

APRIL 2012

DEPARTMENT OF JUSTICE FILES SUIT AGAINST APPLE AND FIVE MAJOR PUBLISHERS ALLEGING A SCHEME TO RAISE AND FIX PRICES FOR E-BOOKS

On April 11, 2012, the U.S. Department of Justice (DOJ) filed suit in the U.S. District Court for the Southern District of New York (case number 12-cv-2826) against Apple, Inc., and five of the six largest publishers of general interest fiction and non-fiction books in the United States: Hachette Book Group, Inc., HarperCollins Publishers, Macmillan, The Penguin Group, and Simon & Schuster, Inc. Along with Random House, which was not named in the DOJ's complaint, these publishers comprise the "Big Six" of the publishing industry and are responsible for approximately 60 percent of the revenue from print titles sold in the United States and approximately 85 percent of the revenue generated by *New York Times* bestsellers. The DOJ alleges that Apple and the publisher defendants entered into a conspiracy to raise and stabilize prices for e-books by eliminating price competition at the retail level in violation of Section 1 of the Sherman Act, 15 U.S.C. § 1.

E-Book Pricing

Prior to the consummation of the alleged conspiracy, publishers sold e-books according to a "wholesale" model, which had been the industry standard for physical books for more than 100 years. Under the wholesale model, publishers sold the e-books to retailers at a discount from the list price, and the retailers then independently determined the final retail prices. Price competition at the retail level had benefited consumers by lowering the retail price at major retailers such as Amazon and Barnes & Noble to \$9.99 for newly released popular titles. The publisher defendants allegedly were concerned that

Amazon's pricing would establish a consumer expectation of \$9.99 as the price of e-books, leading to retailer demands for reduced wholesale prices as well as price erosion for print editions. In addition, the publishers feared that a low price point for e-books would allow digital publishers, particularly companies with large retail operations like Amazon, to achieve the scale necessary to eliminate the intermediary role of traditional publishers and engage directly with content owners.

The Alleged Conspiracy

The DOJ alleges that beginning no later than September 2008, the publisher defendants and Apple conducted regular discussions on how to change their business model to eliminate retail price competition and to fix higher prices for their e-books. By late 2009, Apple and the publisher defendants had outlined a strategy to accomplish this goal: the defendants jointly agreed to transition to an agency model, under which retailers would act as agents with no authority to alter the prices set by the publishers. In July 2009, the CEO of a publisher defendant's parent company noted, "The goal is less to compete with Amazon as to force it to accept a price level higher than \$9.99." The DOJ asserts that no single publisher could unilaterally force large retailers such as Amazon to either increase their prices or to accept the agency model. One publisher executive acknowledged 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." However, according to the complaint, Apple's entry into

the e-book market, which coincided with the release of the iPad, served as the perfect vehicle for a coordinated, industry-wide transition from the wholesale model to the agency model.

The Apple Agency Agreements

Apple allegedly acted as a central coordinator for collusion among the publisher defendants. By routing all negotiations through Apple, the publisher defendants were able to signal to each other the agency terms they would each find acceptable. In addition, during the negotiation of these agreements, Apple mitigated the risk that other publishers would abandon the scheme by giving each publisher assurances that every other publisher defendant would enter into a materially identical agency agreement. Within a three-day span ending on January 26, 2010, each of the publisher defendants entered into an Apple agency agreement. The iPad and Apple's iBookstore service were announced at a launch event the next day.

Under the Apple agency agreements, the publishers retained complete control over retail prices subject to a tiered maximum price schedule, and Apple received a 30 percent commission on all e-book sales through iBookstore, which was significantly above the prevailing competitive margin for e-book retailers. Although the price tiers were structured as a cap on publisher prices—publishers could set prices as high as \$12.99 or \$14.99 for new releases—the DOJ alleges that each defendant understood the effect of the agreements as fixing de facto prices for e-books. According to the complaint, in

Continued on page 2...

Department of Justice Files Suit . . .

Continued from page 1...

practice publishers rarely set prices below the allowed maximum. In the course of negotiating the agency agreements, Apple CEO Steve Jobs allegedly recognized that “[t]he customer pays a little more, but that’s what [the publishers] want anyway.”

In order to eliminate retail price competition, Apple also included a most-favored-nation (MFN) clause in each contract that prevented the publisher defendants from allowing their e-books to be sold anywhere for less than the price offered by Apple’s iBookstore, even if the publisher had no control over the retailer’s pricing decisions. According to the complaint, this clause served as a critical enforcement mechanism, giving each publisher a strong incentive to require every e-book retailer to accept the agency model. For example, in February 2010, one publisher defendant observed that “[t]he Apple agency model deal means that we will have to shift to an agency model with Amazon which [will] strengthen our control over pricing.”

Coercive Conduct

Moreover, the publisher defendants allegedly jointly pressured both retailers and other publishers to accept the agency model. According to the complaint, after signing its Apple agency agreement, Macmillan issued an ultimatum to Amazon: either Amazon had to accept an agency agreement or Macmillan would withhold its titles from Amazon until seven months after release. Amazon resisted and effectively ceased selling Macmillan e-books. The DOJ alleges that the other publisher defendants came to Macmillan’s defense, and after only two days, Amazon capitulated and announced that it would accept the agency model. In addition, the publisher defendants, led by The Penguin Group, encouraged retail partners to “punish” a publisher that refused to adopt the agency model in its own contracts (and consequently was gaining market share at the expense of the publisher defendants). Apple took a more direct approach and flatly refused to sell the holdout publisher’s e-books until it agreed to an agency relationship.

Anti-competitive Effects

According to the DOJ’s complaint, the conspiracy was highly effective. Within four

months, each publisher defendant had transitioned to an agency model with all the major e-book retailers and imposed outright prohibitions on e-book discounting or other means of price competition. As a result, the DOJ claims that e-book prices have stabilized at or near the maximum price levels allowed by Apple’s agency agreements, causing retail prices for many e-books to rise 30 to 50 percent over the past two years and costing consumers millions of dollars. In some cases, the publisher defendants’ e-book prices are actually higher than Amazon’s prices for print editions of the same titles. In addition, retailers have been prevented from developing innovative sales strategies such as a subscription-based “all you can read” model.

The DOJ’s Proposed Settlement

The DOJ already has reached a settlement with three of the publisher defendants, Hachette Book Group, HarperCollins Publishers, and Simon & Schuster, Inc. Under the terms of the settlement, the publishers are required to terminate their agreements with Apple and other e-book retailers that contain either restrictions on the retailer’s ability to set prices or a price MFN clause. The settling defendants may negotiate new contracts with e-book retailers, including Apple, on either a wholesale or an agency basis, but they are barred from entering into agreements that limit retailers’ ability to offer discounts or other promotions for two years. In addition, the publishers are prohibited from entering into an MFN agreement that might undermine the settlement, and from conspiring or sharing competitively sensitive information for five years. The DOJ found these relatively short terms sufficient to restore competition to the market given the rapid pace of innovation. The settling publishers also are prohibited from sharing confidential or competitively sensitive information with any other publisher. In addition, the settling defendants may not retaliate or encourage others to retaliate against an e-book retailer on the basis of its pricing behavior.

Finally, the publishers must comply with a strict monitoring program. The DOJ’s

Competitive Impact Statement notes that the settling defendants must notify the DOJ before forming or modifying any joint venture relating to e-books. In addition, the settling publishers must supply the government on a quarterly basis with any agreements entered into with e-book retailers. As part of the compliance program, each settling publisher must appoint an Antitrust Compliance Officer, who is required, among other duties, to conduct an annual antitrust review and to keep a record of all communications among the officers of the settling defendants.

The DOJ has announced that it will continue its suit against Apple, Macmillan, and The Penguin Group. In response, John Sargent, the CEO of Macmillan, published an open letter denying a conspiracy to force retailers to accept the agency model and stating that the agency model is critical to maintaining an “open and competitive market for the future.”

Conclusion

In addition to the DOJ’s suit, the Southern District of New York is managing more than two dozen private actions that have been filed against Apple and/or the publisher defendants, and 16 State Attorneys General have filed a suit against Apple, Macmillan, The Penguin Group, and Simon & Schuster in the Western District of Texas. Hachette and HarperCollins are not named in the state-led suit, as they already have agreed to a consumer payback plan. These lawsuits will have a major impact on the large and rapidly growing market for e-books. At present, e-books comprise roughly 10 percent of all general-interest fiction and non-fiction book sales in the United States and are predicted to reach 25 percent within two to three years. In 2010, 114 million e-books were sold with sales of nearly \$450 million. Sales grew 117 percent in 2011, with industry revenues jumping to nearly \$1 billion.

In response to the announcement of the suit and proposed settlement agreement, an Amazon spokesperson said, “This is a big win for Kindle owners, and we look forward to being allowed to lower prices on more Kindle books.” Apple, on the other hand, has indicated that the pricing pressure from

Continued on page 3...

Department of Justice Files Suit . . .

Continued from page 2...

retailers such as Amazon created by a return to the wholesale pricing model may cause Apple and many other e-book retailers to exit the market entirely, allowing Amazon to achieve a dominant position.

For More Information

For more information on the DOJ's suit against Apple and the publisher defendants or the proposed settlement agreement, please contact Jonathan Jacobson (212-497-7758), Scott Sher (202-973-8822), or another member of Wilson Sonsini Goodrich & Rosati's antitrust practice.



Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

This WSGR Alert was sent to our clients and interested parties via email on April 11, 2012. To receive future WSGR Alerts and newsletters via email, please contact Marketing at wsgr_resource@wsgr.com and ask to be added to our mailing list.

This communication is provided for your information only and is not intended to constitute professional advice as to any particular situation. We would be pleased to provide you with specific advice about particular situations, if desired. Do not hesitate to contact us.

650 Page Mill Road
Palo Alto, CA 94304-1050
Tel: (650) 493-9300 Fax: (650) 493-6811
email: wsgr_resource@wsgr.com

www.wsgr.com

© 2012 Wilson Sonsini Goodrich & Rosati,
Professional Corporation
All rights reserved.