Apple Found Liable of Conspiracy to Fix Prices in E-books Case

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On July 10, 2013, Judge Denise Cote in the Southern District of New York handed down an opinion and order finding that Apple had violated Section 1 of the Sherman Act by persuading five leading publishers jointly to abandon "wholesale" e-book pricing in favor of "agency pricing," pursuant to which the publisher set a higher retail price, with the distributor acting as the publisher's agent and receiving a commission. All five publishers (Hachette, HarperCollins, MacMillan, Penguin, and Simon & Schuster) settled with the government before trial, but Apple chose to press on.

In an entertaining 160-page opinion, Judge Cote vividly described how Apple orchestrated a transformation in the e-book market over a period of just a few weeks in late 2009 and early 2010. Under the wholesale model, publishers sold book titles to the dominant e-tailer, Amazon, at a wholesale price, and Amazon set the retail price – almost always $9.99. Under the agency model, by contrast, publishers could set the retail price and retailers would sell the e books at that price as the publishers' agents. Apple and the publishers negotiated a series of price tiers with caps for different types of books depending on popularity and hardcover price. As the court found, Apple and the publishers understood that the caps (either $12.99 or $14.99 for most books, and thus a sharp increase over the Amazon $9.99 price) would become in effect the going rate. Interestingly, given the 30% commission Apple charged, publishers earned less per book sale than they had under the wholesale arrangement with Amazon. The publishers nevertheless went along with agency pricing, the court found, because they feared that Amazon's $9.99 retail price would eat into the value of their hardcover books and brick-and-mortar stores and ultimately erode prices for all books.

Before Apple entered the scene with its iPad in early 2010, Amazon dominated the nascent e-book market. Amazon remained committed to its $9.99 price even when publishers set a wholesale price several dollars higher – Amazon simply sold the books as loss leaders. The major publishers "abhorred" the $9.99 price, which was far lower than the prices at which publishers could sell best-seller hard cover books – often upwards of $30. The publishers tried to move Amazon off wholesale pricing, but they faced a collective action problem – any publisher that tried to change its pricing model would simply lose sales to its rivals.

Enter Apple. As the court wrote, "[u]nderstanding that no one Publisher could risk acting alone in an attempt to take pricing power away from Amazon, Apple created a mechanism and an environment that enabled them to act together in a matter of weeks to eliminate all retail price competition for their e-books." *Id.* at 136-37. In late 2009, Apple was preparing to launch the iPad, and it wanted to offer an

"iBookstore" as a complement to iTunes and its other popular online offerings. But to have an iBookstore, it needed content. To obtain the content, it enticed the publishers with the promise of higher prices and the ability to set the retail price. In marathon negotiations over just a few weeks before the introduction of the iPad in early 2010, Apple reach agreement with the five publishers using the agency model and price tiers with caps.

To make the new agency arrangement work, of course, Apple and the publishers had to move the entire industry – especially Amazon – to the new prices. To achieve this goal, the court found, Apple negotiated an MFN clause which allowed it to charge whatever lower price any publisher arranged with any other e-tailer. Thus, in order to get the benefit of higher agency pricing, the publishers had to compel Amazon to abandon wholesale pricing. Now able to present a united front and with a separate distribution platform available to them, the publishers succeeded in forcing Amazon to enter into agency agreements in early 2010. Google, a new entrant into the e-book business, also entered into agency agreements. Random House, the nation's largest trade book publisher and the sole remaining holdout among the major publishers, capitulated and entered into agency agreements in 2011.

The court found that Apple's orchestration of the industry's move to a different pricing model and sharply higher prices constituted a per se violation of the Sherman Act. *Id.* at 120. For good measure, Judge Cote also found Apple violated Section 1 of the Sherman Act under a rule of reason standard. *Id.* at 121.

Apple argued that per se liability was inappropriate because (i) it was a vertical participant in the e-book market, and per se liability does not apply to vertical arrangements, and (ii) the United States' reliance on traditional hub-and-spoke price fixing conspiracies where per se liability had been found did not apply here because Apple was a new market participant that lacked market power. The court easily disposed of both arguments. As to the first, it found that Apple had participated directly in a horizontal price-fixing conspiracy. As to the second, the court found that market dominance for the hub of the conspiracy was not required by caselaw.

Apple argued that its entry into a concentrated market dominated by Amazon was pro-competitive and created a healthier market. But the court found that the salutary effects of Apple's entry were no justification for a price-fixing conspiracy. As the court was at pains to explain, agency agreements, pricing tiers with caps, MFN clauses, and simultaneous negotiations with suppliers are not problematic in and of themselves. What is problematic is their use to facilitate a price-fixing conspiracy.

A trial on injunctive relief and damages will follow. Apple remains defiant, stating that it will appeal to the Second Circuit.

About the Authors

Mr. Cohen is a partner and co-founder of the firm, and head of its Litigation & Arbitration practice group and its *Chambers USA* recognized White Collar Defense, Regulatory Enforcement and Internal Investigations practice group. He is a former Assistant United States Attorney for the Eastern District of New York. Mr. Cohen was recognized as a leading lawyer in his field by the 2013 edition of *Chambers USA*, the 2012 edition of *Benchmark Litigation,* and included as one of New York's *Super Lawyers* in 2008-2012.

Mr. Thomson is counsel at the firm and has experience in commercial litigation, antitrust matters, white collar criminal defense, regulatory enforcement and internal investigations. Mr. Thomson is a graduate of Columbia Law School where he was a Harlan Fiske Stone Scholar and was on the Editorial Board of the Columbia Journal of Transnational Law.

About Cohen & Gresser

Founded in 2002, Cohen & Gresser LLP has been recognized in *Chambers USA*, *Legal 500*, and *Benchmark Litigation* and was recently named to *The National Law Journal*'s 2013 "Midsize Hot List." The firm has offices in New York and Seoul and has grown to over fifty lawyers in four practice groups: Litigation and Arbitration; Corporate Law; Intellectual Property and Technology; and White Collar Defense, Regulatory Enforcement and Internal Investigations. Its attorneys are graduates of the nation's best law schools and have exceptional credentials, and its clients include Fortune 500 companies and major financial institutions throughout the world.

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