice of differing technologies, advanced and standard, and by providing competing manufacturers the incentive to enter the new product market by developing similar products of advanced technology." *Foremost Pro*, 703 F.2d at 542. This conclusion applies with equal force here. Nothing prevents Apple's competitors from competing with Apple's path-breaking products by seeking to develop their own "similar products of advanced technology." Protecting the incentives for such competition, and the innovative products it creates, is a bedrock purpose of the antitrust laws. *Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 407-08 (2004).

Plaintiffs also try to distinguish *Foremost Pro* by pointing to their allegations that Apple "deliberately used" its own proprietary DRM (FairPlay) and issued "software updates" to keep FairPlay proprietary when a competitor hacked into it. Opp. 7 (citing Compl. ¶¶ 51-55). But these allegations simply repeat plaintiffs' underlying claim that a tie exists because Apple's decision to use and maintain its own DRM has supposedly made an iPod necessary for "practical and effective use" of iTS content. Just as the Ninth Circuit and this Court ruled that such allegations do not establish a tying arrangement for purposes of *per se* analysis, they also are insufficient for rule of reason purposes. Plaintiffs assert (Opp. 7) that this "type of exclusionary conduct violates antitrust law." But the cases they cite for this assertion only prove the point that no tying claim exists here. None of the cases they cite was a tying case. Instead, they involved only monopolization claims under section 2. *See Xerox Corp. v. Media Scis. Int'l, Inc.*, 511 F. Supp. 2d 372, 390 (S.D.N.Y. 2007) (holding that "MS may proceed on its § 2 claims based on Xerox's alleged redesign and patenting and its loyalty rebates"); *In re IBM Peripheral EDP Devices Antitrust Litig.*, 481 F. Supp. 965, 971 (N.D. Cal. 1979) (plaintiff alleged that IBM "violated Section 2 of the Sherman Act which forbids the monopolization or attempted monopolization of any part of trade or commerce"), *aff'd sub nom. Transamerica Computer Co., Inc. v. IBM*, 698 F.2d 1377 (9th Cir. 1983).[5]

Finally, plaintiffs assert (Opp. 8) that tying law does not require that the two products be purchased "at the same time." But that assertion does not help them because Apple does not

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[5] Apple vigorously denies that plaintiffs have a valid claim under section 2. As will be shown in a subsequent motion addressed to that claim, a company such as Apple is not obligated when designing its products to make them as equally compatible with its competitors' products as with its own. Plaintiffs' cases do not hold to the contrary, because they were addressed to the situation in which a firm with monopoly power redesigns its products that were originally compatible with competitors' complementary products to render those competitors' products incompatible. *E.g., Xerox*, 511 F. Supp. 2d at 387-88 (Xerox allegedly changed an existing product to eliminate original compatibility); *IBM Peripheral*, 481 F. Supp. at 973 (same). That is not what occurred here. For present purposes, however, the dispositive point is that plaintiffs' allegations of product incompatibility fail to state a valid tying claim under section 1.

require that iTunes Store customers ***ever*** purchase an iPod—either at the time of their iTunes Store purchase or at any other time. Nor is it relevant that tying law does not require that the buyer actually buy the second product so long as the buyer agrees not to buy the second product from any other supplier. Opp. 8 (citing *N. Pac. Ry.*, 356 U.S. at 5-6). Apple does not require that iTunes Store customers agree not to purchase competing digital players, and plaintiffs do not allege otherwise.

B. Plaintiffs Have No Answer to Apple's Showing that Plaintiffs' Theory Conflicts with Basic Antitrust Policies.

Apple's opening memorandum showed that expanding tying law to regulate product design and interoperability would be unworkable and violate basic antitrust polices. Plaintiffs have no answer to this point. They assert (Opp. 10) that rule of reason analysis gives the court the "flexibility" to decide when a tie is anticompetitive. But they do not suggest any feasible means by which a company is to know when a technological interrelationship between its products rises to the level of a tie. They assert that courts are "competent" to make such determinations, but they do not identify any test by which they are to do so. Nor do they identify any means by which a company could avoid liability under their theory other than by giving up its rights to use its own proprietary software or otherwise ensuring that its products were compatible with competing products. They do not dispute that, under their theory, Apple could not have avoided the alleged tie simply by offering the products separately. Apple has done that from the beginning.

Rather than respond to these points, plaintiffs only broadly assert that their "claim is well within existing section 1 jurisprudence." Opp. 12. But they do not cite a single case in which tying law has been applied to regulate the degree to which a company's products must interoperate with its competitors' products. Instead, they rely on cases that involved an express contractual tie,[6] an agreement among competitors to perpetuate a patent monopoly[7] or to divide

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[6] *Microsoft*, 253 F.3d at 84; *Times-Picayune Pub. Co. v.United States*, 345 U.S. 594, 597 (1953) (contractual requirement that advertisers must purchase space in both morning and evening editions); *City of Lafayette, La. v. Louisiana Power & Light Co.*, 435 U.S. 389, 403-04 (continued)

geographic markets,[8] and a monopolization case under section 2.[9] None of these cases even remotely supports applying tying law in this circumstance.

Contrary to plaintiffs' mischaracterization (Opp. 10), holding that tying law is inapplicable here does not grant an "exemption" or "immunity." Rather, it simply recognizes that tying law does not apply in these circumstances. It was developed to deal with the perceived evil of a seller refusing to sell its products separately, not to regulate product interoperability.

Plaintiffs assert that their theory would not require Apple to deal with its competitors because Apple supposedly took "several anticompetitive steps" beyond just not licensing its software to others. But the alleged additional steps to which plaintiffs point are nothing more than Apple adopting its own proprietary DRM and issuing updates to it. Given that the labels required that Apple encode their music with DRM, the only way Apple could have avoided the alleged anticompetitive effect supposedly created by these steps would have been to license its proprietary DRM to competitors, or to license Microsoft's DRM. No other method exists to avoid the alleged incompatibility about which plaintiffs complain. No court, however, has ever found a tie based on a company's decision to not engage in such licensing with its competitors.

C. <u>Plaintiffs' Failure to Allege Individual Coercion Also Defeats Their Rule of Reason Claim</u>.

Apple's motion also demonstrated that, in addition to failing to allege a cognizable tie between iTS content and iPods, these plaintiffs also do not have a tying claim under either *per se* or rule of reason analysis because none of them alleges that he or she was coerced by any iTS

(1978) (contractual requirement that customers buying gas and water service must also purchase electricity); *Rick-Mik Enters., Inc. v. Equilon Enters. LLC*, 532 F.3d 963, 968 (9th Cir. 2008) (defendant contractually required service station dealers to use defendant's credit card processing services). *Cf. Ungar v. Dunkin' Donuts of America*, Inc., 531 F.2d 1211 (3d Cir. 1976) (reversing class certification because plaintiffs had not shown that a contractual tie existed; individual proof would be required to show that the defendant refused to sell separately to individual purchasers).

[7] *In re Tamoxifen Citrate Antitrust Litig.*, 466 F.3d 187 (2d Cir. 2006).

[8] *Los Angeles Memorial Coliseum Com'n v. National Football League*, 726 F.2d 1381 (9th Cir. 1984).

[9] *Xerox Corp.*, 511 F. Supp. 2d at 378.

purchases into buying an iPod. Because Apple had fully briefed this issue in its earlier Rule 12(c) motion, Apple referred the Court to that earlier briefing. Plaintiffs likewise rely on their prior briefing on this issue.

The only additional point plaintiffs raise is to suggest that, even if their failure to allege individual coercion defeats their *per se* claim, that failure carries "less weight" for their rule of reason claim. This is so, they assert, because rule of reason analysis is better suited to determine whether the alleged incompatibility between iTS files and competing players is a "burdensome term." But the only alleged "burden" plaintiffs assert is that customers with a large number of iTS purchases were locked into buying iPods rather than competing players. None of these plaintiffs, however, alleged that they bought their iPods because of any such lock-in. Any such alleged "burden" is therefore irrelevant to these plaintiffs.

Moreover, whether any alleged incompatibility "burdened" consumers by locking them in has no relevance to whether *per se* or rule of reason treatment applies. At best, any such burden would go only to whether Apple had coerced customers by conditioning the sale of one product on the other. For the reasons discussed above (at 5-6), coercion goes to whether a tie exists at all, not to whether the tie is subject to *per se* or rule of reason treatment.

III. PLAINTIFFS' STATE LAW TYING ALLEGATIONS SHOULD BE DISMISSED.

Plaintiffs do not dispute that their state law tying claim is governed by the same standards as their federal claim. For the same reasons discussed above, the Court should accordingly dismiss Count Four of plaintiffs' complaint, which asserts a tying claim under the Cartwright Act, and likewise dismiss Counts Five and Six to the extent they also assert a claim for unlawful tying.

CONCLUSION

For these reasons, judgment on the pleadings on the tying claims should be granted.

Dated: September 14, 2009

Respectfully submitted,

Jones Day

By: /s/ Robert A. Mittelstaedt
Robert A. Mittelstaedt

Counsel for Defendant
APPLE INC.

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