

E-Book Lawsuit Will Test Antitrust Principles On The Electronic Frontier

ON APRIL 11, 2012, ATTORNEY GENERAL Eric Holder announced the filing of a civil antitrust lawsuit against Apple and two of the country's largest publishers, MacMillan and Penguin. The lawsuit represents one of the

James Morsch

government's first forays into the world of digital media, and the outcome of the case likely will influence how government regulates and fosters competition in rapidly evolving technology markets. This article discusses the background of and issues raised by the electronic book (or e-books) lawsuit.

The Genesis of the Lawsuit

For the past decade, the music and publishing industries have been undergoing a revolution as technology in the form of portable media players, electronic book readers, tablets, and mobile telephone devices have spurred consumer demand for digital media. Since the introduction of the iPod™ by Apple in 2001, consumers have flocked to digital music. Sales of songs and records in digital form now outpace compact discs. Since 2005, the U.S. digital music industry has grown from approximately \$1 billion to \$6 billion in annual sales, with sales projected to rise to \$11 billion by 2014. Digital publication sales have experienced similar growth since the introduction of the Kindle™ by Amazon in 2007. According to the government's complaint in the E-Books Lawsuit, electronic books now represent 10% of all book sales and likely will constitute 25% of all book sales in two to three years. Nearly 90% of these sales are made through Amazon.

The Allegations in the Lawsuit

The government's lawsuit alleges that five of the country's six largest publishers (including Hachette, HarperCollins, and Simon & Schuster, each of which settled with the Department of Justice just as the lawsuit was being filed) entered into a conspiracy, facilitated by Apple, to increase the price of e-books. According to the complaint, the publishers had used a "wholesale" pricing model whereby distributors of books are allowed to set the retail prices of titles. When Amazon began

distributing e-books, it established a \$9.99 price for all newly released titles and bestsellers. Other e-book retailers often matched or lowered their prices in response to the \$9.99 price point in order to compete with Amazon. The government alleges that the publishers feared that Amazon's \$9.99 would become the price for new and bestselling e-books and, in turn, would drive down the price of the publishers' hard cover books. The complaint also alleges that the publishers believed that the \$9.99 price point would become so popular that companies like Amazon would enter into the digital publishing business themselves and contract directly with authors, threatening their role as the "gate-keepers of the publishing world."

In response to Amazon's pricing, the publishers allegedly began discussing ways to force Amazon to increase its prices above the \$9.99 price point. By the end of 2009, the publishers purportedly reached an agreement to replace the "wholesale" model with an "agency" model of pricing that gave the publishers the ability to increase retail prices of e-books on their own. Knowing that no one publisher could solve the "\$9.99 problem" by itself, the publishers allegedly agreed to act collectively by (1) entering into agency model contracts with Apple in connection with the launch of its iPad™, (2) acceding to a request from Apple that they require all e-book retailers to adopt the agency model of pricing, and (3) ultimately agreeing to a most favored nations ("MFN") provision in their contracts with Apple that required the publishers to ensure that the retail prices charged for their e-books by any retailer match the prices charged in Apple's iBookstore™. Finally, the complaint alleges that all of the publishers agreed to uniform tiered pricing with Apple whereby they all agreed to charge either \$12.99 or \$14.99 for e-book versions of their hardcover bestsellers and new releases.

By February 2011, all five publishers entered into similar e-book distribution agreements with Apple. According to the complaint, when Amazon objected to the publishers' demand that it either move to the agency model or conform its retail prices to their prices with Apple, the publishers threatened to pull their new releases and bestsellers from Amazon. Amazon quickly

capitulated and accepted the agency model. According to the government, retail prices for defendants' e-books rose almost immediately to \$12.99 or \$14.99 for new releases and bestsellers.

Issues Raised by the Lawsuit

Establishing that Apple is liable for facilitating the alleged conspiracy may prove the government's biggest challenge since, according to the complaint, Apple executives did not attend the meetings between the publishers where the purported agreements to act collectively to take on Amazon's \$9.99 price point were hatched and since Apple negotiated its agency contracts individually with each of the publishers. This difficulty arises from the fact that the government's case is premised on Section I of the Sherman Act, which bars conspiracies among competitors. Apple is not a competitor of the publishers, and the law makes it difficult to hold a non-competitor liable for violating Section I of the Sherman Act. In order to establish liability, the government must establish that the MFN provision that Apple insisted be included in its agency model contracts with the publishers ran afoul of the Act. The MFN provision may not be illegal in and of itself, however, and therefore must be shown to have had an adverse impact on competition. Large distributors often insist on MFN provisions to guarantee that their investment in a supplier's products is not undermined by a competitor offering the same products for rock-bottom prices. The question presented by the E-Books Lawsuit is whether Apple's MFN actually resulted in higher e-book prices or otherwise reduced price competition in the e-book industry. On that topic, it appears that the evidence may be mixed since Amazon still offers many bestsellers and new releases at or below the \$9.99 price point, despite the assertions made in the lawsuit.

The government's case against the publishers also may prove not be as "open and shut" as the government and many observers think. Although the complaint is rife with what appear to be conspiratorial communications between the publishers, in order to prove a violation of the antitrust laws the government will need to demonstrate that the publishers actually reached an agreement either on prices or to collectively boycott Amazon. Competitors may, under certain circumstances, discuss challenges that their industry is facing and jointly collaborate on solutions to those problems, provided they do not collude on verboten topics such as setting prices, allocating territories or customers, or boycotting suppliers or distributors. If the

publishers can establish that their communications were legitimate joint venture activities, the government's case may come down to whether the alleged conspiracy had the impact on competition that the government claims. It is evident from several early statements issued by publishers and their supporters that the defendants are going to argue that their activities were unilateral in nature and aimed at enhancing, not restraining, competition. The publishers are likely to argue that Amazon had a near monopoly on e-books sales under the wholesale model of pricing and was intent on virtually giving e-books away in order to keep its competitors from making inroads in the e-book market. Absent a move by the industry to an agency model, publishers would be forced to cut back drastically on book promotions and cultivation of authors, a result which would hurt consumers in the long run and lead to fewer offerings and, ultimately, higher retail prices given Amazon's stranglehold on e-book distribution. The publishers may also argue that the tiered pricing in their agreements with Apple was imposed by Apple itself in order to guarantee that its commission on e-book sales was sufficiently high to justify entry into competition with Amazon for book sales.

The Impact of the E-Books Lawsuit

Whatever happens in the case is likely to influence not only the book industry, but other industries where digital media is becoming more common. A victory by the government may leave publishers in a desperate situation as to how best to deal with the Amazons (and Apples) of the world. A defeat may usher in new antitrust rules for rapidly developing technology markets to the delight of many who believe that traditional antitrust principles need to adapt to the challenges of the electronic frontier. Stay tuned; it should be an interesting plot to follow.

James Morsch is a partner with Butler Rubín Saltarelli & Boyd LLP, a Chicago litigation boutique. He represents clients in a wide variety of complex commercial litigation, including counseling companies and litigating antitrust and other competition law matters and class actions. The views expressed are personal to the author. www.butlerrubin.com



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