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ANTITRUST

Expert Analysis

Publishers Charged With E-Book Pact

By
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The U.S. Department of Justice and several states claimed that Apple facilitated a conspiracy among book publishers to raise the retail prices of e-books and wrest pricing control away from Amazon. In another suit involving publishers—in this case magazine publishers—the U.S. Court of Appeals for the Second Circuit reinstated a conspiracy complaint and stated that the lower court's inquiry under the plausibility pleading standard was "misdirected" because the court improperly chose one plausible inference over another.

Other antitrust developments of note included the Federal Trade Commission's 3-1 decision to close its investigation into Express Scripts' acquisition of Medco, combining two of the nation's three largest pharmacy benefits managers, and a ruling by the U.S. Court of Appeals for the Ninth Circuit that a prior class action settlement precluded a member of the settling class from bringing a new suit involving different defendants arising from the same alleged conspiracy.

E-Books

The Department of Justice filed a complaint in federal court in Manhattan charging five book publishers and Apple, the computer device maker and digital retailer, with conspiring to raise the prices of e-books and limit retail price competition. Three of the publishers settled, and the remaining defendants seem intent to fight the suit.

The complaint alleged that the book publishers, concerned that Amazon posed a threat to their business by selling e-books at very low prices and enabling authors to bypass traditional publishing houses, communicated and met in private dining rooms at upscale New York restaurants beginning around September 2008 to explore means to counter Amazon's strategy and growing power as the leading seller of e-books.

According to the complaint, their efforts did not coalesce into a functioning arrangement until late 2009 and early 2010, as Apple made plans to launch an e-book store in competition with Amazon. The government claimed that even as they communicated about working jointly in 2008 and the first half of 2009, each publisher worried about the competitive impact of taking a tough stand individually against Amazon, for example by demanding that Amazon raise prices, if other publishers did not follow. But through negotiations with Apple, the department asserted, they were able to confirm that the others would be taking the same course of action.

> The e-books case has some significant wrinkles that distinguish it from traditional 'hub-and-spoke' or indirect horizontal conspiracies.

The complaint alleged that Apple recognized that its interest in selling e-books at profitable margins—above Amazon's $9.99 bestseller price point—coincided with the publishers' fears and their desire to take pricing power away from Amazon. Following discussions with the publishers, Apple proposed that e-books would be sold through an agency model rather than a wholesale model and in effect insisted that all other retailers also adopt the agency model. Under the then-prevalent wholesale model, publishers sold books (whether paper or electronic) to retailers and distributors at a wholesale price (often about half the suggested retail price for paper books) and the retailers had the freedom to set prices to consumers. Under the agency model, the publishers would control prices to consumers and retailers would act as the publishers' agents, taking a commission.

The Department of Justice alleged that Apple kept each publisher informed of the state of negotiations with other publishers and assured them that the deals would be the same. The complaint also asserted that Apple knew it "could facilitate" the publishers' "goal of raising book prices across the industry" and demanded a relatively high 30 percent commission. Apple proposed to charge $12.99 for most bestsellers, with $14.99 and higher price points for more expensive bestsellers.

According to the Justice Department, Apple also demanded, in what the complaint labels an "unusual" most favored nation (MFN) clause, that publishers not charge a higher price for e-books on Apple's store than the price charged by any other website, effectively requiring each publisher to take pricing authority away from other retailers. In addition, the complaint alleged that each publisher sought assurances that it would not be the only publisher to sign a deal with Apple that "would compel it either to take pricing authority from Amazon or pull its e-books from Amazon."

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The complaint alleged that during their negotiations with Apple in December 2009 and January 2010, the publishers' chief executives placed numerous calls to one another. In late January, Apple signed e-book distribution agreements with each publisher to take effect upon the date of the release of Apple's new iPad on April 3, 2010. Following some resistance, Amazon ultimately agreed to change to an agency model and, according to the complaint, e-book prices for most newly released and bestselling e-books rose to $12.99 or $14.99.

The government claimed that these arrangements constituted a per se violation of §1 of the Sherman Act, but also set out the basic elements of a rule of reason claim. At the time the Department of Justice's complaint was filed, three publishers agreed to settle the charges and to permit retailers to freely set prices. On the same day, over a dozen states, including Texas and Connecticut, filed a complaint with similar allegations against three publishers and Apple in federal court in Austin, Tex. Shortly thereafter, Amazon announced that it would return to charging $9.99 for bestseller e-books.

United States v. Apple, No. 12-cv-2826 (S.D.N.Y. April 11, 2012); *Texas v. Penguin Group (USA)*, No. 12-cv-00324 (W.D. Tex. April 11, 2012)

Comment: The allegations of horizontal collusion among publishers, if true, are weighty, but the case has some significant wrinkles that distinguish it from traditional "hub-and-spoke" or indirect horizontal conspiracies. Apple, the distributor accused of acting as the hub and forcing higher margins for distributors, was not a dominant player, but rather a new entrant with a history of disrupting and reinventing fast-changing technology markets, and Amazon, the apparently injured distributor, had a dominant position and had been accused of predatory conduct.

While the government acknowledges that Amazon sold e-books at around the same price that the publishers sold them to Amazon, around $9.99, the complaint goes out of its way to allege that Amazon's e-book distribution business has been consistently "profitable"—possibly anticipating claims of unlawful predatory pricing. But the suits do not satisfactorily respond to concerns that Amazon's exercise of its alleged market power as a buyer and seller will hurt the book industry.

Apprehension of the impending demise of the traditional book publishing business elicits passionate responses in some quarters, including calls for exemptions from antitrust restrictions to protect intellectual inquiry and cultural heritage. Indeed, last year French publishers successfully lobbied for legislation fixing retail prices for e-books, as has been the case there for paper books since 1981 under the Lang Law, which provides that publishers set retail book prices and retailers have very limited freedom to discount. Similar laws, designed to protect small booksellers and publishers, prohibit discounting books in several other countries and may provide opportunities for empirical studies on output (in terms of units as well as number of titles), price, and quality of books under various regimes.

In a decision providing guidance on the standards set forth in 'Twombly,' and 'Iqbal,' to successfully plead a claim alleging a conspiracy in violation of §1 of the Sherman Act, the Second Circuit panel emphasized that at the pleading stage plaintiffs must merely present plausible claims and that such claims are not subject to a probability requirement.

Pleading Standards

In a decision providing guidance on the standards set forth in *Bell Atlantic v. Twombly*, 550 U.S. 544 (2007), and *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009), to successfully plead a claim alleging a conspiracy in violation of §1 of the Sherman Act in the Second Circuit, a three-judge appellate panel vacated a district court decision dismissing a complaint and refusing to grant leave for amended pleadings. Anderson News, once the nation's second largest magazine wholesaler, brought suit alleging that national magazine publishers and a rival wholesaler conspired to eliminate Anderson from the market and drove it out of business.

The appellate panel emphasized that at the pleading stage plaintiffs must merely present plausible claims and that such claims are not subject to a probability requirement. Where two plausible inferences may be drawn from a factual allegation contained in a complaint, the "choice between or among plausible inferences or scenarios is one for the factfinder." The panel added that even if the claims pleaded in Anderson's original complaint were insufficient, Anderson's proposed amended complaint met the standard under *Twombly* and *Iqbal*.

According to the complaint, in January 2009, after Anderson announced a seven-cent surcharge on publishers for every magazine copy that it distributed to retailers to offset overstocking costs, the magazine publishers ceased dealing with Anderson and another wholesaler as a result of a conspiracy to eliminate them from the magazine wholesale market, which at the time consisted of four firms. The district court ruled that the plausibility standard was not met, reasoning that publishers and distributors have an economic self-interest in a wholesaler market with a greater number of participants and that their parallel decisions to terminate Anderson could have been unilateral. The district court also found the alleged participation of a rival magazine wholesaler implausible because, according to the trial court, it could not have engaged in parallel conduct with the publishers.

The Second Circuit stressed that "permission generally should be freely granted" to parties who wish to amend their complaints and that at the pleading stage, the question is not whether there are plausible alternatives to the theories proposed by plaintiffs, but rather whether the complaint contains sufficient factual allegations that the claims pleaded in the complaint are plausible. Therefore, the district court's "plausibility inquiry was misdirected." In finding that the amended complaint met the standards set forth in *Twombly* and *Iqbal*, the appellate panel emphasized that the complaint alleged an actual agreement to cease dealing with Anderson and included allegations that defendants had met or communicated on various dates to plan a concerted boycott of Anderson and to divide the magazine wholesaler market. The Second Circuit noted that the conspiracy could plausibly have had horizontal and vertical components and that the rival wholesaler could have hoped to gain market share through participating in the alleged agreement.

The appellate panel observed that even though an "innocuous" interpretation of the magazine publisher's conduct in terminating Anderson was plausible, Anderson's allegations of a conspiracy were not necessarily implausible. Moreover, the court stated that plaintiffs were not required to "rule out the possibility of independent action" at the pleading stage. The Second Circuit admonished that it was "not the province of the district

court" to reject pleadings based on the court's "choice among plausible alternatives."

Anderson News v. American Media, No. 10-4591-cv, 2012-1 CCH Trade Cases ¶77,843 (April 3, 2012).

Comment: The case reported immediately above represents another instance where the Second Circuit has reversed dismissal of an antitrust conspiracy complaint (the first was *Starr v. Sony*, 592 F.3d 314 (2d Cir. 2010)) since the Supreme Court's two decisions adopting an arguably heightened pleading standard. Both *Twombly* and *Iqbal*, coincidentally, reversed the Second Circuit.

Pharmacy Benefits Merger

The Federal Trade Commission (FTC) closed its eight-month investigation into the proposed $29 billion merger of Express Scripts and Medco, combining two of the three largest domestic pharmacy benefit managers (PBMs)—firms that administer drug benefits under contracts with large health plans or directly with employers. According to the commission's statement, the decision not to challenge the combination was not easy, as the merged firm would account for over 40 percent of a broadly defined market and an even larger share of a narrower market.

Chairman Jon Leibowitz had initially supported imposing limitations on some types of exclusionary conduct by the merged firm while Commissioner Julie Brill dissented and issued a separate statement. Nevertheless, a majority determined that the parties' high market shares did not accurately reflect the likely competitive effects of the transaction as there are at least eight other significant PBMs and Medco recently lost a substantial amount of business. In addition, Medco's business is focused on very large employers while Express Scripts has more health plans and mid-sized businesses as customers, such that very few customers viewed Express Scripts and Medco as their first and second choices.

The commission's majority statement also observed that the bidding process to obtain major contracts with employers provides opportunities and wins for smaller rivals and strong incentives for bidders to compete aggressively. The commission noted that the merger was not likely to confer monopsony power upon the combined firm as a buyer to enable it to pay lower reimbursement rates to pharmacies in a way that would injure competition.

Commissioner Brill viewed the proposed transaction as a merger to duopoly, especially in the large commercial employer segment of the market, and concluded that the remaining participants were fringe rather than significant players. She added that she believed the market was susceptible to coordinated effects in the form of customer allocation. Brill stated that evidence of benign competitive effects and entry did not rebut the overwhelming legal presumption based on market concentration.

Notwithstanding the FTC's decision, pharmacy associations are pursuing a suit seeking to block the merger in federal court in Pittsburgh, where plaintiffs argued that Medco's assets should be held separate pending the outcome of the private suit.

Statement of the Federal Trade Commission and Dissenting Statement of Commissioner Julie Brill Concerning the Proposed Acquisition of Medco Health Solutions by Express Scripts, FTC File No. 111-0210 (April 2, 2012), available at www.ftc.gov; *National Ass'n of Chain Drug Stores v. Express Scripts*, 2:12-cv-00395 (W.D. Pa. filed March 29, 2012)

Comment: In her dissent, Brill invited the FTC to revisit the PBM market in three years to study the merger's impact. Because antitrust merger decisions are prospective and necessarily prognostic, studies evaluating the state of an industry years after a merger decision could be highly enlightening, albeit of possibly limited specific applicability in future cases because mergers and markets are so often fact-specific.

Prior Settlements

The Ninth Circuit affirmed a California district court's dismissal of an action involving drug benefits, finding that Skilstaf Inc., the named plaintiff, was barred from bringing suit against defendants, nine retail chain pharmacies, by provisions in a previous settlement agreement. Skilstaf, a payroll service company that funds a prescription drug plan for its employees, participated in a class action in Massachusetts against a drug distributor and drug price publisher that settled in 2009. The settlement agreement included a covenant not to sue "any other person" on the released claims. Skilstaf filed a limited objection to the settlement agreement with regard to the "any other person" language and was given the opportunity to opt out. Skilstaf ultimately decided to participate in the settlement and negotiated for the inclusion of a provision allowing it to challenge, in a different court, the enforceability of the covenant not to sue.

The California suit, filed on behalf of part of the same class certified in the prior Massachusetts action, alleged that pharmacies (not defendants in the settled Massachusetts action) conspired with the defendants in the Massachusetts class action (a wholesale prescription drug distributor and a publisher of average wholesale prices of prescription drugs) to inflate average wholesale prices for the same prescription drugs at issue in the previous suit in violation of the Racketeer Influenced and Corrupt Organizations (RICO) Act. The Ninth Circuit stated that the covenant not to sue was enforceable against Skilstaf given that it had full notice of the covenant's language and had rejected the opportunity to opt out of the settlement.

Skilstaf v. CVS Caremark, 669 F.3d 1005 (Feb. 9, 2012).

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