Court Finds Apple Conspired to Raise E-Book Prices

After a much watched bench trial, the United States District Court in the Southern District of New York (Cote, J.) ruled that Apple Inc. conspired with book publishers to raise the price of e-books in violation of §1 of the Sherman Act and applicable state antitrust laws.[1] The United States Department of Justice and 33 states alleged that Apple entered into distribution agreements with five of the six major publishers (the five publishers are referred to in this memo as the "Publishers") to raise the retail prices of e-books from $9.99 to as much as $14.99. The court found that Apple played a central role in facilitating the conspiracy by providing the publishers with "the vision, the format, the timetable, and the coordination that they needed to raise e-book prices"[2] without which the conspiracy would not have succeeded.

I. Factual Background[3]

Prior to 2009, several top book publishers[4] became concerned with Amazon.com's pricing of their e-books at the below-wholesale price of $9.99 because this price point tended to reduce sales of more expensive hardcover offerings and had the potential to drive down all book prices. The Publishers also feared that with its growing market power, Amazon could eventually demand lower wholesale prices from the Publishers or possibly negotiate directly with authors, cutting out the Publishers. The Publishers sold their e-books to Amazon under a wholesale model whereby the Publishers would set a suggested retail list price for each title and sell the title at a wholesale discount to Amazon; Amazon would set the e-book's retail price.

In 2009, before the launch of its iBookstore, Apple met individually with the Publishers to discuss e-book pricing. The parties eventually negotiated a deal in which each of the Publishers would sell its e-book selections to Apple under an agency model (the "Agreements"). Under this model, the Publishers would set the e-book's retail price directly and Apple would take a 30% commission of each sale. The Agreements also created price tiers for e-books at $12.99 and $14.99 and included a Most-Favored-Nations clause ("MFN") that ensured the e-books in Apple's e-bookstore would be sold for the lowest retail price in the market by guaranteeing that publishers set the prices for the iBookstore at or below the lowest retail price for any e-book offered by other retailers, effectively making publishers earn less per e-book sold in the iBookstore if other retailers decided to lower prices.

In 2012, the Department of Justice, together with 33 state attorneys general (the "Plaintiffs"), filed suit against Apple and the Publishers, alleging a conspiracy to eliminate retail price competition and raise e-book prices. The Plaintiffs alleged that the Agreements were executed with the intention to and had the effect of moving industry e-book prices upwards. Before trial, the Publishers settled.

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[1] *United States v. Apple Inc., et al.*, No. 12 Civ. 2826 (DLC), slip op. (July 10, 2013) (the "*Opinion*"), *available at* http://www.nysd.uscourts.gov/cases/show.php?db=special&id=306.

[2] *Id.* at 11.

[3] The facts set forth in the text are drawn from the Court's *Opinion* issued after the bench trial, which lasted from June 3-20.

[4] The Publishers are Hachette Book Group, Inc., HarperCollins Publishers LLC, Holtzbrinck Publishers LLC d/b/a Macmillan, Penguin Group (USA), Inc., and Simon & Schuster, Inc.

II. District Court's Decision

Following a three-week bench trial, District Judge Denise Cote found that the Publishers engaged in a horizontal price-fixing conspiracy and that Apple was not only "a knowing and active member of that conspiracy . . . . but also forcefully facilitated it."[5]

Judge Cote found that Apple constructed the Agreements' agency model together with the MFN clause in order to make the Publishers' wholesale agreements with Amazon unsustainable.[6] The MFN clause ensured that Apple would not compete with any e-book retailer on price. Moreover, combining the MFN clause with price tiers reduced the Publishers' price discretion. Together, these terms meant that any Publisher who wished to raise prices of their iBookstore offerings would also have to ensure that books sold through all their other e-book retailers, including Amazon, would be increased.[7] Judge Cote explicitly noted that neither the agency model, nor the MFN, was "inherently illegal."[8] She noted that entirely lawful agreements may include an MFN clause, agency model, pricing caps, or tiered pricing and may result from "simultaneous negotiations with suppliers".[9] Nevertheless, she found that under the totality of the circumstances, including weeks of negotiations with the Publishers, Apple employed these terms in a manner that restrained trade. She also relied on the fact that adoption of the agency model was against the "near-term" financial interests of the Publishers absent realization of the overall scheme that she found had been agreed to.[10]

Judge Cote found that Apple facilitated the conspiracy by signing the Publishers to the agency model and coordinating action among them. No Publisher would unilaterally raise e-book prices for fear that either Amazon would retaliate or that the other Publishers would not follow the price increase. Thus, Judge Cote found the Publishers and Apple shared the same risks and rewards. Judge Cote rejected the contention that the restraint was a purely vertical one subject to rule of reason analysis and also rejected the contention that a "hub and spoke" conspiracy required that the hub be a "dominant" player.[11]

Judge Cote held that Apple's role in the conspiracy was a *per se* violation of §1 of the Sherman Act, but noted that the Plaintiffs would also prevail under a rule of reason analysis and that the Agreements lacked any pro-competitive effects.

The Court also rejected Apple's argument that its conduct was pro-competitive and designed to provide a healthier book market. The suggestion advanced by some commentators was that Amazon's pricing policies actually thwarted consumer welfare because its apparently money-losing pricing policy, designed to gain market

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[5] *Opinion* at 113.

[6] As Judge Cote explained, under the Amazon wholesale model, the Publishers would take home 50% of the hardcover list price. For a book with a $26 hardcover list price, the Publisher would net $13 while Amazon would sell the book to consumers for $9.99. Under the Apple agency model, Apple could match Amazon's $9.99 price point for the same book; after paying Apple's 30% commission, the Publisher only received $7.00. *Id.* at 53.

[7] *See id.* "By combining the MFN with the pricing tiers, the pricing discretion Apple gave to the Publishers with one hand, it took away with the other. While Publishers could theoretically raise e-book prices in the iBookstore above the $9.99 price point to the top of the Apple pricing tiers, unless the Publishers moved all of their retailers to an agency model and raised e-book prices in all of those e-bookstores, Apple would be selling its e-books at its competitors' lower prices." *Id.* at 48.

[8] *Id.* at 132.

[9] *Id.* at 157.

[10] *Id.* at 120.

[11] *Id.* at 153-54.

share, would have the effect of hampering publishers' ability to support books requiring extensive authorial research and editing.

In commenting on what she understood to be an argument that the challenged conduct combatted Amazon's allegedly improper below-cost sales practices, the Court observed that whatever the complaints about Amazon's own alleged anti-competitive conduct, to which the Agreements arguably were addressed, the "remedy for illegal conduct is a complaint lodged with the proper law enforcement offices or a civil suit or both. Another company's alleged violation of antitrust laws is not an excuse for engaging in your own violations of law."[12] The Court was also clear that regardless of the benefits the Agreements might have brought to the market, the effect of raising prices via a price fixing agreement rendered the arrangement illegal.

III. Effect of Decision

The decision highlights the risks of introducing business practices that may enable horizontal competitors to coordinate their conduct, even if those practices have legitimate business purposes.

The decision does not undermine the view that MFNs—while posing risks in some circumstances—can be lawful in many scenarios. The finding that Apple's use of an MFN restrained trade because it was used in conjunction with coordinated implementation of the agency model departs from the typical situation where MFNs have been challenged by the Department of Justice, such as when a dominant buyer imposes an MFN on its suppliers in a manner that raises its smaller rivals' costs. This aspect of the ruling may cause companies to proceed cautiously when incorporating MFNs into contracts, especially with multiple suppliers, while lending support to the antitrust authorities' increased scrutiny of MFNs.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Elai Katz at 212.701.3039 or ekatz@cahill.com; Dean Ringel at 212.701.3521 or dringel@cahill.com; or Lauren Rackow at 212.701.3725 or lrackow@cahill.com.

[12] *Id.* at 157.