US Department of Justice v. Apple Inc.

United States District Court for the Southern District of New York, 10 July 2013

In a civil antitrust suit, the district court ruled that Apple had conspired with five book publishers to increase the price of e-books for consumers, in a case that sees vertical pricing conduct subject to the *per se* rule.

On 10 July 2013, a United States District Court for the Southern District of New York found Apple liable for price-fixing e-books in the United States. The district court must now rule on the appropriate scope of an injunction sought by the Department of Justice. This article will explore the background of the e-book market, the legal allegations, the applicable antitrust laws, the district court's findings and its aftermath.

Background on the US e-book market

E-books are electronically formatted versions of printed books, designed to be read on an electronic device. It was not until 2004 when Phillips, Sony and E-Link collaborated on Sony's LIBRIé that e-readers became commercially viable. Refinements in Sony's e-reader products and the eventual release of competitive products, like Amazon's Kindle in 2007, Kindle 2 in 2009, and Barnes & Noble's Nook in 2009, sharply increased consumer demand for electronic content.

Prior to Apple's entry into the e-book market in the US, book publishers used a traditional 'wholesale model' of retailing e-books, whereby book publishers sold e-books (as well as hard cover and paperback books) to retailers at wholesale prices. Retailers would, in turn, sell e-books to consumers at retail prices. Because book publishers transferred title and risk of loss to the retailers, the retailers legally 'owned' the e-books and were thus free to set retail prices to consumers. Amazon, by far the largest online e-book retailer in the US, began to severely discount retail prices of e-books, setting retail prices far below wholesale prices. Amazon's strategy was obvious: lowering the price of e-books fostered greater demand for its highly profitable Kindle products. The book publishers, however, were unhappy with the declining retail prices of e-books and tried unsuccessfully to encourage Amazon to raise its below-cost pricing. Enter Apple.

Apple considered entering the e-book market through its new online bookstore called iBooks that was to be offered in conjunction with the launch of Apple's iPad in January of 2010. As a new entrant, Apple intended to transform the consumer's e-reading experience through product innovations, including changes to e-reading software, enabling consumer self-publication, colour viewing, audio and video capabilities, and significantly expanding the e-book market through its extensive distribution network. Apple, however, took a dim view of the wholesale model and in its place proposed to the book publishers an alternative 'agency model.' Under the agency model, book publishers would retain title and risk of loss to all e-books (i.e., the book publishers retained legal ownership of the e-books) and Apple would sell the e-books as their agent. Under the agency model, the book publishers, not Apple, would set retail prices and pay Apple a 30% agency commission. In its agency contracts, Apple required a retail most-favoured-nation provision ensuring that Apple could match the lowest retail price listed on any competitor's e-bookstore. Apple eventually entered into separate agency agreements with some, but not all, e-book book publishers. During this same period, some e-book publishers also entered into similar agency agreements with Amazon. After Apple's entry into the e-book market, the e-book publishers raised prices of their e-books. Enter the Department of Justice.

The lawsuit

On 11 April 2012, a civil antitrust lawsuit was filed by the Antitrust Division of the United States Department of Justice on behalf of the United States (the 'Department of Justice'), and separately by 33 US states and US territories (the 'States') (collectively, the 'Plaintiffs') against Apple and five e-book publishers: Hachette Book Group, Inc.; HarperCollins Publishers L.L.C.; Hotzbrinck Publishers LLC d/b/a Macmillan and Verlagsgruppe Georg von Holzbrinck GmbH; Penguin Group (USA), Inc.; and Simon & Schuster, Inc. (the 'Defendant Book Publishers') alleging a violation of Section 1 of the Sherman Antitrust Act, 15 U.S.C. §1 (the 'Sherman Act') and, as to the States, various corresponding state antitrust statutes. The Plaintiffs' central allegation in the lawsuit was that Apple and the Defendant Book Publishers entered into a horizontal conspiracy to raise e-book retail prices to consumers, a *per se* violation of Section 1 of the Sherman Act. Prior to trial, the Plaintiffs resolved their claims against the Defendant Book Publishers, leaving Apple as the sole defendant at trial.

The applicable antitrust laws

Section 1 of the Sherman Act makes unlawful '[e]very contract, combination..., or conspiracy, in restraint of trade or commerce among the several states.' 15 U.S.C. §1. Despite its broadly expressed language, the Sherman Act prohibits only 'unreasonable' restraints of interstate commerce. What distinguishes 'reasonable' from 'unreasonable' has kept the courts, the government, and the private bar busy since the Sherman Act was enacted in 1890. Historically, the primary standard by which restraints were judged 'unreasonable' was through the 'rule of reason' analysis, which

requires the finder of fact to decide whether the restraint, on balance, imposes an unreasonable restraint on competition. The factors to be considered include the nature of the industry, the participants, the history and nature of the restraint, and the competitive conditions before and after the imposition of the restraint. See Standard Oil Co. v. US, 221 US 1 (1911); Board of Trade of Chicago v. US, 246 U.S. 231 (1918).

Over time, the Supreme Court learned through experience that certain classes of restraints were so 'plainly anticompetitive,' so 'manifestly anticompetitive' that they 'always or almost always' produced adverse effects on competition. Thus, the Supreme Court could comfortably predict actual harm to competition without the need for a full-blown factual investigation into actual market effects demanded by the rule of reason. These classes of restraints were referred to as presumptively unreasonable or *per se* unreasonable. Price-fixing agreements were one class of *per se* restraints. During this era, there was no legal distinction between the horizontal or vertical nature of the restraint. See Dr. Miles Medical Co. v. Park & Sons Co., 220 US 373 (1911) (vertical minimum price agreements); US v. Trenton Potteries Co., 273 US 392 (1927) (horizontal minimum price agreements); Interstate Circuit, Inc. v. US, 306 US 208 (1939) (horizontal and vertical minimum price agreements); US v. Socony-Vacuum Oil. Co., 310 US 150 (1940) (horizontal minimum price agreements); and Albrecht v. Herald Co, 390 US 145 (1968) (vertical maximum price agreements).

Beginning with White Motor Co. v. US, 372 U.S. 253 (1963), the Supreme Court chipped away at long-standing *per se* rules as to vertical restraints. White Motors held that vertical territorial (non-price) restraints were to be judged under the rule of reason while horizontal territorial (non-price) restraints would continue to be judged under the *per se* rule. Following White Motors, the Supreme Court later made clear that all vertical non-price restraints were to be judged under the rule of reason. See Continental T.V., Inc. v. GTE Sylvania, Inc., 433 US 36 (1977) (overruling US v. Arnold, Schwinn & Co., 388 U.S. 365 (1967)). GTE Sylvania laid out the economic basis for the distinction between horizontal and vertical restraints: while horizontal restraints reduced inter-brand competition, vertical restraints constrained only intra-brand competition and often promoted inter-brand competition through product distribution efficiencies and innovation, producing pro-competitive effects on competition. Following the rationale of White Motor and GTE Sylvania, and going the final step, the Supreme Court made clear that the *per se* rule would no longer apply to vertical price restraints either. See State Oil v. Kahn, 522 US 3 (1997) (overruling Albrecht and requiring the rule of reason to apply to maximum vertical price restraints); Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007) (overruling Dr. Miles and requiring the rule of reason apply to minimum vertical price restraints). Thus after Leegin, all vertical restraints, price and non-price alike, were to be judged under the rule of reason.

What is clear by examining the methodical erosion of the *per se* rule as to vertical restraints was that very real, pro-competitive effects exist by imposing vertical price and non-price restraints on competition: (1) increasing inter-brand competition; (2) preventing 'free riding' by firms with lower cost structures; (3) increasing customer service competition; (4) providing alternatives to service contacts; and (5) increasing market entry by new firms and alternative brands.

While the Supreme Court was very clear that horizontal price restraints were to be judged under the *per se* rule and vertical price and non-price restraints were to be judged under the rule of reason, which standard would apply in a mixed horizontal-vertical restraint case? The answer was suggested in Leegin. The majority's opinion, *in dictum*, recognised the possibility that some restraints could involve a mix of both vertical and horizontal actors, but made clear that the vertical actor still be judged under the rule of reason.

'A horizontal cartel among competing manufacturers or competing retailers that decreases output or reduces competition in order to increase price is, and ought to be, *per se* unlawful. [Citations omitted]. To the extent a vertical agreement setting minimum resale prices is entered upon to facilitate either type of cartel, it, too, would need to be held unlawful under the rule of reason. This type of agreement may also be useful evidence for a plaintiff attempting to prove the existence of a horizontal cartel.'

Leegin, 551 US at 893. Thus, as Leegin suggested, even in the presence of both vertical and horizontal actors, the vertical conduct should be judged independently under the rule of reason.

The trial

The Defendant Book Publishers were clearly horizontally related to one another. Apple, however, as a retailer, was vertically related to each of them. Considering the Supreme Court's bright line

distinction between horizontal and vertical restraints, one would have thought that the Defendant Book Publishers' conduct would have been examined under the *per se* rule, while Apple's vertical conduct would have been judged independently under the rule of reason. That should have been so despite the fact that the restraint at issue was admittedly a horizontal-vertical mix. Not so fast.

The district court took a different view and adopted Department of Justice's strategy that as long as the Plaintiffs first proved the existence of a horizontal price-fixing conspiracy between the Defendant Book Publishers, Apple's vertical conduct could constitute a *per se* violation if the Plaintiffs also proved Apple's knowing participation in that conspiracy. In essence, once the horizontal conspiracy was proved, a vertical actor could be drawn into the *per se* rule if that actor knowingly entered or facilitated that conspiracy. The process advanced by the Department of Justice and employed by the district court appeared consistent with the Supreme Court's prior decision in Interstate Circuit and the US Court of Appeals for the Seventh Circuit's more recent decision in Toys 'R' Us, Inc. v. FTC, 221 F.3d 928 (7th Cir. 2000), two cases which had both vertical and horizontal actors participating in a restraint.

However, properly put in their historical contexts, they have limited value here. Interstate Circuit was decided in 1939, some 68 years before Leegin during an era when the *per se* rule captured both horizontal and vertical actors equally in price restraints. In fact, in examining the Interstate Circuit's decision, part of its rationale to find vertical liability in a mixed horizontal-vertical restraint was based on Dr. Miles: 'The consequence of the price restriction, though more oppressive, is comparable with the effect of resale price maintenance agreements, which have been held to be unreasonable restraints in violation of the Sherman Act.' Interstate Circuits, 306 US at 232 (citing Dr. Miles). Of course, Dr. Miles was expressly overruled by Leegin. The same type of problem infects Toys 'R' Us as it was decided in 2000, well before Leegin, and relied heavily on Interstate Circuit for its rationale. Toys 'R' Us, 221 F.3d at 934-35. At the end of the day, Interstate Circuit and Toys 'R' Us are out of place in a post-Leegin world. Apple's vertical conduct should have been independently judged under the rule of reason which would have taken into consideration: (1) Apple was vertically related to the Defendant Book Publishers; (2) Apple was a new entrant to the e-book market; (3) Apple had little or no market share in e-book retailing; (4) Apple intended to introduce new, innovative software products meant to enhance e-readership; and (5) Apple's entry into the e-book market would facilitate market entry for new entrants and products. The rule of reason would also have permitted Apple the opportunity to introduce evidence at trial that the price and non-price restraints at issue were, on balance, pro-competitive.

Because the district court treated Apple as a horizontal actor under the *per se* standard, it did not permit Apple the full and fair opportunity to put forth all of its evidence that would have been plainly relevant and admissible under the rule of reason approach. Ultimately, the district court found that the Defendant Book Publishers entered into a horizontal price-fixing conspiracy to increase prices for e-books and that Apple had knowingly participated in that conspiracy in violation of Section 1 of the Sherman Act.

Injunctive relief and appeal

The district court must now determine the appropriate injunctive remedy to prevent recurrence of the anticompetitive harm. Apple maintains its opposition to any injunction and strongly opposes the government's over-reaching into its business decisions thereby stifling its ability to compete in the e-book market going forward. Recently, each side has filed competing proposed orders, briefs in support, and letters to the district court articulating terms of the injunction within the parameters set forth by the district court. It is expected that the district court will hold a hearing on the injunction and then enter a written order in the near future. Apple has vowed to appeal the district court's final order to the US Court of Appeals for the Second Circuit (sitting in New York, NY). It would not be surprising to see an eventual appeal to the US Supreme Court, no matter who prevails in the Second Circuit.

Immediate implications

US v. Apple, Inc. opens a door once thought closed under Leegin: vertical pricing conduct can be subject to the *per se* rule. As such, actors in vertical relationships may be subject to more stringent antitrust treatment than had been considered after Leegin. While this case will surely wind its way up through the appellate courts, the outcome is uncertain. In the meantime, vertical actors should take pause and perhaps re-examine their vertical relationships.

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