13-3741-cv(L)

13-3748 (CON), 13-3783 (CON), 13-3857 (CON), 13-3864 (CON), 13-3867 (CON)

United States Court of Appeals for the Second Circuit

UNITED STATES OF AMERICA, STATE OF TEXAS, STATE OF CONNECTICUT, COMMONWEALTH OF PUERTO RICO, STATE OF UTAH, STATE OF ALABAMA, STATE OF ALASKA, STATE OF SOUTH DAKOTA, STATE OF NORTH DAKOTA, DISTRICT OF COLUMBIA, STATE OF ARIZONA, STATE OF TENNESSEE, STATE OF NEBRASKA, STATE OF MICHIGAN, STATE OF COLORADO, STATE OF VERMONT, COMMONWEALTH OF MASSACHUSETTS, STATE OF ILLINOIS, STATE OF WEST VIRGINIA, STATE OF NEW MEXICO, STATE OF IOWA, COMMONWEALTH OF VIRGINIA, STATE OF KANSAS, STATE OF MARYLAND, STATE OF NEW YORK, STATE OF IDAHO, STATE OF MISSOURI, STATE OF ARKANSAS, STATE OF OHIO, STATE OF LOUISIANA, COMMONWEALTH OF PENNSYLVANIA, STATE OF WISCONSIN, STATE OF DELAWARE,
Plaintiffs-Appellees,

v.

APPLE, INC., SIMON & SCHUSTER, INC., VERLAGSGRUPPE GEORG VON HOLTZBRINK GMBH, HOLTZBRINK PUBLISHERS LLC, d/b/a MACMILLAN, SIMON & SCHUSTER DIGITAL SALES, INC.
Defendants-Appellants,

HACHETTE BOOK GROUP, INC., HARPERCOLLINS PUBLISHERS L.L.C., THE PENGUIN GROUP, A Division of Pearson PLC, PENGUIN GROUP (USA), INC.,
Defendants.

On Appeal from the United States District Court for the Southern District of New York (Nos. 12-02826 & 12-03394 (DLC))

BRIEF OF WASHINGTON LEGAL FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT APPLE, URGING REVERSAL

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March 14, 2014

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BRIEF OF WASHINGTON LEGAL FOUNDATION AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT APPLE, URGING REVERSAL

INTERESTS OF *AMICUS CURIAE*

The Washington Legal Foundation (WLF) [1] is a public interest law firm and policy center with supporters in all 50 states. WLF devotes a substantial portion of its resources to defending free enterprise, individual rights, a limited and accountable government, and the rule of law. To that end, WLF has appeared frequently in this and other courts to address the proper scope of the federal antitrust laws. *See, e.g.*, *FTC v. Actavis*, 133 S. Ct. 2223 (2013); *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007); *Texaco, Inc. v. Dagher*, 547 U.S. 1 (2006); *In re Stock Exchanges Options Trading Antitrust Litig.*, 317 F.3d 134 (2d Cir. 2003).

WLF is concerned that the decision below, if allowed to stand, would create excessive uncertainty among firms contemplating entry into new markets. As the district court conceded, the business practices engaged in by Appellant Apple, Inc. as it sought to enter the retail e-book market were legitimate, time-honored practices, regularly employed by new entrants. Yet, Apple now stands condemned

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[1] Pursuant to Local Rule 29.1, WLF states that no counsel for a party authored this brief in whole or in part; and that no person or entity, other than WLF and its counsel, contributed monetarily to the preparation and submission of this brief. Counsel for the parties have consented to the filing of this brief.

as an antitrust law violator and faces the possibility of massive damages awards. As a consequence, firms will be more hesitant in the future to enter new markets lest they too run afoul of the antitrust laws. That result runs directly counter to the purposes of the antitrust laws, which are designed to encourage precisely the sort of procompetitive conduct exemplified by entry into new markets.

The district court held that Apple's conduct was anticompetitive, but it arrived at that conclusion by adopting a *per se* unlawfulness analysis. WLF believes that invocation of the *per se* rule was wholly unjustified under the facts of this case, particularly given the district court's failure to cite a single case in which conduct even remotely similar to Apple's was determined to constitute an unreasonable restraint of trade. WLF is concerned that if invocation of the *per se* rule is upheld here, significant amounts of procompetitive conduct will be chilled.

WLF is particularly concerned by the district court's condemnation of Apple's inclusion of a most-favored-nation (MFN) clause in its agreements with the five publisher Defendants. MFNs are routinely used by businesses to protect themselves against losses they would incur if the prices they paid to their suppliers exceeded prices charged to their competitors. The district court's decision calls into question the continued viability of MFNs in a wide variety of business contexts.

STATEMENT OF THE CASE

The facts of the case are set out in detail in Apple's opening brief. WLF wishes to highlight several facts of particular relevance to the issues on which this brief focuses.

The retail e-book market was largely dysfunctional in 2009. At the time, Amazon.com dominated the retail sales, with a nearly 90% market share. Amazon was able to maintain that share by establishing a nearly-uniform $9.99 retail price, a price that was well below the wholesale price it paid for much of its inventory. Other sellers, including Barnes & Noble, Inc., were incurring massive, unsustainable losses trying to compete with Amazon. Major book publishers were upset by Amazon's below-cost pricing because they feared both that it was cutting into their sales of higher-priced hardcover books and that Amazon would soon be dictating wholesale price terms to them. Obviously, Amazon's pricing was unsustainable; it would eventually either have to raise prices significantly (and hope to recoup prior losses by preventing re-entry by firms it previously drove from the market) or demand cuts in wholesale prices, or both.

In an effort to counter below-cost prices, the publishers repeatedly denied Amazon e-book access to their newly released books until the books had been on sale for many months in hardcover form (a practice referred to as "windowing").

Indeed, the district court found that major publishers, in this pre-Apple era, were acting "collectively" to pressure Amazon to abandon its below-variable-cost pricing strategy. *United States v. Apple, Inc.*, 952 F. Supp. 2d 638, 647 (S.D.N.Y. 2013).

Apple's potential entry into the e-book market coincided with the scheduled January 2010 launch of the iPad tablet device. Not surprisingly, Apple did not want to enter the market without reasonable assurances that its business would be profitable. *Id.* at 656. By definition, the business would not be profitable if Apple purchased e-books at wholesale prices and then was forced by competitive pressures to match Amazon's below-cost pricing. It thus determined that its business interests required that its contracts with publishers include three essential features: (1) an agency model (*i.e.*, Apple would sell e-books at whatever price the publisher established, with Apple retaining a commission equal to 30% of the sales price), *id*. at 662; (2) a most-favored-nation (MFN) clause (*i.e.*, a guarantee that Apple could match the lowest retail price listed on any competitor's e-bookstore), *id.* at 664-65; and (3) price caps (to restrain the publishers' desire "to raise e-book prices sky-high"). *Id.* at 659. The Agreements it entered into with the publisher Defendants included each of those features.

In the years following Apple's market entry, the e-book industry flourished.

E-book sales exploded, overall sales prices decreased, and retail competition increased. Amazon is still the dominant player, but by 2011 Apple and Barnes & Noble together accounted for between 30% and 40% of e-book sales. The use of the iPad as an e-reading device has brought considerable innovation to the market. Perhaps most importantly, the threat of "windowing" has been eliminated, and thus readers are no longer denied access to e-book versions of new releases.

The district court nonetheless found that the Agreements entered into between Apple and the five publisher Defendants demonstrated a conspiracy in restraint of trade, in violation of Section 1 of the Sherman Act, 15 U.S.C. § 1. The court found "compelling direct and circumstantial evidence that Apple participated in and facilitated a horizontal price-fixing conspiracy." 952 F. Supp. 2d at 694. "As a result," the court concluded, the Plaintiffs "have proven a *per se* violation of the Sherman Act." *Id.*

The district court cited the MFN clauses as the principal evidence that Apple had entered into a conspiracy to raise prices. It reasoned as follows. Apple's entry into the market would be unlikely to cause Amazon to abandon below-cost pricing so long as Amazon continued to operate under a "wholesale model"—whereby it purchased e-books from publishers at the wholesale price (generally, about $12.50) and then sold them at retail for $9.99. If Amazon continued its $9.99 pricing, then

the MFN clauses authorized Apple to match that price. In that event, the sole result of Apple's entry into the market would have been a substantial reduction in the publishers' revenue, because each $9.99 sale by Apple would generate (following Apple's deduction of its 30% commission) only $6.99 in revenue—a figure far below wholesale prices typically paid by Amazon. Thus, the district court concluded, the MFN clauses gave the publishers a strong incentive to push Amazon to convert to the agency model so that they could avoid the losses described above. *Id.* at 665 (concluding that the MFN "literally stiffened the spines of the Publisher Defendants to ensure that they would demand new terms from Amazon").[2]

The district court concluded that Apple wanted the publishers to push Amazon to adopt an agency model and that it used the MFN clause to accomplish

[2] Left unmentioned by the district court was an economic fact that ran counter to its "stiffened the spines" theory: switching Amazon to an agency model entailed even *more* revenue losses for the publishers. Under an agency model, the publishers would receive only 70% of Amazon's retail price; thus, a $12.99 retail price would generate only $9.09 in revenue, far less than the $12.50 wholesale price typically paid by Amazon. As explained in more detail below, those losses were substantially greater than the increased revenues that the publishers could hope to generate if (due to Amazon's switch to an agency model) new releases were retailed by Apple for $12.99 instead of $9.99. Thus, if (as the district court suggested) the publishers were principally motivated by a desire to avoid short-term revenue losses, they would have been reluctant to push Amazon to an agency model, with or without an MFN clause in the Apple contracts.

that aim:

> [T]he "elegant" solution presented by the MFN accomplished all of Apple's objectives. It eliminated any risk that Apple would ever have to compete on price when selling e-books, while as a practical matter forcing the Publishers to adopt the agency model across the board.

Id. at 662-63.[3]

The district court noted that in the months following the signing of Agreements with Apple, the five publisher Defendants did, in fact, successfully push Amazon to switch to an agency model. Although the five publishers approached Amazon separately, the court concluded that they agreed jointly that each would push Amazon to switch and that Apple was part of that agreement, an agreement that the court labeled "a horizontal price-fixing conspiracy." *Id.* at 694. It concluded that the conspiracy "would not have succeeded without the active facilitation and encouragement of Apple," because no publisher dared to challenge Amazon on its own—according to the court, each feared that Amazon, which maintained a near monopoly on on-line hardcover book sales in addition to it monopoly on retail e-book sales, would retaliate by cutting off all sales by that

[3] The court did not attempt to explain why Apple would care greatly whether retailers switched to an agency model. There is little evidence to suggest that it did care. With or without a switch, the MFNs ensured that Apple's prices would be competitive, and Apple was assured of a 30% gross profit on every sale, without regard to the price at which the sale took place.

publisher. *Id.* at 691.

Having succeeded in switching e-book retailers to the agency model, the five publisher Defendants were thereafter free to set the retail prices for their own e-books. After Apple opened its iBookstore in April 2010, the five publishers set the retail prices of most of their new releases at or near the price caps established by the Apple Agreements—in other words, several dollars above the $9.99 below-cost prices previously offered by Amazon. *Id.* at 682-85. The court did not contest the accuracy of Apple's evidence that the increases were non-uniform and that overall prices actually *decreased* during the period. *Id.* at 685. Nor did the court find that the Defendants conspired in connection with any of the price increases. Indeed, the court conceded that each publisher was quite prepared to raise e-book prices independently of the others, and that each would have raised its prices "sky-high" in the absence of the price caps imposed by Apple. *Id.* at 659.

After concluding that the Defendants' "horizontal price-fixing conspiracy" was a *per se* violation of Section 1 of the Sherman Act, the Court added that the Plaintiffs would prevail even "[i]f it were necessary to analyze this evidence under the rule of reason." *Id.* at 694. However, the court's rule-of-reason analysis was confined to a single paragraph and declined to consider whether Apple's entry into the e-book market had any pro-competitive effects. *Id.* It reasoned that any such

effects were independent of the Agreements entered into between Apple and the five publishers. *Id.*

Apple has appealed from the district court's liability finding as well as its injunctive relief.

SUMMARY OF ARGUMENT

The district court's finding that Apple violated Section 1 of the Sherman Act was based on numerous errors of law and should be reversed. In particular, the court erred in concluding that Apple's conduct was subject to *per se* condemnation under the antitrust laws. As the Supreme Court has repeatedly explained, "The rule of reason is the accepted standard for testing whether a practice restrains trade in violation of § 1," and a restraint should not be subject to a *per se* prohibition unless it has "manifestly anti-competitive effects" and "lack[s] any redeeming virtue." *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877, 885-86 (2007).

Restraints that are *per se* unlawful include horizontal agreements among competitors to fix prices. *Texaco*, 547 U.S. at 5. The district court held that the Agreements constituted a "horizontal price-fixing conspiracy" and that Apple participated in the conspiracy. But the court's characterization of the Defendants' conduct as a "horizontal price-fixing conspiracy" does not make it so. To the

contrary, WLF is unaware of any previous cases in which a horizontal price-fixing conspiracy was deemed to exist based on facts even remotely similar to those that the district court found here.

The district court found that Apple and the five publisher Defendants agreed to act in concert to force Amazon to switch to an agency model. WLF concurs with Apple that there is insufficient evidence to conclude that it ever harbored such an intent. But even if Apple did agree to help with forcing a switch, that agreement cannot be classified as a horizontal price-fixing conspiracy. It is not "horizontal" because Apple is not a direct competitor of the publishers. More importantly, it cannot properly be characterized as "price fixing" because a switch from the wholesale model to the agency model is indifferent to price. While the switch removed an obstacle—created by Amazon's monopoly position—to the publishers' abilities to make independent pricing decisions, it did not constitute an agreement that retail prices would, in fact, be raised. The district court found that Apple was aware that the publishers (acting independently from one another) intended to use their new-found pricing power to increase many e-book prices, but such knowledge of likely future conduct by others does not by itself suffice to demonstrate a price-fixing conspiracy.

Instead, the district court should have analyzed the conduct here under the

rule of reason. Under that rule, "the factfinder weighs all the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition." *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 49 (1977). The rule is designed to distinguish "between restraints with anticompetitive effect that are harmful to the consumer and restraints stimulating competition that are in the consumer's best interest." *Leegin*, 551 U.S. at 886.

The district court's cursory, one-paragraph discussion of the rule of reason was not a careful "weigh[ing of] all the circumstances" of the sort mandated by the Supreme Court. Moreover, its analysis was flawed by its refusal to consider—as a procompetitive aspect of the force-Amazon-to-switch-models agreement—the uncontested evidence that Apple's entry into the market significantly increased competition and consumer choice and was followed by an overall *decrease* in e-book prices. The court's assertion that Apple's entry into the market was "independent of the Agreements," 952 F. Supp. 2d at 694, is false. To the contrary, the evidence demonstrated that Apple was unwilling to enter the e-book market without assurances of likely profitability, and that it had determined that the terms contained in its Agreements with the publishers—an agency model, MFNs, and price caps—were essential to providing such assurances. The court also failed

to consider that the Agreements ended rampant dysfunctionality in the retail e-book market brought about by Amazon's monopoly position, and that the Agreements promoted competition by eliminating the threat of "windowing," which regularly deprived readers of all electronic access to books for extended periods.

More fundamentally, the district court erred in concluding that Apple agreed to assist the publishers in their collective efforts to force Amazon to adopt an agency model. The district court conceded that Apple had valid business reasons for each of the terms contained in its Agreements with the publishers; in particular, it conceded that the MFNs protected Apple by permitting it to lower prices to meet the competition. *Id.* at 701. The court nonetheless singled out the MFNs as demonstrating that "Apple shared [the publishers'] goal of raising e-book prices, and helped them to realize that goal." *Id.* at 692. It viewed the MFNs as the device that triggered the collective challenge to Amazon's wholesale model: "Apple fully understood and intended that the MFN would lead the Publisher Defendants inexorably to demand that Amazon switch to an agency relationship with each of them." *Id.* That assertion finds no support in the evidence and was based on an apparent misunderstanding of the nature of MFN clauses.

The court concluded that the publishers could not have challenged

Amazon's monopolistic control of retail pricing without Apple's assistance, but the principal assistance Apple provided was procompetitive: it decided to enter the e-book market. Apple's entry allowed publishers to be more aggressive in their negotiations with Amazon because they knew that they would always have viable alternative outlets for their e-book sales if negotiations with Amazon broke down. The district court may well have been correct that fear of retaliation prevented a single publisher from challenging Amazon's wholesale pricing model on its own. The publishers nonetheless possessed the collective strength to challenge Amazon, and they did not need Apple's assistance to do so—other than Apple's agreement to enter the retail e-book market. As the district court recognized, the publisher Defendants were livid about Amazon's below-cost retail pricing and had previously resorted to collective action in their efforts to fight it. Once Apple entered the market, their collective action against Amazon's wholesale model was inevitable, with or without inclusion of the MFNs in the Agreements. Apple knew of the publishers' desire to force Amazon to switch to an agency model, but mere knowledge that its entry into the market would trigger action against Amazon is not evidence that Apple conspired in that action.

The district court concluded that the MFNs were the tipping point that "forced" the publisher Defendants to take action against Amazon. The court

reasoned that the MFNs would result in both Amazon and Apple selling most e-books at $9.99 so long as Amazon maintained a wholesale model, a situation that would lead to considerable revenue losses for the publishers. The court concluded that the MFNs gave the publishers a strong incentive to push Amazon to convert to an agency model to avoid those losses, *id.* at 665, and further concluded that it was for that very reason that Apple insisted on the MFNs. *Id.* at 692, 701.

That argument makes no sense as a matter of economics. The evidence demonstrated that pushing Amazon to switch to an agency model inevitably would lead to a *reduction* in short-term revenues for the publishers; whatever additional revenues would be gained from Apple sales would be greatly exceeded by the reduction in revenue from Amazon. Thus, it could not have been a desire to avoid revenue losses that prompted the publishers to challenge Amazon. Moreover, the evidence indicated that the revenue losses produced by the MFNs were minor even if the publishers failed in their efforts to move Amazon to an agency model: less than 1% of their e-book sales. Klein Decl. at 7.

Furthermore, although the district court stated that Apple wanted Amazon moved to an agency model, it failed to explain why Apple would have cared greatly about the issue. Apple's chief interest was in having reasonable assurances that it could compete profitably against Amazon. The MFNs provided Apple with

the necessary assurance by guaranteeing Apple the right to match Amazon's prices. It was assured of a 30% gross profit on every sale, without regard to whether Amazon was forced to relinquish its monopoly control over pricing.

The MFNs were procompetitive; they facilitated the entrance into the e-book market of a major competitor to Amazon. MFNs are used in a wide variety of industries for precisely the reason Apple insisted on them: to assure buyers that they will not be offered less favorable terms than their competitors. By singling out the MFNs as the linchpin of a § 1 conspiracy and condemning them as a *per se* antitrust violation, the district court has called into question the legality of such provisions and thereby has chilled a significant amount of pro-competitive behavior.

ARGUMENT

I. THE DISTRICT COURT ERRED IN CONCLUDING THAT APPLE'S CONDUCT WAS SUBJECT TO *PER SE* CONDEMNATION UNDER THE ANTITRUST LAWS

Section 1 of the Sherman Act prohibits "every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States." 15 U.S.C. § 1. Section 1 outlaws only "unreasonable" restraints. *State Oil Co. v. Kahn*, 522 U.S. 3, 10 (1997). The rule of reason is "the accepted standard" for testing whether a practice unreasonably restrains trade in

violation of § 1. *Leegin*, 551 U.S. at 885. The Supreme Court recently cautioned that "abandonment of the 'rule of reason' in favor of presumptive rules (or a 'quick look approach' approach) is appropriate only where 'an observer with even a rudimentary understanding of economics could conclude that the arrangement in question would have an anticompetitive effect on customers and markets.'" *Actavis*, 133 S. Ct. at 2237 (quoting *California Dental Assn. v. FTC*, 526 U.S. 756, 770 (1999). The district court erred in assessing Apple's conduct under a *per se* standard; given the substantial procompetitive effects identified by Apple, the court's abandonment of the rule of reason was unwarranted.

The Supreme Court has made clear that *per se* treatment should be applied with great caution and only in the few cases where sufficient experience has shown that the conduct "always or almost always tend[s] to restrict competition and decrease output." *Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.*, 472 U.S. 284, 289-90 (1985). The reason for this clear. When the *per se* rule is applied to an agreement, a claimant need not prove: that the relevant market exists; that the accused parties have market power; that the accused parties' purpose is anticompetitive; or that the agreement has actual anticompetitive effects. Equally important, particularly in the complex context of the agreements at issue in this appeal, the defendants may not offer any explanation of the rationale for

entering into the challenged agreement. The agreement is *presumed* to be illegal with limited inquiry into the exact type of harm caused. *Id.* at 289.

The *per se* rule should thus only be invoked when its application would generate a low risk of error—*i.e.*, to circumstances in which the courts have consistently found unambiguously anticompetitive conduct after applying the rule of reason to nearly identical conduct in prior cases:

> The object is to see whether the experience of the market has been so clear, or necessarily will be, that a confident conclusion about the principal tendency of a restriction will follow from a quick (or at least quicker) look, in place of a more sedulous one. And of course, what we see may vary over time, if rule-of-reason analyses in case after case reach identical conclusions.

California Dental, 526 U.S. at 780-81.

The limited number of restraints that are deemed *per se* unlawful include horizontal agreements among competitors to fix prices, *Texaco*, 547 U.S. at 5; horizontal agreements to divide markets, *Leegin*, 551 U.S. at 886; and certain concerted refusals to deal or group boycotts. *Anderson News, L.L.C. v. American Media, Inc.*, 680 F.3d 162, 183 (2d Cir. 2012). The Supreme Court has explicitly cautioned, however, against efforts to "pigeonhole" a case into one of the *per se* categories when the facts of the case do not easily fit into a classic *per se* pattern. *FTC v. Indiana Federation of Dentists*, 476 U.S. 447, 458 (1986). The district

court sought to pigeonhole this case into the horizontal price-fixing category, a category into which its facts simply do not fit.

The district court found that Apple and the five publisher Defendants agreed to act in concert to force Amazon to switch to an agency model. WLF concurs with Apple that there is insufficient evidence to conclude that it ever harbored such an intent. But even if Apple did agree to help with forcing a switch, that agreement cannot be classified as a horizontal price-fixing conspiracy. First, the alleged agreement was not "horizontal," a term that refers to agreements among competitors at the same level of the market structure. The publishers were at a higher level of the market structure than was Apple. It is entirely possible, of course, that an agreement regarding pricing among firms at different market levels will have significant anticompetitive effects; but the Supreme Court has nonetheless declined to permit such agreements to be relabeled as "horizontal" agreements in order to pigeonhole them into a *per se* category. *Bus. Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 730 (1988).

More importantly, the agreement cannot properly be characterized as "price fixing" because a switch from the wholesale model to the agency model is price indifferent. While the switch removed an obstacle—created by Amazon's monopoly position—to the publishers' abilities to make independent pricing

decisions, it did not constitute an agreement that retail prices would, in fact, be raised. An agreement to act in concert to force retailers to switch to an agency model is one whose economic effects has rarely, if ever, been considered in antitrust litigation; accordingly, whether the agreement violated § 1 should have been addressed by the district court under the rule of reason.

The evidence is overwhelming that once the major retailers had agreed to an agency model, the publishers foresaw no need to conspire in order to raise prices. The only obstacle they foresaw to independent price increases was Apple's insistence on price caps, and for that reason several of the publishers entered into protracted negotiations with Apple in an effort to persuade Apple to raise the caps. 952 F. Supp. 2d at 667-70. As the district court conceded, the caps were set at levels "below the prices [the publishers] would have preferred," *id.* at 670, thereby recognizing that competitive pressure alone would not have been sufficient to hold down prices in the absence of the caps.

That the publishers could independently exercise substantial pricing power is hardly surprising, given the nature of the book publishing business. Copyright law grants each publisher the exclusive right to sell its own collection of books. Many readers are only interested in purchasing a specific title and will pay any reasonable price established by the publisher. Given that e-books sell at a

substantial discount to their hardcover counterparts, it was entirely reasonable for each publisher to anticipate that many of its new releases could be priced at several dollars above $9.99 without substantially reducing their volume sales.

The district court held that Apple knew "full well" that the publisher Defendants each intended to raise e-book prices if they succeeded in pushing Amazon to switch to an agency model, *id.* at 692, but there is no evidence that Apple either intended or desired a price increase. Mere knowledge that others with whom one has entered into an agreement intend to act independently to raise prices is not the same as a price-fixing conspiracy, even if the agreement facilitates those independent actions. Whether such an agreement constitutes an unreasonable restraint of trade must be analyzed under the rule of reason.

II. THE DISTRICT COURT'S CURSORY RULE-OF-REASON ANALYSIS FAILED TO CONSIDER THE SUBSTANTIAL PROCOMPETITIVE BENEFITS DERIVED FROM APPLE'S ENTRY INTO THE E-BOOK MARKET

Under the rule of reason, "the factfinder weighs all the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition." *GTE Sylvania*, 433 U.S. at 49. The rule is designed to distinguish "between restraints with anticompetitive effect that are harmful to the consumer and restraints stimulating competition that are in the

consumer's best interest." *Leegin*, 551 U.S. at 886.

The district court purported to undertake a rule-of-reason analysis as an alternative basis for its liability finding. 952 F. Supp. 2d at 694. But that cursory, one-paragraph discussion of the rule of reason was not a careful "weigh[ing of] all the circumstances" of the sort mandated by *GTE Sylvania*. The court was able to assert that "Apple has not shown that the execution of the Agreements had any procompetitive effects" only by ignoring the numerous procompetitive effects that flowed from Apple's entry into the market. The court asserted that Apple's market entry should not be counted as a "procompetitive effect" because it was "independent of the Agreement." *Id.* To the contrary, the evidence demonstrated (and the district court conceded, *id.* at 647) that Apple was unwilling to enter the e-book market without assurances of likely profitability; and Apple had determined that the terms contained in its Agreements with the publishers—an agency model, MFNs, and price caps—were essential to providing such assurances.

An important factor in any rule-of-reason analysis is whether the challenged agreement caused prices to increase. Yet, Plaintiffs introduced absolutely *no evidence* on how market prices would have reacted had Apple not entered the market. The district court concluded that the agreement permitted the five publisher Defendants to raise retail prices on many of their new releases, but as

Apple demonstrates, Apple Br. at 57, a plaintiff cannot demonstrate an adverse effect on market-wide competition by focusing on only a subset of publishers or retailers. The only evidence on this issue was the testimony proffered by Apple from one of its experts, Dr. Michelle Burtis. She concluded that the *decrease* in the average price of e-books in the period following Apple's entry into the market (a fact conceded by the district court) was at least partially attributable to Apple's entry. *Id.* at 59. Plaintiffs provided no contrary analysis.

The district court noted the possibility that Amazon's below-variable-cost pricing might have violated antitrust laws. 952 F. Supp. 2d at 708. But it deemed that possibility irrelevant to this case, stating, "Another company's alleged violation of antitrust laws is not an excuse for engaging in your own violations of law. Nor is suspicion that that may be occurring a defense to the claims litigated at this trial." *Id.* But that rejoinder begs the question of whether Apple was violating antitrust laws. Answering that question requires an analysis of the effects the Agreements had upon competition. And one highly procompetitive aspect of the Agreements was the elimination of dysfunction in the retail e-book market created by below-cost pricing practiced by a company with a 90% market share. One need not conclude that Amazon was engaged in illegal predatory pricing to realize that competition was not well served by market conditions that existed prior to Apple's

entry.

Among other things, Apple's entry and the elimination of below-cost pricing brought an end to the threat of windowing. Windowing—a policy invoked throughout 2009 and whose frequency was likely to increase the longer that $9.99 pricing remained in effect—regularly deprived readers of all electronic access to books for extended periods.

In sum, the district court's abbreviated rule-of-reason analysis was woefully inadequate to justify her conclusion that Apple violated the Sherman Act.

III. THE DISTRICT COURT ERRED IN CONCLUDING THAT APPLE AGREED TO ASSIST THE PUBLISHERS IN THEIR EFFORTS TO FORCE AMAZON TO ADOPT AN AGENCY MODEL

The Agreements signed by Apple with the five publisher defendants say nothing about whether other retailers would remain on the wholesale model. The district court nonetheless concluded that Apple entered into those Agreements for the purpose and with the intent of assisting the publishers in their efforts to force Amazon to adopt an agency model. WLF agrees with Apple that the district court failed to heed the Supreme Court's cautions against concluding that a party has entered into a § 1conspiracy when there exist alternate explanations that are equally plausible. *See, e.g.*, *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752 (1984).

WLF writes separately to explain why the district court's conspiracy finding is not even plausible. Even if one assumes that Apple was fully aware that the publishers wished to switch their relationship with Amazon to an agency model, there is no credible evidence that Apple did anything to further that goal other than entering the e-book market.

The district court conceded that Apple had valid business reasons for each of the terms contained in its Agreements with the publishers; in particular, it conceded that the MFNs protected Apple by permitting it to lower prices to meet the competition. *Id.* at 701. The court nonetheless singled out the MFNs as demonstrating that "Apple shared [the publishers'] goal of raising e-book prices, and helped them to realize that goal." *Id.* at 692. It viewed the MFNs as the device that triggered the collective challenge to Amazon's wholesale model: "Apple fully understood and intended that the MFN would lead the Publisher Defendants inexorably to demand that Amazon switch to an agency relationship with each of them." *Id.* That assertion finds no support in the evidence and was based on an apparent misunderstanding of the nature of MFN clauses.

First, the district court's conclusion that the MFNs were the tipping point that "forced" the publisher defendants to take action against Amazon makes no sense as a matter of economics. Its reasoning was as follows. Amazon purchased

e-books from publishers at the wholesale price (generally, about $12.50). If Amazon continued selling new releases at $9.99 following Apple's entry into the market, then the MFNs would require those same books to also be priced at $9.99 on Apple's iBookstore. In that event, the publishers would receive only $6.99 (70% of $9.99) for each book sold by Apple, considerably less than the $12.50 it had been receiving for each book sold by Amazon. Thus, the district court concluded, the MFN clauses gave the publishers a strong incentive to push Amazon to convert to the agency model so that they could avoid the losses described above. *Id.* at 665 (concluding that the MFNs "literally stiffened the spines of the Publisher Defendants to ensure that they would demand new terms from Amazon"). Based on that economic analysis, the district court concluded that Apple included the MFNs for the purpose of ensuring that the publishers pushed Amazon to adopt an agency model. *Id.* at 692.

That conclusion is faulty because the underlying economic analysis is faulty. The evidence demonstrated that pushing Amazon to switch to an agency model inevitably would lead to a *reduction* in short-term revenues for the publishers; whatever additional revenues would be gained from Apple sales would be greatly exceeded by the reduction in revenue from Amazon. Under an agency model, the publishers would receive only 70% of Amazon's retail price; thus, a $12.99 retail

price would generate only $9.09 in revenue, far less than the $12.50 wholesale price typically paid by Amazon. Those losses were substantially greater than the increased revenues that the publishers could hope to generate if (due to Amazon's switch to an agency model) new releases were retailed by Apple for $12.99 instead of $9.99.[4] Thus, if (as the district court suggested) the publishers were principally motivated by a desire to avoid short-term revenue losses, they would have been reluctant to push Amazon to an agency model, with or without an MFN clause in the Apple contracts. So much for the district court's economic rationale for the MFNs; Apple simply had no reason to believe that inclusion of MFNs in the Agreements would "force" the publishers to push Amazon into an agency model,

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[4] This analysis is set forth in the testimony Prof. Benjamin Klein, one of Apple's experts. Plaintiffs did not dispute his conclusions that switching Amazon to the agency model inevitably would lead to a substantial net loss in revenue to the publishers. Klein explained that each Apple sale at $12.99 instead of $9.99 generated a net revenue increase of $2.10 (after deducting Apple's 30% commission). Klein Decl. at 8. Each Amazon sale at $12.99 generated $9.09 in net revenue for the publishers; that was a decrease of $3.41 ($12.50 - $9.09) in revenues for each Amazon book sold following a switch from the wholesale model to the agency model. *Id.* at 9. Because substantially more e-books were sold on Amazon than on Apple in 2010, the revenue losses on Amazon sales following the switch to the agency model dwarfed the revenue gains on Apple sales. *Id.* Prof. Klein also concluded that the MFNs could have had only an insignificant effect on the publishers' revenues; he concluded that if a publisher had failed to convince Amazon to switch to an agency model following Apple's entry into the market, the additional cost to the publisher created by the MFNs would have been less than 1% of e-book sales. *Id.* at 7. Again, Plaintiffs do not dispute the analysis.

nor would it even strengthen their pre-existing desire to do so.

Moreover, the district court failed to explain why Apple would have wanted the publishers to switch Amazon to an agency model. The publishers' motivation in pushing for a switch was clear: their ability to raise retail prices independently would be unimpeded if Amazon switched to an agency model, and they clearly desired to raise prices. Yet, the district court conceded, "The record is equivocal on whether Apple itself desired higher e-book prices than those offered on Amazon." *Id.* at 706 n.68. Apple had little to gain from a retail price increase and thus little to gain from pushing Amazon into adopting an agency model. Apple's chief interest was in having reasonable assurances that it could compete profitably against Amazon. The MFNs provided Apple with the necessary assurance by guaranteeing Apple the right to match Amazon's prices. It was assured of a 30% gross profit on every sale, without regard to whether Amazon was forced to relinquish its monopoly control over pricing.

There is at least one other reason why it makes little sense to conclude that Apple was part of a conspiracy to force Amazon to adopt an agency model: if the publishers were determined to act collectively against Amazon, they had no need of any assistance from Apple other than Apple's agreement to enter the e-book market. Apple's entry allowed publishers to be more aggressive in their

negotiations with Amazon because they knew that they would always have viable alternative outlets for their e-book sales if negotiations with Amazon broke down. The district court may well have been correct that fear of retaliation prevented a single publisher from challenging Amazon's wholesale pricing model on its own. The publishers nonetheless possessed both the motivation and the *collective* strength to challenge Amazon, and they did not need Apple's assistance to do so. As the district court recognized, the publisher Defendants were livid about Amazon's below-cost retail pricing and had previously resorted to collective action in their efforts to fight it. *Id.* at 647. Once Apple entered the market, their collective action against Amazon's wholesale model was inevitable, with or without inclusion of the MFNs in the Agreements. Apple knew of the publishers' desire to force Amazon to switch to an agency model, but mere knowledge that its entry into the market would trigger action against Amazon is not evidence that Apple conspired in that action.

The MFNs were procompetitive; they facilitated the entrance into the e-book market of a major competitor to Amazon. MFNs are used in a wide variety of industries for precisely the reason Apple insisted on them: to assure buyers that they will not be offered less favorable terms than their competitors. *See, e.g.*, Martha Samuelson, *et. al, Assessing the Effects of Most-Favored Nation Clauses*,

ABA Section of Antitrust Law Spring Mtg. 2012 (March 28, 2012) (available at http://www.analysisgroup.com/uploadedFiles/Publishing/Articles/Samuelson_MFN_SpringABA_2012.pdf). By singling out the MFNs as the linchpin of a § 1 conspiracy and condemning them as a *per se* antitrust violation, the district court has called into question the legality of such provisions and thereby has chilled a significant amount of pro-competitive behavior.

In sum, nothing in the Agreements—and certainly not the MFNs—provide any support for the district court's conclusion that Apple agreed to assist the publishers in their collective efforts to force Amazon to adopt an agency model.

CONCLUSION

The Washington Legal Foundation respectfully requests that the Court reverse the judgment of the district court.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

Pursuant to Fed.R.App.P. 32(a)(7)(C), I hereby certify that the foregoing brief of WLF is in 14-point proportionately spaced Times New Roman type. According to the word processing system used to prepare this brief (WordPerfect X5), the word count of the brief is 6,669 words, not including the corporate disclosure statement, table of contents, table of authorities, certificate of service, and this certificate of compliance.

/s/ Richard A. Samp
Richard A. Samp

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 14th day of March, 2014, I electronically filed the brief of *amicus curiae* Washington Legal Foundation with the Clerk of the Court for the U.S. Court of Appeals for the Second Circuit by using the appellate CM/ECF system. I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

/s/ Richard A. Samp
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