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Unbundling the iPhone: Is this Bell 2.0?

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Nearly three decades after the breakup of Ma Bell, 'bundling' has again come under scrutiny, this time in the realm of wireless communications. The breakup of AT&T arose from an antitrust action alleging that the company had exploited its lawful monopoly over local exchange services to monopolise long distance services and telephone equipment manufacturing.[2] In the wireless context, bundling refers to the provision of cellular services and products together under one contract. The wireless industry is arguably competitive, offering consumers a broad array of attractive hardware and service options. Still, consumers and competitors have begun to question not only the gatekeeping role of the major cellular service providers, who decide which phones to bundle with their plans ('service-centric' challenges), but also exclusive distribution deals granting a single service provider sole access to popular phones ('hardware-centric' challenges). Initial indications are that hardware-centric antitrust claims may be better positioned to succeed.

Historical background

Debate over the legality of bundling of cellular hardware and services both originated from and has been informed by historical developments in the landline telephone industry. The telephone service and hardware businesses were married almost from the start. In the early 1880s, American Bell Telephone Company (later AT&T) acquired a majority interest in the Western Electric Company, the leading phone producer of the day. The firms' exclusive dealing agreement meant that for the next nine decades, the Bell monopoly over the telecommunications service infrastructure equated to dominance over the handset business as well. The business model virtually precluded competition. Western Electric made durable, spartan phones which Bell leased to consumers as part of their monthly service contract. Phones required a complex electrical installation by Bell technicians, and third-party hardware was prohibited as posing a threat to the integrity of the Bell transmission network.

AT&T's joint dominance of the US telephone service and hardware markets first attracted Department of Justice scrutiny in 1949, and in the 1956 *Hush-A-Phone* decision, the DC Circuit held that AT&T could not restrict its customers from attaching third-party hardware to leased AT&T phones.[3] Twelve years later, in *Carterfone*, the Federal Communications Commission (FCC) further required AT&T to allow consumers to connect non-AT&T phones to the company's phone lines.[4] What followed was a proliferation of phone options: phones in different colours and styles, cordless phones, phones incorporating answering machines and other consumer-friendly features. By 1978, one million plug-and-play phones were sold directly to consumers in department stores and electronics shops.[5] This proliferation of phone styles was attended by a sharp decline in average prices, reflecting not only the onset of competition, but also a shifting product mix. AT&T retained ownership of, and had to service, the phones it leased to consumers, giving the company a strong incentive to produce high quality phones that would last for decades. New market entrants, by contrast, sold their phones to consumers, and so could maximise their profits by supplying cheaper, less durable equipment.

The cellular telephone industry followed a somewhat different path. Born amidst the breakup of AT&T, the business was never considered to be a natural monopoly. From the outset, the FCC allotted wireless spectrum to two competitors in each metropolitan and rural statistical area, and when the first service vendors were licensed in the early 1980s, numerous other companies had already developed cell phone prototypes. Still, government regulators were initially leery of allowing cellular service providers (CSPs) to control the emerging handset market as well. In its initial order authorising cellular services, the FCC required that cellular equipment and services be 'unbundled and detariffed from the start,' finding 'no compelling reason to treat cellular mobile equipment differently from landline customer premises equipment.'[6] The FCC specifically required that AT&T sell wireless equipment and services through distinct subsidiaries.[7]

Nevertheless, the ban on bundling was largely honoured in the breach, and, when the FCC revisited the rule in 1992, the Commission decided to allow CSPs to offer bundled product/service packages, as long as services were also available separately on a non-discriminatory basis.[8] In 'clarifying and modifying' its policy on bundling, the FCC took note of several features of the cellular market at the time. First, the national market was relatively fragmented. Between 17 and 25 manufacturers sold more than 28 brands of cell phones, while some 125 CSPs competed in the service segment.[9] Second, notwithstanding the bundling that was already occurring, between 1988 and 1990 average cell phone prices had plummeted from US$1,000 to US$400, further evidencing a competitive marketplace.[10] Third, both the CSPs and the Commission were eager to see subscription rates rise to help spread the costs of building up the nation's cellular infrastructure and converting to digital. Even with prices down to US$400, the cost of purchasing a phone was an impediment for many consumers. Bundling allowed CSPs to subsidise the upfront hardware costs. More consumers were thus able to afford cellular services, and the CSPs could recoup the subsidies through higher monthly service fees over the life of mandatory service contracts.[11] The FCC noted that such contracts typically ran one year or less and hence were not overly onerous.[12] Finally, the FCC remarked that the market provided strong incentives for CSPs to offer consumers a broad range of desirable, affordable handset options, which made it unlikely that competition in the hardware market could be foreclosed.[13]

Although the FCC provisionally placed its trust in the CSPs, it warned that it would consider adopting additional safeguards in the future if it found evidence of abuses like anti-competitive exclusive dealing arrangements.[14] The agency noted that independent hardware vendors might be forced to compete against below-cost handsets if regulated CSPs were able to recover their hardware subsidies by inflating tariffed service rates.[15] Moreover, because only two CSPs operated in each local market at that time, it was 'difficult to conclude that the cellular service market [was] fully competitive.'[16] The agency did not want customers to have to buy unwanted carrier-supplied handsets in order to obtain transmission service. Lastly, one commissioner recognised that if both bundled and unbundled

services were priced the same, and the CSPs' hardware subsidies were rolled into the service price, then in effect consumers who did not use carrier-provided phones would be forced to subsidise those consumers who did.[17]

Fast forward to the present

As the industry has evolved with the conversion from analogue to digital technologies, the debate over cell phone bundling has reemerged in the realm of private litigation.

In many ways, the case against bundling is actually weaker now than it was in 1992, when the FCC gave its blessing. Most notably, competition has increased in the service market, reducing the likelihood that CSPs will be able to leverage their market power to anti-competitive effect in the hardware segment. True, the national market has undergone a major shakeout. Consumers are now served by four national service providers, various regional CSPs and 40 or so resellers, with the top two players – AT&T and Verizon Wireless – jointly controlling over half of the business.[18] But at the local level, where government spectrum licensing defines the relevant geographic markets, the 1995 repeal of the FCC's two-licence limit has meant that most markets are now more competitive than during the early days of the industry. More than 95 per cent of the US population lives in census blocks served by at least three CSPs, and over 60 per cent enjoys at least five options.[19] Consistent with the increased competition, prices have fallen steadily; average revenues per minute of calling time dropped from 44 cents in 1993 to just five cents in 2007.[20] Other signs that competition is flourishing include a steady stream of new service offerings, encompassing new calling features (eg, texting, internet access) and pricing plans (eg, unlimited single-fee calling); increased customer satisfaction with service quality; and a high rate of account churn as customers change vendors.[21]

Nevertheless, service market consolidation at the national level, in tandem with a lengthening of the typical contract commitment to two years, has revived concerns that bundling could represent a form of anti-competitive tying. At the same time, with cell phones available for under US$50 and more than 260 million Americans subscribing to cellular services in 2007, the market is now more-or-less fully penetrated, mooting the FCC's primary argument for permitting bundling in 1992. Some observers have therefore come to see the business as ripe for legal challenge.

Over the past half-decade, plaintiffs have brought two types of bundling-related challenges under the antitrust laws. The first, 'service-centric' challenges, allege that the bundling regime in general benefits CSPs at the expense of consumers and certain hardware manufacturers. On this theory, bundling coerces consumers into buying unwanted cell phones, forces existing customers to subsidise new customers, and results in a costlier and less desirable mix of cell phones than would otherwise be the case. At the same time, the theory goes, phone makers unable to ink deals with the handful of national CSPs are wrongfully excluded from the market. These challenges essentially posit that the FCC got it wrong in 1992, and that bundling is inherently anti-competitive.

The second type of challenge, by contrast, picks up on the FCC's own concern that while bundling in general is not problematic, CSPs might enter into exclusive distribution contracts with producers of uniquely desirable phones. These 'hardware-centric challenges' allege that market power on the phone side may be exploited to tie consumers into costly and undesirable service agreements. Early indications are that these hardware-centric claims pose the greatest legal threat to cellular hardware and service vendors alike.

Service-centric bundling

In many ways, the bundling business model is very attractive. By providing customers with free or discounted phones, CSPs reduce the up-front costs of obtaining wireless service, opening the market to a broader range of consumers. In addition, CSPs arguably play a valuable gatekeeping and information collecting role. They ensure that low-quality phones stay off the market, maintain the quality of network connections, and spare consumers the costs and hassle of researching scores of phones from scratch. Once they settle on a service plan and a phone, consumers can then repay the hardware subsidies over time through slightly higher monthly service charges.[22] For their part, CSPs not only grow their customer base through bundling, but also benefit from the ability to commit consumers to profitable service contracts and reduce costly customer churn. Customers typically remain free to change providers before the end of their contract, but must pay an early termination fee if they do to allow the CSP to recoup its hardware subsidy costs.

Those seeking to challenge the practice of bundling on antitrust grounds contend that it represents an illegal form of tying, in which CSPs coerce consumers into purchasing unwanted phones in order to obtain service, harming competition in the process. The coercion claim is that, notwithstanding the availability of unbundled phones and service contracts, the bundling system forces a rational consumer to buy a phone along with his service contract. This is because consumers who decline to purchase a subsidised phone through their CSP still generally pay the normal monthly service charge, which is inflated to cover the hardware subsidy. So to buy one's phone from a third party is in essence to double-pay.[23]

Opponents of bundling allege various harms to competition. For example, CSPs could foreclose the hardware market by restricting access to phones which offered consumer-friendly features, or low prices, but which did not serve the interests of the CSP.[24] One example is the use of SIM locks. Phones that work on the GSM wireless network utilised in the US, by AT&T and T-Mobile, as well as in many international markets, contain removable subscriber identity module (SIM) cards. SIMs securely store the codes used to identify a subscriber. In theory, an AT&T subscriber could switch to T-Mobile service by simply replacing her AT&T SIM card with one from T-Mobile. Similarly, international travellers often avoid onerous roaming charges from their home CSP by simply purchasing inexpensive local SIM cards allowing their phones to call on the host country network. To ensure that users do not change providers, CSPs in the US 'lock' their phones to their cards. To change cards, consumers must request an unlock code from the CSP.[25] In many European countries, by contrast, phones are not typically locked. Users change SIMs at will, and often retain their phones after the initial service contract expires.

Critics of the American system argue that bundling has led to artificially inflated phone prices, restricted consumer access to a complete range of phone types and features, and left buyers unable to use the phones they do purchase to their full functionality. Incentivising consumers to replace their phones every two years also means that American phones tend to be of lower quality and durability. At the same time, arbitrarily short life-cycles result in millions of phones containing tons of toxic waste being needlessly discarded. One critic summed the argument up succinctly: bundling 'severely limits consumer choice, stifles innovation, crushes entrepreneurship, and has made the US the laughingstock of the mobile-technology world.'[26]

Proponents of bundling, by contrast, point to the broad array of increasingly functional and affordable phones offered by all of the major CSPs as evidence of a thriving competitive marketplace.

Indeed, the FCC has concluded that 'US mobile subscribers continue to fare extremely well relative to mobile subscribers in Western Europe and comparable Asia-Pacific countries,' particularly in terms of service prices.[27] Although it may be true that the prevalence of bundling excludes some would-be phone vendors from the market, the touchstone of antitrust law has always been the protection of competition, not of specific competitors.

These competing visions of bundling collided in *In re Wireless Telephone Services Antitrust Litigation*,[28] a case which consolidated a number of federal antitrust claims brought against the major CSPs. The plaintiffs alleged that bundling had artificially inflated phone prices, driven handset manufacturers from the market, deterred entry by would-be competitors, and thwarted the development of both simpler and more sophisticated handsets. They pointed to SIM locking in particular as one source of the alleged harms.

Although expressing scepticism as to all of the plaintiffs' claims, the district court avoided deciding the complex issues of whether the current bundling regime is coercive and whether it benefits or harms competition. Rather, Judge Cote granted the defendants' motion to dismiss on the narrow ground that, absent some evidence of conspiracy, the minimum market share a provider must have to establish the market power necessary for a tying claim is 30 per cent, and no CSP had a US market share in excess of 24 per cent in 2003.[29] Plaintiffs would likely have faced an uphill legal battle establishing coercion and anti-competitive effects as well, but they may yet get the opportunity to try. A recent report projects that by 2013, both AT&T and Verizon will have national market shares in excess of 30 per cent.[30]

Hardware-centric bundling

Hardware-centric challenges scale the market power bar by alleging that an individual phone is so unique that it represents a single-brand market, thus giving its manufacturer market power. To date, the primary hardware-centric challenges to cell phone bundling have targeted Apple Computer's much-touted iPhone. When Apple rolled out the iPhone in 2007, it was unlike any other cell phone on the market. It featured a custom, touch-screen user interface and could run hundreds of unique downloadable applications. It also benefited from intense customer loyalty to other Apple-branded products such as the Macintosh computer and the iPod. Despite a price tag as high as US$600, customers waited in line for hours when the first iPhones arrived in stores.

Still, as Apple has noted, popularity alone is not the stuff of an antitrust violation: 'the natural monopoly every manufacturer has in its own product simply cannot serve as the basis for antitrust liability.'[31] The initial entry of a new competitor into a market cannot, per se, be anti-competitive. On the contrary, the iPhone clearly enhanced consumer choice and competition in the overall cell phone market.[32] Litigants have therefore turned their sights on the iPhone's service bundling agreement.

Major cell phone manufacturers such as Motorola, Nokia and Samsung typically make versions of their phones available to multiple CSPs in order to tap the largest potential market. Apple took a different approach with the iPhone. After failing to conclude a deal with Verizon, Apple entered into an exclusive distribution contract with AT&T Mobility (ATTM). Under the terms of the agreement, customers could only use iPhone's wireless voice and data features by subscribing to a two-year ATTM service plan. ATTM shared a portion of its iPhone service revenues with Apple. The firms cemented ATTM's exclusivity by agreeing not to provide any iPhone customers with SIM unlocking codes that would allow them to use a different CSP while travelling overseas or on the expiration of their initial ATTM contract.[33] Nor did Apple produce a version of the iPhone for use on the CDMA network used by Sprint and Verizon.

In June 2008, consumers filed a federal class action suit against Apple and ATTM in the Northern District of California.[34] Styled *In re Apple & AT&TM Antitrust Litigation*,[35] the suit alleges, among other claims, that the iPhone bundling agreement violates section 2 of the Sherman Act. Specifically, the plaintiffs allege that Apple actually entered into a secret five-year exclusivity agreement with ATTM. This meant that once their initial two-year service contract expired, iPhone owners wishing to keep the same phone would have no choice but to resubscribe with ATTM on whatever terms that company made available.

The plaintiffs argue that, as in *Kodak*,[36] even if the iPhone does compete with other OEM smart phones, and even if consumers did knowingly and voluntarily lock themselves into an initial two-year contract, Apple and ATTM nevertheless illegally monopolised a distinct aftermarket for iPhone renewal services. Their five-year agreement and refusal to release SIM codes on request mean that their dominance of the initial iPhone product-service market could be leveraged to dominate the aftermarket as well. The fact that the companies allegedly failed to inform consumers of either the five-year agreement or the SIM code provisions of the agreement means that such monopolisation was arguably anti-competitive.

For its part, Apple contends that the plaintiffs are simply wrong on the facts: the five-year exclusivity agreement with ATTM was public knowledge, and the need to renew with ATTM was clearly printed on the iPhone packaging.[37] Apple has also argued that, as a legal matter, there could not yet be a distinct aftermarket for iPhone service at the time Apple entered the market and the initial bundles were sold.[38] Further, Apple takes the position that renewal services for the iPhone are not a distinct market; iPhone users buy the very same services from ATTM as do owners of other smart phones, and at comparable prices.[39]

In contrast with *In re Wireless*, in *Apple* the plaintiffs survived the initial motion to dismiss. Judge Ware, in allowing the antitrust claims to go forward, indicated that the plaintiffs had succeeded in alleging the existence of a distinct aftermarket in iPhone voice and data services 'wholly dependent' on the primary market for iPhone sales.[40] The judge accepted the argument that competition in the aftermarket had already been contractually foreclosed, notwithstanding that none of the initial iPhone contracts had yet expired. Moreover, several of the plaintiffs allegedly had already been harmed when they were unexpectedly charged hundreds of dollars in roaming fees while using their iPhones overseas. Also worth noting is Judge Ware's apparent acceptance that mere 'market imperfections such as information and switching costs' might prevent iPhone users from voluntarily accepting an aftermarket commitment to ATTM, even if allegations of fraud and deceit proved false.[41] The implications appear to be that defendants in hardware-centric bundling cases will be hard pressed to respond to *Kodak*-type claims with the defence that their market power arose solely from contractual rights that consumers knowingly and voluntarily gave to them.

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This article has explored potential antitrust challenges to the current regime of bundling cell phones with wireless service contracts, and how those challenges played out in the initial stages of two federal court cases, *In re Wireless* and *Apple*. The results suggest that the legal threat is greatest where, as in *Apple*, an exclusive distribution

agreement creates the possibility that a court may recognise a distinct market segment in which a CSP or phone manufacturer has market power. Looking forward, each case also leaves an important question unresolved. *In re Wireless* left open the question of whether, as major CSPs cross the key 30 per cent market share threshold, elements of the standard bundling arrangement may be deemed coercive and anti-competitive. The *Apple* court has yet to address the issue of whether heavy information and switching costs alone are sufficient to preclude consumers from 'voluntarily' entering into exclusive bundling contracts, or whether a plaintiff must also demonstrate fraud and deceit in order to moot the standard defence that contractually tying oneself to a service cannot result in aftermarket monopoly power.

At the same time, bundling faces rising threats from other quarters. In June 2009, the Senate Commerce Committee began holding hearings over consumer complaints about the cell phone industry, emphasising issues relating to bundling and handset exclusivity. The same month, the FCC announced that it had opened an inquiry into whether wireless handset exclusivity arrangements 'adversely restrict consumer choice or harm the development of innovative devices.'[42] Most recently, the DoJ has reportedly initiated a wide-ranging inquiry into potential antitrust violations in the telecommunications industry. Exclusive cell phone bundling agreements are considered a likely focus of investigation.[43] Even if it emerges unscathed from the courts, bundling may not survive the political branches.

Notes

1 Paul S Bailin was a summer associate at Axinn, Veltrop & Harkrider LLP.
2 See *United States v AT&T*, 552 F Supp 131 (DDC 1982).
3 *Hush-A-Phone Corp v United States*, 238 F2d 266 (DC Cir. 1956).
4 13 FCC2d 420 (FCC 1968).
5 See www.porticus.org/bell/doc/western_electric.doc.
6 86 FCC2d 469, 497 (FCC 1981).
7 Id.
8 *In the Matter of Bundling of Cellular Customer Premises Equipment and Cellular Service*, 7 FCC Rcd 4028 (FCC 1992).
9 Id at 9, 13.
10 Id at 23 n.38.
11 Id at 7, 19- 23.
12 Id at 12.
13 Id at 18.
14 Id at 17-18.
15 Id at 2.
16 Id at 11.
17 Id.at 4036 (Duggan, Comm'r concurring).
18 Thirteenth Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services, FCC 09-54, 16 (FCC 2009).
19 Id at 5.
20 Id at 93; excluding revenues from data services, which have buoyed average prices since 2005.
21 Id at 9-10.
22 According to *Consumer Reports*, the average monthly service charge includes from US$2.55 to US$5 in such fees. 'Best Cell-phone Service', *Consumer Rep*, Jan 2009, at 29.
23 The debate is complicated by the availability of various non-contractual service plans.
24 See, eg, 'Free My Phone', *Wall St J*, 22 Oct 2007, available at http://online.wsj.com/article/SB119264941158362317.html (suggesting that small software companies are unable to get their desirable applications onto popular cell phone models without paying fees to the CSPs); Jessi Hempel, 'Nokia's North America Problem', *Fortune*, 12 Jan 2009, available at http://money.cnn.com/2009/01/12/technology/hempel_nokia.fortune (suggesting that Nokia dominates the global cell phone market but has been unable to gain a foothold in the US because it 'refused to cater to American phone companies' whims').
25 While policies vary, CSPs will often provide unlock codes on request for overseas travel, or at the end of a full service contract.
26 Free My Phone, supra note 23.
27 Thirteenth Annual Report at 34, supra note 17.
28 385 F Supp 2d 403 (SDNY 2005). A different service-centric challenge, alleging antitrust conspiracy, *Freeland v AT&T Corp*, 238 FRD 130 (SDNY 2006), failed to achieve class certification and was dismissed in 2006.

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29 *In re Wireless*, 385 F Supp 2d at 418-19. The court never addressed the possibility that the defendants might possess market power in local geographic service markets, presumably because the complaint emphasised the impacts of bundling on the overall handset market, and CSPs negotiate and contract with handset manufacturers on a national basis.

30 IE Market Research Corp, 2Q09 United States Mobile Operator Forecast, 2008–2013, 7 May 2009, available at www.marketresearch.com/product/display.asp?productid=2265643&g=1.

31 Defendant Apple's Notice of Motion and Motion to Dismiss Revised Consolidated Amended Class Action Complaint, Civil Action No. 07-5152 JW (ND Cal 12 Sept 2008) ('Apple Reply') (citing *Gall v Home Box Office*, 1992-2 Trade Cas (CCH) 69,949 at 68,594 (SDNY 1992)).

32 Apple Reply at 1.

33 When the second generation iPhone rolled out in 2008, the companies reverted to a more traditional bundling model. ATTM sold the iPhone 3G well below cost, hiking monthly service fees by US$10 to recoup the initial subsidies which it paid to Apple, in lieu of revenue sharing.

34 Related actions have been brought in several European courts.

35 596 F Supp 2d 1288, 1294 (ND Cal 2008).

36 *Eastman Kodak Co v Image Tech Serv*, 504 US 451 (1992).

37 Apple Reply at 5, supra note 30.

38 See, eg, *In re Apple*, 596 F. Supp. 2d at 1303-4.

39 See, eg, Apple Reply at 12, supra note 30.

40 *In re Apple*, 596 F. Supp. 2d at 1303.

41 Id at 1305.

42 Remarks of FCC Acting Chairman Michael J Copps: Pike & Fischer's Broadband Policy Summit V, at 6 (18 June 2009), available at www.fcc.gov/Daily_Releases/Daily_Business/2009/db0618/DOC-291492A1.pdf.

43 Amol Sharma, 'Telecoms Face Antitrust Threat', *Wall St J*, July 7, 2009, at A1.

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