The US ebooks judgment

A view from across the Atlantic

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On 10 July 2013, District Court Judge Denise Cote handed down a detailed judgment finding that Apple had conspired with five publishers (Penguin, Simon & Schuster, HarperCollins, Macmillan and Hachette) to raise the retail price of ebooks in the US in breach of section 1 of the Sherman Act.

Apple intends to appeal against the judgment, which has given rise to significant controversy. The circumstances of the case were unusual, involving a new market entrant which initially had no market share; hub-and-spoke style collusion; and a nascent and fast evolving industry, which was apparently oblivious to antitrust norms. The judgment is a major victory for the US Department of Justice. The parallel European proceedings culminated in commitments decisions but no findings of liability.

The saga

The publishers produce books in print and electronic form. According to the judgment, at the relevant time Amazon sold around 90% of all ebooks in the US and was also the "dominant seller" for print books. Amazon had a commercial policy of selling the publishers' New York Times bestseller ebooks as loss-leaders at $9.99 (paying wholesale prices of around $13.00).

The publishers were unhappy with Amazon's policy because it threatened to cannibalise their more profitable print book sales and because they feared long-term devaluation of their content as consumers became accustomed to the $9.99 price point. However, the publishers were unable to pressure Amazon individually because of fear of retaliation.

From around 2008, the publishers began to have regular meetings to discuss potential collective action against Amazon. From autumn 2009, four of the publishers began to "window" their ebooks – ie withhold them for a fixed period following publication of the print version – in an effort to compel Amazon to raise its prices. But windowing was costly to the publishers and fuelled electronic piracy. The boycott was unsuccessful.

▌**Enter Apple.** Apple was separately making plans to launch its new device, the iPad, on 27 January 2010. Apple believed the iPad would transform the ereader market. In contrast to existing ereaders such as Amazon's Kindle, the iPad could display text in colour, and display illustrations and photographs.

Apple was keen to launch its proposed iBookstore on the launch date, but was only willing to do this if it were able to retail ebooks profitably and sign up at least four of the biggest six publishers, giving it sufficient content to be attractive to consumers. Importantly, the judge found that the iPad launch would have happened with or without iBookstore. Apple began to study the publishing industry and, relatively late in the day, began simultaneous negotiations with the "big six" publishers (the five publisher defendants plus Random House) from December 2011.

Apple made clear to the publishers that it would be meeting with each of the big six. Apple enticed them by conveying the unambiguous message that it was willing to sell ebooks for up to $14.99. Apple also made clear that the iBookstore launch would only go ahead if sufficient publishers signed up to establish a "critical mass" of content for the store.

During the negotiations, the publishers expressed their strong dissatisfaction with Amazon's $9.99 price point. Apple reassured them that it was not planning to pursue a low price strategy. As the judge noted:

> "Apple, quite simply, did not want to compete with Amazon on price. Apple was confident that the iPad would be a revolutionary and wildly popular device. It was happy to compete with Amazon on that playing field, where it believed its strength resided. It would match its device – the iPad – against the Kindle."

Following initial meetings, several of the publishers discussed their delight at the proposed iBookstore launch with a $14.99 price point.

▌**Agency model and MFN**. Apple initially proposed using the prevailing wholesale-retail model, where the publisher receives its designated wholesale price for each ebook and the retailer sets the retail price. Hachette and HarperCollins (following discussions among themselves) suggested that Apple should use an agency model instead, allowing the publisher to set the retail price, with Apple taking an agent's commission. Apple initially rejected this proposal but, soon after, changed its mind. In early January 2012, Apple concluded that, to ensure its iBookstore would be competitive at the $14.99 price point, it would need the publishers to shift all their other etailers to the agency model. Initially this demand was an explicit requirement in Apple's term sheet.

A week later, Apple had the idea of using a most favoured nation (MFN) clause to guarantee that Apple could sell ebooks at the lowest retail price available. At the same time, Apple proposed a series of capped price tiers to ensure (from Apple's point of view) that the publishers would not set unacceptably high prices for ebooks. Publishers would only be able to price at the top of the tiers if they prevented etailers from discounting, which in practice required moving all of their etailers onto the agency model so that they gained control of retail pricing.

The judge found that this "elegant" combination of MFN and price cap "eliminated any risk that Apple would ever have to compete on price when selling ebooks, while as a practical matter forcing the publishers to adopt the agency model across the board". With the adoption of the MFN clause, Apple dropped the requirement that the publishers shift their etailers to agency.

▌**Getting it together.** During negotiations in January 2011, Apple proposed largely identical terms with each publisher, including a 30% commission. It assured them that they would each be getting materially the same terms. It kept all the publishers apprised as to progress. The five publishers also kept each other informed, making dozens of telephone calls. Apple

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encouraged the publishers to persuade one another to sign up, praising a CEO at Simon & Schuster as a "real leader". From late January, one-by-one, Apple executed agreements with five of the big six. Random House decided against involvement.

Shortly after execution, the five publishers began pressuring Amazon to shift to an agency agreement, each of them stating that it would impose windowing of ebooks if Amazon refused to comply. Faced with this concerted action, Amazon was unable to retaliate effectively and accepted the publishers' demands. The judge specifically rejected allegations that Amazon had willingly shifted to the agency model.

Following the shift to agency, prices of these publishers' ebooks increased by around 18.6% on average. The court accepted evidence that the publishers' output fell as a result of the move, quoting studies which indicated that volumes fell by around 12%-15%, but did not reach a conclusion on the precise level of the reduction.

Apple condemned

The judge was critical of Apple's conduct, also finding the testimony of several of Apple's witnesses to be unreliable. At trial, there was little dispute that the publishers had conspired together to raise the prices of ebooks. Argument therefore centred on whether Apple knew that the publishers had conspired with each other.

The judge ruled there was overwhelming evidence that Apple had facilitated and encouraged the conspiracy and that, without its participation, the publishers would have been unable unilaterally to impose an agency relationship on Amazon. Accordingly, the judge ruled that there had been a per se violation of section 1 of the Sherman Act, meaning that no effects on competition needed to be proved. There would also have been a violation under a rule of reason approach, which would have required anticompetitive effects to be demonstrated.

The violation related to Apple's involvement in fostering the conspiracy between the publishers rather than other practices:

> "this court has not found that the agency model for distribution of content, or any one of the clauses included in the agreements, or any of the identified negotiation tactics is inherently illegal. Indeed, entirely lawful contracts may include an MFN, price caps, or pricing tiers. Lawful distribution arrangements between suppliers and distributors certainly include agency arrangements. It is also not illegal for a company to adopt a form 'click-through' contract, negotiate with all suppliers at the same time, or share certain information with them. Indeed, as Apple indicates, many common business practices have been found necessary for the efficient distribution of goods and services. [...]
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> "That does not, however, make it lawful for a company to use those business practices to effect an unreasonable restraint of trade. And here, the evidence taken as a whole paints quite a different picture – a clear portrait of a conscious commitment to cross a line and engage in illegal behaviour with the publisher defendants to eliminate retail price competition in order to raise retail prices."

Where we go from here

Apple has indicated its intention to appeal the findings of liability. A trial to assess damages has been scheduled for May 2014. As a subsequent appeal of the damages judgment is likely, the proceedings appear set to continue for several years.

Given the findings of fact, Apple may face an uphill struggle to overturn the judgment on liability. For example, the finding that the iPad would have launched with or without the iBookstore significantly undermines Apple's line that its conduct allowed consumers to benefit from its innovation. However, Apple intends to argue that the judge wrongly excluded certain exonerating evidence from trial.

Beyond condemning Apple's specific conduct, the judgment provides little guidance as to what behaviour will give rise to antitrust concern. In particular, businesses may need to think carefully about whether MFN provisions – which ostensibly bring about lower prices – might impede competition. On this side of the Atlantic, the OFT's September 2012 research paper on price relationship agreements (*Can 'Fair' Prices be Unfair?*) indicates that this issue is complex.

European angle

Given the defeat in the US, Apple did well to settle the parallel European Commission investigation by commitments. That investigation began with dawn raids on 1 March 2011, followed by formal proceedings. Final commitments were published by Apple and four of the publishers on 12 December 2012, followed by the fifth publisher, Penguin, in July 2013. These require the publishers and Apple to terminate their agreements and refrain from including retail MFN clauses in future agreements for a period of five years. Apple was also required to inform counterparties to its other agency agreements that it would not enforce existing MFN provisions. Importantly, Apple has not admitted liability in respect of any acts committed in the EU and the acceptance of commitments brings the Commission's investigation to a conclusion, with Apple having avoided fines. Moreover, Apple's exposure to private law suits in the EU is comparatively limited, given the absence of US-style class actions.

A continuously evolving online world

The US judgment and the Commission's commitments decisions are likely to mean that the wholesale-retail model remains the lower risk way of bringing ebooks to market in the near future, while the focus of courts and authorities will remain on retail price competition. This is against the backdrop of profound recent and potential changes in the sector, as improvements in technology drive innovation and allow alternative disintermediation models, ie self-publishing. Faced with new threats, consolidation is also on the cards, as evidenced by the merger of Penguin and Random House in July 2013.

The saga demonstrates the difficulty of applying conventional antitrust theories of harm and analytical frameworks to the continuously evolving online universe. However one interprets the US judgment and the EU commitments, both serve as a reminder that many of the practices which are prevalent in the digital content world (agency models, MFNs, price caps, pricing tiers and any information exchange among players) must continue to be considered carefully in the online context. Guidance is particularly sparse in the EU, given that the Commission did not proceed to a formal infringement decision. Only time, litigation and investigation will tell which practices, individual or combined, may give rise to genuine antitrust concern.