

## Antitrust Alert

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### The Next Chapter: DOJ Sues Apple and Publishing Companies for Alleged e-Book Conspiracy

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How much should a consumer pay for an electronic book (“e-book”)? Amazon used to sell e-books for \$9.99. After Apple, Inc. (“Apple”) entered the market with its e-book application for the iPad, and entered into different distribution arrangements with publishers, \$14.99 became the new norm. However, with the arrival of the antitrust enforcers, lawsuits, and simultaneous consent decrees with some, but not all, defendants, \$9.99 may again become standard.

In the culmination of antitrust/competition investigations by the U.S. Department of Justice Antitrust Division (“DOJ”), state attorneys general, and the European Commission, the DOJ on April 11, 2012 filed a lawsuit against Apple and five of the six largest U.S. book publishers (“Defendant Publishers”) alleging a *per se* violation of Section 1 of the Sherman Act for conspiring to raise the retail price of e-books. *United States v. Apple, Inc.*, No. 1:12-cv-2826 (S.D.N.Y. filed April 11, 2012). Three of the Defendant Publishers (Hachette, HarperCollins, and Simon & Schuster) agreed to consent decrees with the DOJ, but Apple and the remaining two Defendant Publishers (Macmillan and Penguin) have not reached a settlement. Several states have also filed a lawsuit against Apple, Penguin, Macmillan, and Simon & Schuster. *The State of Texas v. Penguin Group (USA) Inc.*, No. 1:12-cv-00324 (W.D. Tex. Filed April 11, 2012). These enforcement actions follow a number of consumer class actions filed against Apple and the Defendant Publishers across the U.S. in 2011.

#### Development of the e-Book Market

The 2007 launch by Amazon of the Kindle device changed the economics of the publishing industry. At the time, book retailers typically purchased books under a wholesale model from publishers and then resold them to consumers at prices determined by the retailers. The wholesale purchase price was typically half of the retail price. For example, the wholesale price for newly released and bestselling e-books was about \$9.99 at the time of the Kindle launch, but the retail list price might have been twice as much. Wholesale prices, and thus retail prices, for hardcover books were even higher due to the added printing, warehousing, and distribution costs. Amazon entered the market with a significantly discounted retail price of \$9.99 for e-books, the same wholesale price that had been charged by publishers. To compete with Amazon, other e-book retailers frequently matched the \$9.99 retail price.

The DOJ complaint alleged that Publisher Defendants were concerned that \$9.99 would become the standard retail price for e-books, consequently lowering the wholesale prices of both e-books and hardcover books. To support its claim, the DOJ complaint quoted the CEO of one of the Publisher Defendants as lamenting in an e-mail about the “wretched \$9.99 price point.” The DOJ further charged that Publisher Defendants also feared that Amazon would enter the digital publishing business and remove the traditional publishers as “gate-keepers of the publishing world.”

#### Alleged Conspiracy

The DOJ alleged that Publisher Defendants engaged in high-level meetings with each other in which they jointly acknowledged the need to work together to compel Amazon to increase the price of e-books. The DOJ complaint quoted another executive of one of the Publisher Defendants as stating in an e-mail that “we’ve always known that unless other publishers follow us, there’s no chance of success in getting Amazon to change its pricing practices.” By 2009, the DOJ alleged, the Publisher Defendants had settled on a joint strategy to replace the wholesale model with an agency model that would allow Defendant Publishers to set the retail prices of e-books. The DOJ complaint quoted an e-mail from another CEO of one of the Publisher Defendants as explaining that “[o]ur goal is to force Amazon to return to acceptable sales prices through the establishment of agency contracts in the USA... To succeed our colleagues must know that we entered the fray and follow us.”

## Apple’s Alleged Role

At the same time that Publisher Defendants were allegedly struggling to compete with Amazon’s pricing, Apple was in the process of developing a strategy to sell e-books on its new iPad device. According to the DOJ, Apple concluded that competition from Amazon and other retailers would limit Apple’s goal to earn a 30% margin on e-book sales, and thus Apple began having exploratory discussions with Defendant Publishers.

The DOJ charged that the parties settled on an arrangement that would allow Defendant Publishers to set the retail prices of e-books through the agency model, protect Apple from competition on the retail prices of e-books, and provide Apple with its desired 30% margin. The DOJ complaint quoted an Apple executive as saying in an e-mail that the Publisher Defendants viewed Apple as “solv[ing the] Amazon problem.”

The final e-book distribution agreements between Apple and each of the Publisher Defendants allegedly provided that: 1) Apple would be the agent for the publisher and the publisher would retain authority over the retail pricing of e-books; 2) the publisher would guarantee that it would lower the retail price of each e-book sold by Apple to match the lowest price offered by any other retailers, regardless of whether the publisher controlled the retail pricing for that other retailer (the “most favored nation” clause); 3) Apple would receive 30% commission for each e-book it sold; 4) the publishers would all have identical pricing tiers for e-books sold through Apple; and 5) the publisher would provide Apple the complete e-book catalog and not delay electronic releases of books. The DOJ also alleged that shortly after the agreements were signed with Apple, each of the Publisher Defendants entered into agency model agreements with all other major e-book retailers, replacing their previous wholesale model agreements and giving Publisher Defendants control over retail pricing.

Amazon, however, initially refused to sign the new agency model agreements with Publisher Defendants. But shortly after Publisher Defendants proposed the agency model arrangement, Amazon yielded rather than risk losing the ability to sell the e-books of all five Publisher Defendants.

## DOJ’s Complaint

The DOJ alleged the following evidence in support of its claim that Publisher Defendants acted in concert “to raise, fix, and stabilize retail e-book prices, to end price competition among e-book retailers, and to limit retail price competition among the Publisher Defendants.”

- Practices Facilitating Horizontal Conspiracy. Publisher Defendants communicated privately and exchanged sensitive information on a regular basis.
- Direct Evidence of a Conspiracy. Publisher Defendants discussed and agreed to collective action to force Amazon to raise prices of e-books.
- Recognition of the Illicit Nature of Communications. Publisher Defendants took steps to conceal their communications regarding their actions.
- Acts Contrary to Economic Interests. Publisher Defendants pursued a course of action that would be contrary to the economic interest of any single company acting alone.
- Motive to Enter the Conspiracy. Publisher Defendants were motivated to maintain the prices of books.
- Abrupt, Contemporaneous Shift in Behavior. Publisher Defendants, prior to January 23, 2010, all sold e-books under the traditional wholesale model, but by January 25, 2010, they had all committed to transition to the agency model.

Under the settlement reached by the DOJ with defendants Hachette, HarperCollins, and Simon & Schuster, the publishers will be required to allow retailers the freedom to reduce the prices of e-books, and they will be prohibited from constraining the ability of retailers to offer discounts for two years. The settlement will also require the publishers to terminate their most favored nation agreements with Apple. Additionally, the settlement prohibits the publishers from conspiring or sharing competitively sensitive information, and requires them to implement an antitrust compliance program. Press reports have already indicated that Amazon intends to reduce its e-book prices back to \$9.99.

As indicated above, Apple and two publishers did not enter into consent decrees, and may litigate the matter. If the case evolves, it will be interesting to see whether it is tried as a horizontal conspiracy matter (focusing upon the publishers' direct communications), a horizontal hub-and-spoke conspiracy (with Apple as the hub, and the publishers as the spokes), or as a hybrid vertical/horizontal arrangement, with Apple as a more proactive moving force.

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One final note. Agency distribution arrangements are quite common in the economy. Neither the contours of the Complaint, nor the Consent Decrees or accompanying explanations, suggest that the DOJ is attacking or asserting that agency arrangements, standing alone, are antitrust improper.

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