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## The E-Books Price Fixing Litigation: Curious Outlier or Harbinger of Change in Antitrust Enforcement Policy?

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# The E-Books Price Fixing Litigation: Curious Outlier or Harbinger of Change in Antitrust Enforcement Policy?

by EVAN D. BREWER\*

Note: After this paper was written, the case against Apple was tried to bench in the United States District Court for the Southern District of New York. On July 10, 2013, Judge Denise Cote found Apple had committed a per se Sherman Act violation by conspiring with the publishers to eliminate retail price competition and to raise e-book prices.<sup>†</sup> The discussion here, based in part on the Government’s allegations against Apple in the complaint, echoes much of Judge Cote’s analysis. It remains unknown, however, why the government chose to pursue a civil action, and what its choice means for antitrust enforcement policy going forward.

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† Opinion & Order, *United States v. Apple, et al.*, No. 12 CV 2826 DLC, 2013 WL 3454986 (S.D.N.Y. July 10, 2013). In September 2013, final judgment was entered against Apple, and part of the remedy included an injunction prohibiting Apple’s use MFN clauses in conjunction with the agency model. Plaintiff United States’ Final Judgment and Plaintiff States’ Order Entering Permanent Injunction, *United States v. Apple, Inc.*, No. 12 CV 2826, 2013 WL 4774755 (S.D.N.Y. Sept. 5, 2013). *See infra* Part II.

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## I. Introduction

In 2012 the Department of Justice (“DOJ”) brought suit against Apple and five major US publishing houses for conspiring to fix the price of e-books.<sup>1</sup> The suit named five of the six largest publishers in the United States: HarperCollins, Hachette, Macmillan, Penguin, and Simon & Schuster.<sup>2</sup>

The complaint contained many detailed factual allegations, including the sort of high-level executive collusion commonly seen in criminal price fixing cases.<sup>3</sup> The charged conduct, horizontal price fixing, is per se illegal under the Sherman Act and among the “hardcore” violations that under Antitrust Division policy merit

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1. Complaint, *United States v. Apple, et al.*, No. 12 CV 2826, 2012 WL 1193205 (S.D.N.Y. Apr. 11, 2012) [hereinafter Complaint].

2. *In re Elec. Books Antitrust Litig.*, 859 F. Supp. 2d 671, 674 (S.D.N.Y. 2012). Random House, also one of the six largest publishers, was not named. *Id.* at 1, n.1.

3. A recent example is the AU Optronics LCD price fixing litigation. See Superseding Indictment, *United States v. AU Optronics Corp.*, No. CR-09-0110, 2010 WL 5641429 (N.D. Cal. June 10, 2010).

criminal charges.<sup>4</sup> Yet the government brought a civil case against Apple and the publishers. Exactly why the Division chose to pursue the matter as a civil rather than criminal case may never be totally clear: the decision was made at a high level and the specific details of such decision making are not made available to the public.<sup>5</sup> But analysis of the details of the Division's case, viewed in light of current antitrust law, antitrust policy, and public perception of the players and the case, suggests a number of possible explanations for the choice of a civil action.

The decision may reflect a shift in DOJ or Antitrust Division policy concerning the criminality of per se antitrust violations. Or it may augur a change in department policy regarding discretion to file civil versus criminal suits depending on the strength of the case. Another possibility is a change in the DOJ's opinion about the application of per se and rule of reason modes of analysis to horizontal price fixing. Finally, and most likely, I believe, the decision could have been motivated by the particular facts of the case. The government may have judged the departure from policy justified by prudential reasons, including public perception of antitrust enforcement, questions about the deterrence efficacy of criminal sanctions, and concerns about over enforcement in dynamic, high-tech sectors. If this is correct, it is possible the decision simply be an aberration, a one-time departure from enforcement policy, or a harbinger of a more flexible enforcement policy.

On the one hand, because there seem to have been no other indications of a broader shift, it seems likeliest this case is simply an outlier. On the other, the facts of this case illustrate many good reasons for such a shift in policy. Regardless, opacity in decision-making endangers both deterrence efforts and public confidence in antitrust enforcement agencies. Thus whether this is simply a one-off oddity or reflects a farther-reaching change, antitrust enforcement and those affected by it would all be well served by more transparency concerning antitrust prosecution decisions.

This paper begins with a discussion of the background of the case. Part I describes the rise of e-books over the past several years; Part II lays out the alleged conspiracy and the details behind the Agency Agreements signed between Apple and the defendant

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4. See Donald I. Baker, *To Indict or Not to Indict: Prosecutorial Discretion in Sherman Act Enforcement*, 63 CORNELL L. REV. 405 (1977).

5. Final decisions are made by the Assistant Attorney General in consultation with senior officials in the Antitrust Division following an extensive analytical process. *Id.* at 408 n.21.

publishers; Part III the industry's rapid shift from wholesale to agency e-book distribution. In Part IV I discuss the deterrence rationale for criminal sanctions. Part V details application of and recent developments in the antitrust modes of analysis, the per se rule and the rule of reason, and how the alleged conspiracy fits in. It also discusses the government's proposed definition of the relevant market. Part VI examines strategic considerations that likely weighed on the Division's decision to bring a civil case. And Part VII puts it all together and reviews possible explanations. The final section concludes.

## II. Background

### A. The Rise of E-Books

E-books have proven a disruptive force in the publishing industry.<sup>6</sup> Production, distribution, and retailing costs are all lower for e-books than for their physical counterparts. So, too, are e-book prices. But how much lower? An entire industry rides on the answer to this question, and the machinations of major companies in tech, retail, and publishing to provide one are at the heart of the government's case.

Though not directly involved in the case, Amazon is central to the dispute. Through its online sales portal and Kindle e-reader, Amazon's aggressive marketing and sales popularized reading on tablets and devices and in large part birthed the e-book industry. Amazon's success hinged on its strategy of selling e-books for \$9.99, particularly newly released and bestselling titles.<sup>7</sup> This price is well below the price of corresponding hardcover editions, and often below the wholesale prices paid to the publishers.<sup>8</sup> For Amazon, this sales model of razor-thin, or in some cases nonexistent, margins powered sales of Kindles and enabled them to capture the nascent e-book

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6. See Complaint at ¶ 2; Letter from Scott Turow: *Grim News*, THE AUTHORS GUILD BLOG (Mar. 9, 2012) (Authors Guild President Scott Turow describing impacts of e-books on the publishing industry), available at <http://www.authorsguild.org/advocacy/letter-from-scott-turow-grim-news/>.

7. Complaint at ¶¶ 2–4.

8. Because it is easier, I refer to the transactions of e-books between the publishers, retailers and consumers as sales, though in reality, like many other electronic goods, e-books are distributed via licenses and sub-licenses. Amazon licenses an e-book from the publisher, and subsequently licenses it to the end user who reads it on their Kindle, or other device.

market. At the point Apple entered the market, nearly 90% of all e-books were sold through Amazon.<sup>9</sup>

Amazon's success, however, was seen by publishers as a major, possibly existential threat. Plummeting prices of e-books, they argued, would give rise to consumer expectations for similarly low prices of print books.<sup>10</sup> Receding margins in the market for print books, and small margins for e-books would combine to imperil the industry. If publishers were unable to recoup investments in book production, the industry would grind to a halt, output falling to a trickle of current day production.<sup>11</sup> This \$9.99 problem—falling prices and consumer expectations of falling prices—lies at the heart of the alleged conspiracy.

Apple entered the scene in 2010 with its launch of the iPad and iBookstore. The publishers saw Apple, an influential and disruptive player in many markets, as a potential ally with whom they might challenge Amazon's influence over retail e-book prices. Their interests were closely aligned: Although Apple was not overly concerned with the publishers' \$9.99 problem, it was uninterested in competing with Amazon on price. Apple did (and does) not need to sell e-books at a loss to generate sales of its iPad, which is more computer than e-reader. Apple makes money off its hardware,<sup>12</sup> whereas Amazon's motivations are more complex. Because it entered the e-book market in its infancy, Amazon was more interested in establishing the market for e-books than turning a profit. Even as the market has matured, Amazon continues to sell Kindles at a loss.<sup>13</sup> Amazon's real motivations lie in selling content, services, and

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9. Turow, *supra* note 6.

10. Brad Stone & Motoko Rich, *With Rival E-Book Readers, It's Amazon v. Apple*, N.Y. TIMES, Jan. 21, 2010, at B1 (reporting that "publishers fear that Amazon has accustomed buyers to unreasonably low prices" and believe "if Kindle were to maintain its dominant position, it could force publishers to lower their wholesale prices.").

11. Publishers finance many if not most major titles in advance. Because author profits from books come after publication, advance payments provide the necessary income smoothing for authors to undertake long writing projects by essentially borrowing against future expected income from the book. See Jim Kukral, *The New Business Model of Book Publishing*, HUFFINGTON POST (Apr. 16, 2012), [http://www.huffingtonpost.com/jim-kukral/ebook-publishing\\_b\\_1428197.html](http://www.huffingtonpost.com/jim-kukral/ebook-publishing_b_1428197.html).

12. Apple's gross profit margin on iPhones is an astounding 60%, and the principal reason Apple is the most valuable company in the world. See Thomas J. Duesterberg, *The Apple Business Model Is Good for U.S. Manufacturing*, HUFFINGTON POST (Nov. 2, 2011), [http://www.huffingtonpost.com/thomas-j-duesterberg/us-manufacturing-apple\\_b\\_1072089.html](http://www.huffingtonpost.com/thomas-j-duesterberg/us-manufacturing-apple_b_1072089.html).

13. Hayley Tsukayama, *Amazon Loses \$3 on Every Kindle Fire*, WASH. POST (Nov. 18, 2011), [http://articles.washingtonpost.com/2011-11-18/business/35282380\\_1\\_kindle-fire-nook-tablet-e-reader](http://articles.washingtonpost.com/2011-11-18/business/35282380_1_kindle-fire-nook-tablet-e-reader).

goods across many categories, and many of its ventures are designed to bring more users to the Amazon brand.<sup>14</sup> Apple wanted to offer e-books, but doing so at prices significantly higher than Amazon would serve them little good, and in fact might turn people off if they saw higher prices as Apple taking advantage of their customers.

The agency model provided a solution to both Apple and the publishers' problems. Apple sought a way to avoid retail price competition with Amazon, and the publishers wanted to take away Amazon's pricing power. As it turned out, Apple proved a powerful ally, with whom the publishers collaborated to break Amazon's stranglehold on the retail e-book market, and introduce competition and a sustainable business model to the industry. Either that, or they illegally colluded to fix the price of, and restrain retail price competition in the market for, e-books.

## **B. The Alleged Conspiracy**

The collusion alleged in the Complaint is a hub-and-spoke conspiracy hatched by Apple and the publishers to solve a collective action problem.<sup>15</sup> This collective action problem stemmed from the fact that the publishers faced monopsony, with Amazon as the only real buyer of e-books.<sup>16</sup> With nowhere else to sell e-books, the publishers sold to Amazon, on Amazon's terms. Although they all wanted to end Amazon's discounting, they could not do so without coordination. Apple's involvement proved instrumental in helping the publishers do just that.

### *1. Collective Action Problems*

To solve the \$9.99 problem, the publishers could have insisted on minimum retail price agreements with Amazon. Such arrangements would avoid antitrust issues because retail price maintenance scrutiny<sup>17</sup> is limited to the sales of goods and does not extend to

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14. See, e.g., Mark W. Johnson, *Amazon's Smart Innovation Strategy*, BUSINESSWEEK (Apr. 12, 2010), [http://www.businessweek.com/innovate/content/apr2010/id20100412\\_520351.htm](http://www.businessweek.com/innovate/content/apr2010/id20100412_520351.htm) (describing Amazon's application of this business strategy across a number of markets).

15. Complaint at ¶¶ 46, 60–84.

16. Amazon's advantage as the popularizer of e-books should not be understated: it allowed them to capture nearly the entire market and made entry by others very difficult without competing on price, something few have been able to do in any market Amazon has entered.

17. Minimum and maximum retail price restrictions, as vertical price fixing agreements, were per se violations of the Sherman Act until 2007, when the Supreme

licensing rights to intellectual property.<sup>18</sup> However, the publishers faced a collective action problem that prevented this solution.

In such a situation, what is best for the group is not best for the individual acting alone, and the optimal group outcome requires cooperation.<sup>19</sup> While the publishers shared a desire for higher minimum prices, each individual publisher was deterred from acting unilaterally by the prospect that the others would not follow. If one publisher renegotiated its contract with Amazon to require higher minimum retail prices, the others would have an incentive to not follow suit—to defect from the optimal group behavior. By not following, publishers would see an increase in their respective shares of the market as consumers switched to their e-books on account of the price differential. Even if most publishers ignored the profit potential of defection and followed the first mover, the more publishers switched, the greater the incentive to defect would be for each remaining publisher.<sup>20</sup> As a result, the optimal outcome for the publishers, higher minimum retail prices, was unlikely to arise without coordination. Or, according to the DOJ, unlawful collusion.

## 2. *Hub-and-Spoke Conspiracy*

Coordinating through Apple to adopt agency distribution proved an effective way of solving the publishers' collective action problem. But because this shift required coordination and resulted in higher prices, the DOJ alleges it amounted to price fixing. According to the Complaint, the conspiracy to fix e-book prices grew out of private meetings among the publishers at various Manhattan restaurants,<sup>21</sup>

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Court held they should instead be subjected to the rule of reason. *Leegin Creative Leather Prods., Inc. v. PSKS Inc.*, 551 U.S. 877, 899 (2007).

18. *United States v. Gen. Elec.*, 272 U.S. 476 (1926); *LucasArts Entm't. Co. v. Humongous Entm't. Co.*, 870 F. Supp. 285, 289 (N.D. Cal. 1993) (“[T]he statutory right of intellectual property owners to forbid entirely sales by licensees necessarily includes the power to restrict the prices at which such licensees may sell licensed material.”). *See also* Herbert Hovenkamp, Mark Janis & Mark Lemley, *INTELLECTUAL PROPERTY AND ANTITRUST*, §24.9 at 24-59 (explaining an implication of *General Electric* is that where “intellectual property owners license their rights by arrangements that contemplate sublicensing,” so “long as no goods are attached to the primary license, the licensor's maintenance of the sublicense price is generally lawful”).

19. *See* Russell Hardin, *Collective Action As an Agreeable n-Prisoner's Dilemma*, 16 *BEHAVIORAL SCIENCE*, 472–81 (1971).

20. Assuming the publishers are right that \$9.99 improperly reflects the cost of an e-book, the market likely would have adjusted prices upward over time, as a result of small changes, as publishers slowly adjusted their pricing arrangements with Amazon, seeking to increase prices without losing market share. Or it would have resulted in exit from the market, as publishers could no longer profitably provide e-books at \$9.99.

21. Complaint at ¶¶ 39–45.

continued under the guise of joint venture discussions,<sup>22</sup> and took final form with the help of Apple as go-between.<sup>23</sup> The end result was a concerted shift from wholesale to agency distribution of e-books. Under the wholesale model, suppliers (publishers) sell products to retailers (Amazon, Apple, etc.), who then set retail prices.<sup>24</sup> The agency model, by contrast, makes retailers agents of their suppliers. As agents they have no pricing power: they sell products at prices set by suppliers and keep a percentage of revenue as commission. Under the wholesale model, Apple would face two undesirable options: price books higher than Amazon or accept low margins.<sup>25</sup> Thus both the publishers and Apple stood to benefit from a move to agency distribution. Apple would get a 30% cut and, standing on equal footing with Amazon, could then bank on its better tablet to drive up its market share. And the publishers would solve their \$9.99 problem by retaining sole pricing power, foreclosing Amazon's destructive discounting.

The collusion between the defendants took the form of a hub-and-spoke conspiracy. Coordination and agreement between publishers formed the rim, and the vertical Apple Agency Agreements they negotiated with Apple formed the spokes. Apple's involvement eliminated the collective action problem facing the competing publishers. With Apple at the center, the publishers could both signal which agency terms they would accept and lock each other into the model, eliminating the risk of defection.<sup>26</sup>

### 3. Agency Agreement Terms: MFNs and Pricing Tiers

Although the Agency Agreements signed between Apple and the publishers specifically governed only individual distribution relationships, they were designed to induce a shift to agency across the entire industry. Two key features accomplished this goal: most-favored-nation ("MFN") clauses and formulaic pricing tiers for newly released and bestselling titles. Together, these terms effectively

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22. Complaint at ¶¶ 46–49.

23. *Id.* at ¶¶ 50–78.

24. Again, because e-books are licensed to retailers for subsequent sub-license, this is not strictly true, as the publishers hypothetically could have determined the retail price. But because of collective action difficulties discussed above, in reality they were unable to do so.

25. In other words, Apple faced retail price competition. Whether the margins would have been sufficiently small (or negative) so as to foreclose entry into the e-book market is a factual question, and one that would be relevant under rule of reason analysis.

26. Complaint at ¶ 61.

required the publishers to adopt agency distribution with not just Apple, but all their retailers, including Amazon.<sup>27</sup>

The Agency Agreements' MFN provisions prohibited publishers from pricing e-books at other retailers lower than at Apple's iBookstore, regardless of whether other retailers were an agent of the publisher or operated under the wholesale model. MFNs arguably restrict retail price competition, and may have the effect of causing price uniformity.<sup>28</sup> But MFN clauses are not per se illegal, and may be reasonable restraints if, for example, they are instituted to correct market failures.<sup>29</sup> MFNs can also help protect market entrants by shielding up-front investments from predatory pricing from competitors.<sup>30</sup>

Pricing tiers in the Agency Agreements linked prices of newly-released and best-selling e-books to their respective hardcover list prices, with ostensible maximum prices between \$12.99 and \$14.99.<sup>31</sup> In effect, however, these price points amounted to actual prices. Whereas before wholesale prices often exceeded Amazon's preferred retail price of \$9.99 (with Amazon taking the loss),<sup>32</sup> now retailer-agents would take a 30% commission on sales, meaning that in order for publishers to maintain even current profit margins, retail prices would have to rise, likely to the maximum price tiers.<sup>33</sup>

### C. Agreements in Action – The Shift From Wholesaling to Agency

In January, 2010, before the Agency Agreements came into effect, Apple launched the iPad and iBookstore.<sup>34</sup> Apple's announced e-book price points were well above Amazon's.<sup>35</sup> When asked why one would buy an e-book from the iBookstore for \$14.99 when the

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27. Complaint at ¶ 76.

28. See, e.g., Letter from Richard Blumenthal, Attorney-General of Connecticut, to Bruce Sewell, Apple's General Counsel (July 29, 2010), available at <http://www.ct.gov/ag/lib/ag/consumers/appleltr080210.pdf>.

29. See *Leegin Creative Leather Products*, 51 U.S. at 877, 879.

30. *Id.* at 913.

31. *Id.* at ¶ 75.

32. *Amazon Pulls Macmillan Titles in First E-book Skirmish*, LATIMES.COM (Jan. 30, 2010), <http://latimesblogs.latimes.com/jacketcopy/2010/01/amazon-pulls-macmillan-titles-in-first-ebook-skirmish.html>.

33. A book which previously carried a wholesale price of \$12 under the agency model would need to retail for over \$17.14 for publishers to receive the same revenue (70% \* \$17.14 = \$12).

34. Brad Stone, *With Its Tablet, Apple Blurs Line Between Devices*, N.Y. TIMES, Jan. 28, 2010, at A1.

35. *Id.*

same title was sold for \$9.99 on Amazon, Steve Jobs responded: “that won’t be the case . . . the prices will be the same.”<sup>36</sup> For Jobs to be right about uniform prices, either prices on the iBookstore would have to end up below what he announced, or prices across the market would have to rise. In either event, Apple would be insulated: nowhere would there be lower prices, and they would always receive a 30% cut. But the new Agency Agreements and Apple’s place at the hub of the conspiracy ensured prices would go up, not down.

While the agreements insulated Apple from risk, they left publishers even more exposed. The Agency Agreements effectively raised the stakes of not acting in concert. If only some publishers signed Agency Agreements with Apple, not only would their \$9.99 problem remain, but as Apple gained a larger share of the market, those who had signed up would see their margins decline even more dramatically. They would be obligated to price books on the iBookstore no higher than offered elsewhere, but would receive less per book: 70% of retail rather than wholesale prices. Before, Amazon took the discounting loss; now, on sales through the iBookstore, the publishers would take the hit, and the loss would be greater.

If all the publishers signed Agency Agreements with Apple, the MFN clauses would provide incentive to adopt the same agency model with Amazon and other retailers. If not, they would all face declining margin problems as Apple’s market share increased. But the same collective action problem remained, as did the risk of defection. With these increased stakes, the publishers badly needed a way to coordinate and police defection. According to the DOJ, Apple proved an able constable, providing assurances the other parties would all sign the same Agency Agreements and thus all face the same risks.<sup>37</sup> Apparently high-level Apple executives passed information between publishers signaling commitment to the plan.<sup>38</sup> And it worked: The publishers signed Agency Agreements with Apple and all subsequently negotiated agency agreements with their other e-book retailers, including Amazon.<sup>39</sup> In the end it took only four months for most of the publishing industry to jettison the

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36. Walt Mossberg, *All Things Digital*, WALL ST. J. (Jan. 28, 2010), [http://m.wsj.net/video/20100128/012810atdmossy/012810atdmossy\\_320k.mp4](http://m.wsj.net/video/20100128/012810atdmossy/012810atdmossy_320k.mp4). In the same clip Jobs can be overheard remarking that “Publishers are actually withholding their books from Amazon, because they’re not happy with it.”

37. Complaint at ¶ 69.

38. *Id.* at ¶¶ 70–74.

39. *Id.* at ¶¶ 74–75, 79.

wholesale model in use for over 100 years in favor of the agency model.<sup>40</sup>

### III. Discussion

The Antitrust Division chooses to pursue criminal and civil enforcement by asking whether the investigated conduct constitutes a “hardcore” violation of antitrust laws. Such conduct, which includes price fixing, market division, and bid rigging, is typically illegal per se under the Sherman Act, and it alone merits criminal prosecution.<sup>41</sup> The strength of the government’s evidence affects only whether a case is brought, not which type: if the conduct merits criminal prosecution, the government files a criminal case; otherwise, enforcement is civil.<sup>42</sup> The Division will not file a civil case against defendants engaged in “hardcore” conduct such as price fixing simply because it cannot meet the criminal burden of proof.<sup>43</sup> If the DOJ does not believe it can win a case, it does not bring it.<sup>44</sup>

Despite this, against Apple and the publishers the DOJ alleged a horizontal price fixing conspiracy—the paradigmatic criminal case—in a civil action. The decision to bring a civil case in these circumstances runs directly contrary to Division policy and practice.

Several key legal and strategic factors undoubtedly influenced DOJ decision-makers, and shed some light on how the Division may view the case and why it chose to bring a civil action. First, there are significant questions about the link between deterrence and criminal sanctions, and reason to believe that criminal penalties may not deter

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40. Complaint at ¶ 79.

41. See Antitrust Division Manual, *Standards for Determining Whether to Proceed by Civil or Criminal Investigation* (Nov. 2012), at page III-12, available at <http://www.justice.gov/atr/public/divisionmanual/chapter3.pdf>; Thomas O. Barnett, Assistant Attorney General, Department of Justice Antitrust Division, *Criminal Enforcement of Antitrust Laws: The U.S. Model* (Sept. 14, 2006) (remarks before the Fordham Competition Law Institute’s Annual Conference on International Antitrust Law and Policy, New York, NY), available at <http://www.justice.gov/atr/public/speeches/218336.pdf>; and Gary R. Spratling, Deputy Assistant Attorney General, Department of Justice Antitrust Division, *Transparency in Enforcement Maximizes Cooperation From Antitrust Offenders* (Oct. 15, 1999) (presented at Fordham University School of Law, New York, NY), available at <http://www.justice.gov/atr/public/speeches/3952.pdf>.

42. Baker, *supra* note 4, at 406 n.6.

43. *Id.*

44. This is the case for any federal prosecutor contemplating criminal prosecution. The DOJ’s Principles of Federal Prosecution state the government should proceed with prosecution where “the admissible evidence will probably be sufficient to obtain and sustain a conviction.” U.S. DEPT’ OF JUSTICE, *United States Attorneys’ Manual*, § 9-27.220.

as well in practice as in theory. Second, the facts of the case, in light of recent developments in the application of the per se rule to both horizontal and vertical price fixing arrangements, raise significant legal questions about whether the per se rule is appropriate for the alleged collusion and what the relevant market for assessing competitive effects should be.

Many strategic considerations likely influenced the decision as well, including the sufficiency of civil remedies, whether this case presents a truly novel question of fact or law, maintenance of public confidence in prosecutorial discretion, assessment of harm to consumers, Apple's central role in the case, Amazon's substantial market power in the market for e-books, and public perception of the defendants.

#### **A. Criminal Antitrust Penalties and Deterrence**

The argument for imposing criminal penalties on individuals involved in antitrust violations is based in large part on deterrence. Standard deterrence theory assumes actors have knowledge of the law and potential consequences of transgression, and make rational self-interested choices, weighing the benefits of breaking the law with the likelihood of detection and the severity of the penalties they would face.<sup>45</sup> To deter companies from engaging in cartel conduct like price fixing, then, an optimal fine should be greater than the gains of fixing prices, increased to compensate for imperfect enforcement.<sup>46</sup> Because detection of offenses like price fixing is difficult, and many transgressors will never be detected, optimal fines likely need to be increased to many times the amount of potential gain.<sup>47</sup> But given the large profit motives involved, the results of such large fines might well lead the offending companies into bankruptcy. Antitrust enforcers face what is known as the "deterrence trap": deterrence-optimal fines would bring hardship on innocent employees and investors.<sup>48</sup>

A solution to this problem is to penalize individual participation in cartels by imposing either civil or criminal sanctions, or both.

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45. More precisely, rational choice theories of deterrence. *See, e.g.*, Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

46. Peter Whelan, *A Principled Argument for Personal Criminal Sanctions as Punishment under EC Cartel Law*, 4 COMP. L. REV. 7 (2007).

47. Wouter P.J. Wils, *Optimal Antitrust Fines: Theory and Practice*, 29 WORLD COMPETITION 183, 194-195 (2006).

48. *See* Christine Parker, *The "Compliance Trap": The Moral Message in Responsive Regulatory Enforcement*, 40 L. & SOC'Y REV. 591 (2006); John C. Coffee Jr., *"No Soul to Damn: No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386 (1981).

Because companies can mitigate fines by compensating employees, fines alone are a weak individual deterrent.<sup>49</sup> Criminal penalties, especially incarceration, however, are less easily mitigated, and should provide stronger disincentive for individual participation in antitrust violations.<sup>50</sup> In addition to the increased severity of criminal sanctions, people may fear the increased investigatory powers that accompany criminal prosecution, and infer more generally a greater financial and time commitment to enforcement of criminal offenses.<sup>51</sup> In fact, enhanced investigatory powers may provide the most potent deterrent effect in light of research showing people are much more responsive to increased likelihood of detection and enforcement than increased severity of punishment.<sup>52</sup>

Over the past two decades, antitrust penalties have significantly strengthened. However, there is significant evidence that despite drastic increases in corporate fines, individual fines, and individual jail terms, more and bigger cartels are being detected.<sup>53</sup> Between the early 1990s and mid-2000s, average corporate fines have increased from \$480,000 to \$44,000,000 and €2,000,000 to €46,000,000, in the United States and European Union, respectively.<sup>54</sup> Similarly, the average jail sentence imposed for antitrust violations in the United States more than doubled from 274 days in the early 1990s to 717 days in 2005-09.<sup>55</sup> Also during this period, the United States and many other countries implemented corporate leniency programs, offering reduced penalties, and, for the first in the door, near immunity, in exchange for cooperation and whistle-blowing.<sup>56</sup> Leniency programs

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49. Donald I. Baker, *The Use of Criminal Law Remedies to Deter and Punish Cartels and Bid-Rigging*, 69 GEO. WASH. L. REV. 693, 705 (2001).

50. Donald Baker, a former head of the Antitrust Division, reports a very senior corporate executive telling him: “as long as you are only talking about money, the company can at the end of the day take care of me . . . but once you begin talking about taking away my liberty, there is nothing that the company can do for me.” *See id.*

51. Caron Beaton-Wells & Christine Parker, *Justifying Criminal Sanctions for Cartel Conduct: A Hard Case*, 1 J. ANTITRUST ENFORCEMENT 198, 207 (2013).

52. *See, e.g.*, John Braithwaite & Toni Makkai, *Testing an Expected Utility Model of Corporate Deterrence*, 25 L. & SOC’Y REV. 7, 8–9 (1991).

53. *See* John M. Connor & C. Gustav Helmers, *Statistics on Modern Private International Cartels, 1990-2005* (Am. Antitrust Inst., Working Paper No. 07-01, 2007), available at <http://ssrn.com/abstract=944039>; Douglas H. Ginsburg & Joshua D. Wright, *Antitrust Sanctions*, 6 COMPETITION POL’Y INT’L 3, 14–15 (2010).

54. Ginsburg & Wright, *supra* note 53, at 4.

55. *Id.* at 12–13, fig.6.

56. Nathan H. Miller, *Strategic Leniency and Cartel Enforcement*, 99 AM. ECON. REV. 750 (2009).

have likely increased cartel detection rates,<sup>57</sup> and combined with drastically increased penalties, should have had the effect of better deterring and reducing antitrust behavior. But the number of international cartels (typically the largest and most harmful to consumers) discovered per year increased from 4 to 6 per year in the early 1990s to 35 per year in the mid-2000s.<sup>58</sup> It is possible that enforcement agencies are simply doing a better job detecting and prosecuting cartels, but it could just as well be the case that cartels are fixing prices more frequently despite the increased penalties. Evidence on recidivism suggests the latter is more likely, and that cartels are currently being under-deterred: The top ten recidivists between 1990 and 2009 have had an average of over 15 judgments, with the worst, BASF, had 26 judgments against in in that period.<sup>59</sup> In the 15-year period 1990-2005, there were 86 companies with three or more judgments, and seven companies averaging one or more per year.<sup>60</sup>

It is possible that enforcement has been too focused on corporate fines, and larger increases in individual penalties would better deter antitrust violations.<sup>61</sup> And the fact that the majority of major cartels have been located outside the United States, where individual criminal penalties are strongest, suggests inconsistent criminal penalties worldwide may explain current cartel under deterrence. But several problems with criminal antitrust penalties have been identified, particularly behavioral biases that render such measures less effective than they appear in theory.

Deterrence theory assumes that businesspeople can identify antitrust behavior and recognize it is a criminal offense, and also assumes that they can accurately estimate the likelihood they will be detected and successfully prosecuted. It is not clear, however, that these are reasonable assumptions. Many cognitive biases have been shown to distort perceptions about the likelihood of detection and sanction, and these biases tend to be magnified when individuals attempt to estimate the risks they themselves face.<sup>62</sup> Empirical

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57. Miller, *supra* note 56, at 760.

58. Connor & Helmers, *supra* note 53, at 37–38.

59. Ginsburg & Wright, *supra* note 53, at 15 fig.7.

60. Connor & Helmers, *supra* note 53, at 23 tbl.E.

61. *See generally* Ginsburg & Wright, *supra* note 53.

62. *See, e.g.*, Paul H. Robinson & John M. Darley, *Does Criminal Law Deter? A Behavioural Science Investigation*, 24 OXFORD J. LEGAL STUD. 173 (2004); John T. Scholz & Neil Pinney, *Duty, Fear, and Tax Compliance: The Heuristic Basis of Citizenship Behavior*, 39 AM. J. POL. SCI. 490 (1995).

evidence for the deterrence effect of criminal enforcement in the United States is limited.<sup>63</sup> And recent evidence from surveys conducted during the implementation of criminal antitrust laws in Australia calls into question several basic assumptions about deterrence.<sup>64</sup>

First, antitrust violations are complex, and businesspeople may not readily recognize behavior that amounts to criminal antitrust violations. Analysis of the Australian surveys revealed that a majority of those surveyed were unable to identify criminal price fixing, and even where they had accurate knowledge of the law and available penalties, one-third still judged it likely that businesspeople would engage in conduct meriting criminal penalties.<sup>65</sup> The United States has a long history of antitrust laws, and people may more readily recognize antitrust conduct than elsewhere. Still, recognizing behavior that violates antitrust laws is bound to be more difficult than, for example, recognizing theft or assault. This is likely to be even more so in cases involving complex arrangements like the e-books agreements, where there is arguably no literal price fixing.

Second, an individual's perception about societal support for laws tends to be strongly correlated with estimation of the chances of detection and punishment, and compliance.<sup>66</sup> That is, if a person thinks society condemns certain behavior and supports laws that punish such behavior, he is more likely to comply with the law, and consider the probability of detection and enforcement to be higher. Likewise if a person himself agrees with the law: in the Australian survey, this was the strongest predictor of perceived likelihood of detection and enforcement—more so than prior knowledge of cartel law and sanctions.<sup>67</sup>

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63. What empirical evidence there is, is weak. *See, e.g.*, Christine Parker, *Criminal Cartel Sanctions and Compliance: The Gap Between Rhetoric and Reality*, in CRIMINALISING CARTELS: CRITICAL STUDIES OF AN INTERNATIONAL REGULATORY MOVEMENT 239 (Caron Beaton-Wells & Ariel Ezrachi eds., Hart Publ'g 2011); Maurice E. Stucke, *Am I a Price Fixer? A Behavioural Economics Analysis of Cartels*, in CRIMINALISING CARTELS: CRITICAL STUDIES OF AN INTERNATIONAL REGULATORY MOVEMENT 263, 267–69 (Caron Beaton-Wells & Ariel Ezrachi eds., Hart Publ'g 2011); Jesse W. Markham Jr., *Does Criminalization of Cartels Work? A Few Lessons from the United States Experience*, 3 NEW J. EUR. CRIM. L. 115 (2012).

64. *See* Beaton-Wells & Parker, *supra* note 51.

65. *Id.* at 210.

66. *See* Harold G. Grasmick & Robert J. Bursik Jr., *Conscience, Significant Other, and Rational Choice: Extending the Deterrence Model*, 24 L. & SOC'Y REV. 837 (1990); Vibeke Lehmann Nielsen & Christine Parker, *To What Extent Do Third Parties Influence Business Compliance?*, 35 J. L. SOC'Y 309 (2008).

67. Beaton-Wells & Parker, *supra* note 50, at 209–210.

Beliefs about the inherent criminality of antitrust violations are also relevant. If “what distinguishes a criminal from a civil sanction . . . is the judgment of community condemnation which accompanies and justifies its imposition”<sup>68</sup> and if the public does not see certain antitrust violations as meriting criminal punishment, there will naturally be lower public support of and agreement with the law. To the extent that this is true, it will affect individual perception of the likelihood of detection and prosecution, and by extension the efficacy of criminal penalties in deterring antitrust violations.<sup>69</sup> In the Australian antitrust criminalization survey, the majority of respondents believed price fixing cartels should be illegal, but less than half believed they should be criminal, and less than 20% believed incarceration was appropriate punishment.<sup>70</sup> In the United States, the backlash to the e-books lawsuit has demonstrated there is little (or, at least, inconsistent) public support for some antitrust laws. In particular, although ruinous competition has long since been rejected as a defense to antitrust violations,<sup>71</sup> it seems the argument that collusion is necessary to combat monopoly is very appealing to the public.<sup>72</sup>

The Antitrust Division has long maintained that individual criminal penalties are more effective than corporate fines,<sup>73</sup> and this is among the principal reasons that the DOJ policy is to file criminal suits in cases of hardcore price fixing. While there is insufficient empirical evidence to conclude this is an effective deterrent, and there are reasons to question whether criminal penalties function as well in practice as they do in theory, it is unlikely that the choice of

68. Henry M. Hart Jr., *The Aims of the Criminal Law*, 23 LAW & CONTEMP. PROBS. 401, 404 (1958). See also Sanford H. Kadish, *Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations*, 30 U. CHI. L. REV. 423, 447 (1963).

69. Others have argued criminal law leads rather than follows, public opinion. See, e.g., Harry V. Ball & Lawrence M. Friedman, *The Use of Criminal Sanctions in the Enforcement of Economic Legislation: A Sociological View*, 17 STAN. L. REV. 197, 217 (1964).

70. Beaton-Wells & Parker, *supra* note 50, at 212.

71. The Supreme Court first rejected this defense in *United States v. Trans-Missouri Freight Ass'n*, 166 U.S. 290 (1897). The Court has consistently held that competition is presumptively beneficial, and that no defense may be raised on the “assumption that competition itself is unreasonable.” *Nat'l Soc'y of Prof'l Eng'rs v. United States*, 435 U.S. 679, 696 (1978).

72. See, e.g., David Carr, *Book Publishing's Real Nemesis*, N.Y. TIMES, (Apr. 16, 2012), available at [http://www.nytimes.com/2012/04/16/business/media/amazon-low-prices-disguise-a-high-cost.html?\\_r=0](http://www.nytimes.com/2012/04/16/business/media/amazon-low-prices-disguise-a-high-cost.html?_r=0).

73. John M. Connor, *The United States Department of Justice Antitrust Division's Cartel Enforcement: Appraisal and Proposals*, 60, n.170 (Am. Antitrust Inst., Working Paper No. 08-02, 2008), available at <http://ssrn.com/abstract=1130204>.

civil enforcement in this case reflects a broad change in attitudes within the Antitrust Division regarding the efficacy of criminal enforcement. Longstanding policy and lack of clear indication otherwise also suggest there is no reason to think the DOJ is rethinking its general stance that criminal penalties are effective deterrents. But the various potential problems with criminal punishments, combined with the facts of this case suggest, at the very least, that a more nuanced policy regarding criminal enforcement may be preferable, and that the DOJ may adopt a less categorical approach in the future.

## **B. Price Fixing, Modes of Analysis, and the E-Book Conspiracy**

### *1. The Per Se Rule and Rule of Reason Analysis*

Section 1 of the Sherman Act prohibits “[e]very contract, combination . . . or conspiracy in restraint of trade or commerce.”<sup>74</sup> Despite this literal (and very broad) wording, the Supreme Court has long interpreted the provision to prohibit only unreasonable restraints.<sup>75</sup> The Act’s purpose is to safeguard competition,<sup>76</sup> and in examining challenged actions, courts must “form a judgment about the competitive significance of the restraint.”<sup>77</sup> Conduct that raises prices or reduces output restrains competition.<sup>78</sup> To determine whether competition is unreasonably restrained, courts apply the rule of reason and analyze the restraint’s actual effects on competition in a relevant market.<sup>79</sup> Certain categories of restraint, however, are presumed to unreasonably restrain competition: conduct that “always or almost always tend[s] to restrict competition and decrease output” is condemned per se illegal without further analysis.<sup>80</sup> In such circumstances, therefore, a plaintiff need only prove that such an

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74. 15 U.S.C. § 1 (2006).

75. *Standard Oil Co. v. United States*, 221 U.S. 1, 60–68 (1911); *Northwest Wholesale Stationers v. Pacific Stationary & Printing Co.*, 472 U.S. 284, 289 (1985) (“[E]very commercial agreement restrains trade. Whether this action violates §1 of the Sherman Act depends on whether it is adjudged an unreasonable restraint.”).

76. In the words of Justice White, the purpose of the Sherman Act is not to protect “against conduct which is competitive, even severely so, but against conduct which unfairly tends to destroy competition itself.” *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447, 458 (1993).

77. *Nat’l Soc’y of Prof’l Eng’rs*, 435 U.S. at 692.

78. *Nat’l Collegiate Athletic Ass’n v. Bd. of Regents of Univ. of Oklahoma*, 468 U.S. 85, 113 (1984).

79. *Nat’l Soc’y of Prof’l Eng’rs*, 435 U.S. at 688.

80. *Leegin Creative Leather Products*, 551 U.S. at 886 (quoting *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717, 723 (1988)).

agreement exists. Only after extensive experience with certain business relationships will courts be satisfied this is the case and classify them as per se illegal,<sup>81</sup> and horizontal price fixing is among the few practices courts are comfortable condemning outright.<sup>82</sup>

Over time, however, the Supreme Court has taken an increasingly nuanced approach to horizontal price fixing. Because application of the per se rule is appropriate only where restraints undoubtedly will impede competition, cases in which there was not clear and unambiguous horizontal price fixing have prompted the Court to err on the side of caution and delve deeper before condemning the challenged arrangements.<sup>83</sup> Because in complex modern markets, arrangements that have the effect of fixing prices may not necessarily result in net anticompetitive effects, what was once a very robust rule has been pared back and now seems appropriate only where literal price fixing can be readily identified.<sup>84</sup> Otherwise, courts must first look at the effects and purpose behind a practice and determine whether it will “threaten the proper operation of a predominantly free-market economy.”<sup>85</sup>

## 2. *Recent Developments in Horizontal and Vertical Price Fixing*

While the Complaint alleges per se violation, in reality the Division may question whether the sort of conduct at issue in the e-books case necessarily merits per se illegality. First, the Court’s recent decision in *Leegin* removed vertical price fixing (in the form of minimum retail price maintenance) from the ambit of the per se rule. Because the challenged arrangement in this case is a series of similar vertical restraints, it too may be better suited to rule of reason analysis. The Supreme Court has also added significant wrinkles to its horizontal price fixing doctrine, and several parallels with two

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81. *United States v. Topco Assocs.*, 405 U.S. 596, 607–08 (1972).

82. *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150, 223 (1940). Per se illegality stems from the fundamental economic assumption that competitive markets will correctly price goods to achieve allocative efficiency and maximum social utility.

83. *See, e.g., Nat’l Soc’y of Prof’l Eng’rs*, 435 U.S. 679 (adopting rule of reason in assessing legality of horizontal restraint involving professional code of ethics); *Broadcast Music, Inc. v. Columbia Broadcasting System*, 441 U.S. 1 (1979) (holding rule of reason appropriate in examining commercial blanket licensing arrangement, even though a price fixing agreement was “literally” at issue); *Nat’l Collegiate Athletic Ass’n*, 468 U.S. 85 (rejecting per se analysis despite finding horizontal price and output restrictions).

84. Mark A. Lemley & Christopher R. Leslie, *Categorical Analysis in Antitrust Jurisprudence*, 93 IOWA L. REV. 1207, 1226–28 (2008).

85. *Broadcast Music, Inc.*, 441 U.S. at 19.

recent cases suggest the per se rule may be inappropriate for the challenged conduct here.

Initially, the Court did not distinguish between vertical (supplier-retailer) and horizontal (supplier-supplier, retailer-retailer, etc.) price fixing arrangements: both were per se illegal.<sup>86</sup> A series of decisions,<sup>87</sup> culminating in *Leegin*, created a distinction between horizontal and vertical restraints: the former remaining subject to the per se rule, and the latter evaluated under the rule of reason.<sup>88</sup> Like other anticompetitive conduct evaluated under the rule of reason, vertical restraints may thus be justified by pro-competitive effects.<sup>89</sup>

Horizontal price fixing doctrine has likewise seen change in recent years. In the 1980s, Sony and Phillips coordinated to charge license fees for the use of the CD technology in an effort to introduce CDs as an alternative to tape media.<sup>90</sup> This coordinated imposition of license fees obviously resulted in a markup over competitive prices, but the Federal Circuit found it justified by the fact that the fees were necessary to recoup sunk investments in technology.<sup>91</sup> If such coordination was disallowed, the new technology would never have made it to market.<sup>92</sup>

The Supreme Court followed similar logic in *Broadcast Music, Inc. v. CBS* and declined to apply the per se rule to a system of blanket license fees negotiated by competitors, even though the coordination had the effect of fixing prices.<sup>93</sup> The motivation was to create a new product: a blanket license to TV stations for copyrighted musical works.<sup>94</sup> Because of the transaction costs involved in licensing

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86. *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911).

87. Vertical non-price restraints were deemed subject to rule of reason analysis in *Cont'l T. V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977) and *State Oil Co. v. Khan*, 522 U.S. 3 (1997) did the same for maximum retail price maintenance.

88. *Leegin Creative Leather Products*, 551 U.S. at 877.

89. *Id.*

90. *Princo Corp. v. Int'l Trade Comm'n*, 616 F.3d 1318, 1322 (Fed. Cir. 2010).

91. *Id.* at 1322–23.

92. Herbert Hovenkamp, *FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE* 251 (3d ed. 2005). *See generally* Robert S. Pindyck, *Sunk Costs and Real Options in Antitrust Analysis*, 1 *ISSUES IN COMPETITION LAW AND POLICY* 619 (ABA Section of Antitrust Law 2008) (concluding the danger of sinking capital into development of new technologies only to be preempted by a competitor's standard can induce firms to wait, which in the aggregate can result in market failure).

93. *Broadcast Music*, 441 U.S. at 23. The Court noted its doubt that the practice threatened the “central nervous system of the economy,” and concluded the more discriminating examination of the rule of reason was appropriate. *Id.* at 24 (quoting *Socony-Vacuum*, 310 U.S. at 226 n.59).

94. *Id.* at 4.

copyrights from thousands of rights-holders, TV stations were unable to efficiently license music for broadcast. Coordination between the rights-holders in aggregating their copyrights and determining a fixed licensing fee was necessary to bring a new product to market.<sup>95</sup>

In *Texaco Inc. v. Dagher* the Court again narrowed the scope of the per se rule.<sup>96</sup> Texaco and Shell had formed a joint venture to jointly refine gasoline, and agreed upon a price at which to sell it under their respective brand names.<sup>97</sup> The Court, in declining to apply the per se rule, reasoned that joint ventures, which are legally single entities, must, “like any other firm, . . . have the discretion to determine the prices of the products that it sells, including the discretion to sell a product under two different brands at a single, unified price.”<sup>98</sup> The Court quoted *Broadcast Music* for the proposition that “joint ventures and other cooperative arrangements are also not usually unlawful, at least not as price-fixing schemes, where the agreement on price is necessary to market the product at all.”<sup>99</sup> Unlike in *Broadcast Music*, however, Texaco and Shell had not really introduced a new product. Rather, they jointly produced an existing product and sold it under their different brands.

### 3. *The E-Books Agreement*

The specifics of the e-books case, in conjunction with the Supreme Court’s recent price fixing jurisprudence, provide Apple and the publishers with several strong arguments that their conduct should not be considered per se illegal.

First, the publishers may argue their conduct was necessary to prevent free riding and protect sunk investments, emphasizing the vertical restraints, not the horizontal collusion required to put them in place. Consumers can free ride by browsing Apple’s bookstore (or physical bookstores, if the relevant market includes all books), which arguably provides a better experience, only to take advantage of Amazon’s discounted prices. In *Leegin*, the Supreme Court held minimum retail price maintenance to be justified along these lines,<sup>100</sup> and there is considerable evidence that, in practice, such vertical price

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95. *Broadcast Music*, 441 U.S. at 23.

96. *Texaco Inc. v. Dagher*, 547 U.S. 1, 5 (2006).

97. *Id.* at 3.

98. *Id.* at 7.

99. *Id.* at 8 (quoting *Broadcast Music, Inc.*, 441 U.S. at 23).

100. *Leegin Creative Leather Products*, 551 U.S. at 913–14.

fixing (and, for example, by MFN clauses) makes consumers better off.<sup>101</sup>

Second, the *Broadcast Music* and *Dagher* decisions strongly suggest that in cases where cooperation is either required to introduce a new product, or perhaps simply if conducted under the guise of a joint venture, resultant horizontal price fixing should be evaluated under the rule of reason. On the facts alleged in the Complaint, the case against the publishers appears strong, and the Division may have been able to bring and win a criminal per se case against them. Including Apple, however, changes the picture. Apple will certainly argue that absent insulation from price competition with Amazon, it would not have entered the market at all, and can very plausibly claim significant benefit to consumers by its entry, which resulted in greater diversity of offerings, and several beneficial innovations (color, pictures, video, etc.).<sup>102</sup> To a certain extent, the Apple marketplace for e-books amounts to a new product, and one which may have required coordination to bring to market. Moreover, market changes engineered by Apple and the publishers have undeniably coincided with increased, rather than depressed, output.<sup>103</sup> And the fact that prices and output have risen simultaneously also strengthens Apple's arguments about the pro-competitive effects of the agency model and its entrance into the e-book market. All these factors indicate a situation where, as in *Broadcast Music*, the pro-competitive benefits of some measure of collusion and horizontal restraint outweigh the anticompetitive effects.

Third, the Apple Agency Agreements may not literally restrain pricing of e-books. Because e-books are distributed by license, the publishers are free to set retail prices, regardless of which model is adopted.<sup>104</sup> Before Apple's entry into the market and the shift to agency distribution, the publishers had but one real option for selling e-books: Amazon. Because of this monopsony, no publisher could individually exercise its pricing power and impose minimum retail

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101. Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, in HANDBOOK OF ANTITRUST ECONOMICS 391–414 (Paolo Buccirossi ed., MIT Press 2008) (reviewing empirical research on RPM and finding broad consensus that it most often results in consumer benefit, including higher quality products and better services.), available at [http://www.economics.ubc.ca/files/2013/05/pdf\\_paper\\_margaret-slade-exclusivecontracts-verticalrestraints.pdf](http://www.economics.ubc.ca/files/2013/05/pdf_paper_margaret-slade-exclusivecontracts-verticalrestraints.pdf).

102. Answer, United States v. Apple, et al., 12-CV-2826, 2012 WL 1862008, at ¶ 1 (S.D.N.Y. May 22, 2012) [hereinafter Answer].

103. Answer at ¶ 93. This flies in the face of basic economic theory, which suggests a downward sloping demand curve, whereby higher prices correspond with less demand.

104. Hovenkamp, et al., *supra* note 18.

prices. Apple's entry provided the publishers' opportunity to adopt a distribution model Amazon otherwise would have blocked. They will argue that, in effect, their power to set prices is unchanged under the agency model. All that really changes is Amazon's veto on retail pricing, a power to which it is not legally entitled.

These arguments may have been sufficient to convince the DOJ that the agreements between the publishers and Apple do not quite reach the level of traditional, hardcore per se illegal horizontal price fixing. This may be why the Complaint appears to allege both per se and rule of reason cases. On the one hand, the Complaint alleges an "understanding and concert of action" among the publishers and Apple to "raise, fix, and stabilize retail e-book prices, end price competition among e-book retailers, and to limit retail price competition among" the publishers.<sup>105</sup> On the other, it contains lengthy exposition of anticompetitive effects—the sort of arguments necessary to bring a rule of reason case. Thus while the Complaint does allege a horizontal price fixing conspiracy, this may simply be posturing. Perhaps actions speak louder than words: after all, the DOJ filed a civil suit, not a criminal one.

#### 4. *Relevant Market*

Also questionable is the proposed definition of the relevant market, which would be critical if the case were analyzed under the rule of reason. The relevant market is critical in rule of reason cases because it is key to determining defendant market power and potential anticompetitive effects of a restraint.<sup>106</sup> Although the Supreme Court's famous footnote 59 in *Socony-Vacuum* explained that market power is not a precondition to application of the per se rule,<sup>107</sup> subsequent decisions have demonstrated the Court is in fact willing to consider the participants' market positions in determining per se illegality.<sup>108</sup> If a court were to look at the relevant market in examining anticompetitive effects of the alleged conspiracy, the proposed definition might prove a weak point in the government's case.

The government proposes a narrow definition limited to trade e-books, excluding print.<sup>109</sup> It presents several strong arguments for this

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105. Complaint at ¶ 95.

106. See *United States v. E.I. Du Pont de Nemours & Co.*, 351 U.S. 377, 391–92 (1956).

107. *Socony-Vacuum*, 310 U.S. at 226 n.59.

108. See cases cited *supra* note 83.

109. Complaint at ¶ 99.

position, noting several advantages of e-books and differences between them. And it concludes e-books have no good substitutes.<sup>110</sup> Whether or not this is the case, elsewhere the Complaint convincingly tells the story of beleaguered publishers inspired to collusion by their concerns about the adverse impact of Amazon's e-book discounting on print books.<sup>111</sup> The complaint specifically alleges that the publishers were gravely concerned about the large price differential between print and electronic versions and that expectations of lower prices would spill over to print.<sup>112</sup> This would negate the "competitive advantages they held as a result of years of investments in their print book business."<sup>113</sup>

Thus despite the Division's arguments to the contrary, its own Complaint evidences the fact that many consumers do consider e-books substitutes for print books. After all, electronic and print books contain generally the same content, are written by the same authors, and are funded by the same investments of the publishers. If the competitive threat to print books was enough to motivate the publishers to engineer an elaborate scheme to change the industry distribution model, the converse is likely true as well: print books are a competitive threat to e-books. If this is so, then the relevant market may well include all books. In which case the government will face a tougher task should it be required to prove anticompetitive effects. If the government had brought a criminal case rather than civil, that task would have been tougher still.

### C. Strategic Considerations

The Division is usually not fortunate enough to have an open-and-shut case, and price fixing cases are often brought based on circumstantial evidence. And there is always risk involved in bringing charges before a jury. Thus if the legal issues discussed above were insufficient on their own to have ruled out a criminal case, several strategic considerations weighing in favor of a civil action may have tipped the balance.

#### 1. Civil Injunction

The availability of a civil injunction provides the government a powerful tool to restore the pre-Apple status quo. If the principal

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110. Complaint at ¶ 99.

111. *Id.* at ¶¶ 3–4.

112. *Id.*

113. *Id.* at ¶ 34.

goal of the Division in bringing the case was to return prices to previous levels rather than punish the defendants or provide an example for deterrence purposes, then the Division may have weighed the risks of bringing the case against the sufficiency of a civil remedy and found a criminal case unattractive. Also, the DOJ's Principles of Federal Prosecution state that where a criminal prosecution would otherwise be called for, it may be unnecessary if "there exists an adequate non-criminal alternative to prosecution."<sup>114</sup> As of early 2013, Apple is the only remaining defendant, with the publishers all having settled with the DOJ.<sup>115</sup> The settlements entered between the United States and publishers mandate termination of the Agency Agreements, a return to the wholesale model, and restitution to purchasers of e-books.<sup>116</sup> That all the settlements contain this restitutionary remedy lends support to the view that the DOJ's overriding concern was a return to the status quo.

## 2. *Novel Issues of Fact or Law*

Antitrust Division standards for determining whether to bring criminal charges contain a discretionary exception for "truly novel issues of fact or law."<sup>117</sup> It is possible the Division found the particular arrangement between Apple and the publishers falls into this exception. The government has criminally prosecuted arrangements involving series of vertical restraints before, and the courts has found them per se illegal.<sup>118</sup> But these both involved a group of competitors at the supplier level colluding with a retailer possessing substantial market power. The publishers, by contrast, colluded with Apple, who, although a powerful company with significant power in other markets, had yet to enter the market for e-books. With that said, the Division is generally not shy about bringing criminal charges where

114. U.S. DEP'T OF JUSTICE, United States Attorneys' Manual, § 9-27.220.

115. Cyrus Farivar, *Macmillan, sole e-book publishing holdout, settles with Justice*, ARS TECHNICA (Feb. 8, 2013), <http://arstechnica.com/tech-policy/2013/02/macmillan-sole-e-book-publishing-holdout-settles-with-justice/>.

116. *See, e.g.*, United States v. Apple, Inc., 12 CIV. 2826 DLC, 2012 WL 3865135 (S.D.N.Y. Sept. 5, 2012) (order granting motion for entry of final judgment against three of the five publishers).

117. Antitrust Division Manual, *supra* note 39, at page III-12.

118. *See, e.g.*, Interstate Circuit v. United States, 306 U.S. 208 (1939) (finding conscious parallelism combined with several "plus factors" sufficient to infer an illegal horizontal agreement from a series of vertical distribution agreements); Toys "R" Us v. FTC, 221 F.3d 298 (7th Cir. 2000) (inferring a horizontal agreement from a series of vertical agreements).

the collusion does not correspond perfectly with previous examples.<sup>119</sup> In light of this, it appears unlikely this particular arrangement presents a sufficiently novel issue of law that would foreclose criminal prosecution.

Perhaps more importantly, cases for which the application of the per se rule is not entirely clear tend to be brought anyway because they involve blatant anticompetitive conduct and effects.<sup>120</sup> Two factors may distinguish the e-books case: the anticompetitive effects here are not entirely self-evident, and the defendants have several potential pro-competitive arguments to offer in defense of the new model. Regardless, if this was a principal reason for bringing a civil rather than criminal case, the Division would likely have made that clear. Doing so would prevent uncertainty about whether policies are in flux. In light of its silence, it is hard to imagine this exception was a key factor in deciding to forego criminal prosecution, though in conjunction with other considerations, the relative novelty of the facts may have played a part.

### 3. *Prosecutorial Discretion*

Concern about public perception of antitrust enforcement, and federal prosecution in general, may also have weighed against a criminal case. The Sherman Act's bipolarity—both criminal and civil penalties flow from the same words—vests a great deal of prosecutorial discretion with the DOJ. The choice between seeking civil or criminal redress on behalf of the public for antitrust violations is a serious responsibility and getting it wrong will have serious consequences. Inappropriately bringing criminal cases carries the risk of appearing to the public an erratic or arbitrary enforcer, perhaps motivated more by political factors, back-room dealing, or favoritism than strict adherence to application of the antitrust laws.

And yet a steady hand is needed on the wheel of antitrust, and the Division, like any other public prosecutor, should seek to apply laws consistently. Clear enforcement policies establish predictable boundaries between civil and criminal conduct. To this end the government regularly prosecutes specific categories of anticompetitive conduct criminally, and others civilly. Horizontal price fixing and market allocation nearly always give rise to criminal

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119. See, e.g., *United States v. Brown*, 925 F.2d 1182 (9th Cir. 1991) (holding intent requirement introduced in *Gypsum* typically does not extend to per se violations).

120. See, e.g., *Nat'l Collegiate Athletic Ass'n.*, 468 U.S. 85 (rejecting per se analysis despite clear horizontal price and output restrictions).

charges, and others, including tie-ins, merger cases, and restrictive membership rules, result in civil cases.<sup>121</sup>

So there may be tension between, on the one hand, consistency in prosecuting cases, and on the other, public perception of impartial and even-handed enforcement. In this case, the Division may have concluded bringing a criminal case against defendants for violations widely perceived to be worthy of civil penalties would expose the government to criticism of abuse of its prosecutorial discretion. The attendant impact on public confidence in the government's antitrust enforcement might well defeat whatever positive impact (deterrence, retribution, or public confidence) stemmed from the criminal case.

#### *4. Sympathetic Narratives and The Case Against Apple*

Whether criminal or civil, Amazon would inevitably loom over the case. Backlash against the case indicates the public views Amazon as a monopolist, and there appears to be genuine appreciation for increased diversity of e-book offerings.<sup>122</sup> Regardless of their merits, the Division is undoubtedly aware of these feelings. And the government is equally aware that at trial the defendants would paint themselves as struggling to cast off the traditions of print, the dominant paradigm for centuries and embrace the nascent world of e-books, a transition made all the more difficult by Amazon's machinations.

A criminal case against Apple would also be more difficult to win.<sup>123</sup> Not only is the legal case against Apple weaker, Apple would have a compelling narrative to tell a jury. The government would have to overcome a perception of an Amazon-monopolized industry to which Apple, a hugely popular company, widely esteemed for its innovation and forward-looking nature, attempted to introduce a bit of its magic. And despite the added difficulty of doing so, the government was probably unwilling to bring the case without naming Apple, the hub of the conspiracy.

### **D. Putting It All Together: An Explanation for an Odd Lawsuit**

#### *1. Some Horizontal Price Fixing is Not Per Se Illegal*

It is possible the Division believes the sort of conduct engaged in by the defendants should not be considered illegal per se. They may

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121. Barnett, *supra* note 41.

122. See Carr, *supra* note 72.

123. For several reasons discussed herein, including Apple's history using the agency model and its position at the retail rather than supplier level, and general Apple-philia.

have read the tea leaves in *Broadcast Music* and *Dagher*, which suggested evolving attitudes toward horizontal restraints. The nature of competition in high-tech industries may also demand a more nuanced view of collusion. If so, the DOJ may treat differently collusive conduct that falls short of naked horizontal price fixing motivated solely by a desire to extract consumer surplus. The DOJ may be headed toward a policy where some horizontal price fixing is not illegal per se, and does not call for criminal prosecution. The allegation of a per se violation in the Complaint contradicts this view, but the Division may simply be hedging its bets, or this may reflect an unwillingness to surrender that bargaining chip so early in the game. It does seem unlikely, however, that the DOJ would unilaterally determine certain conduct should no longer be considered per se illegal, and unlikelier still that they would make prosecution decisions on the basis of such a determination. Antitrust laws may well end up with a more nuanced approach to horizontal restraints, much like vertical restraints, but the DOJ will probably wait for the Supreme Court to make that decision first.

*2. Not All Horizontal Price Fixing is Equal (or Treated Equally)*

On the other hand, if we take the complaint at its word, that the DOJ considers the collusion between Apple and the publishers illegal per se, it is possible the DOJ is in the midst of a major change in policy.

One possibility is that the DOJ may be changing its policy about criminal prosecution of horizontal price fixing cases. It may believe certain per se price fixing violations do not merit criminal consequences—a “softcore” category of per se illegal price fixing. Another is that the e-books case may be an example of an intermediate category of cases the Division believes are provable by a preponderance of the evidence but not beyond a reasonable doubt. It is possible the government is simply not willing to give up so easily in cases where they encounter burden of proof problems. Both of these possibilities, however, amount to sweeping policy changes. Either changing the scope of criminal conduct under the Act, or adopting Division prosecution policy that is inconsistent with general DOJ policy, especially without formal notice, seems shortsighted. Transparency in enforcement is one of the Division’s top priorities,

and this sort of shift would very likely merit announcement to the public.<sup>124</sup>

### 3. *Simply an Outlier?*

Finally, the decision could simply be an outlier. It is conceivable that the decision was made based on political, rather than doctrinal, reasons. Because this would seemingly be a major violation of the government's prosecutorial discretion, this seems exceedingly unlikely. It is more probable the DOJ judged the benefits of a nonadherence in this case to outweigh the costs of departing from strict adherence. If this is so, there are several prudential reasons that likely would have weighed in favor of a one-time exception.

First, the DOJ has an interest in maintaining public confidence in antitrust enforcement. On the one hand, possible adverse consequences might include weaker antitrust deterrence (or not, depending on the deterrence efficacy of criminal sanctions) and increased uncertainty about the scope of criminal conduct under the Sherman Act. Such uncertainty can result in deadweight losses as companies make decisions based on incomplete information about the legality of their actions. And such costs are likely to be exaggerated in fast moving, high-tech sectors like e-books. On the other, given public perception of Apple and the publishers as battling the monopolistic Amazon, a departure from form might be the better choice—especially so if sufficient civil remedies were available, as seems to be the case.

Second, the decision may reflect prudential considerations about the dangers of over enforcement and over deterrence in high-tech industries. These risks are greatest in high tech sectors, like e-books, where market forces are least predictable to enforcement agencies, and high rates of innovation lead to rapid changes in market structure. The costs of misidentifying anticompetitive conduct are potentially very great: many high-tech innovators face multidimensional competition, and high-tech markets are more likely winner-take-all. Thus there is good reason to proceed cautiously in the area, and combined with the various strategic and legal considerations that weighed against criminal enforcement, it seems most likely the DOJ made an individualized decision to bring a unique enforcement action.<sup>125</sup>

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124. See, e.g., J. Gregory Sidak & David J. Teece, *Dynamic Competition in Antitrust Law*, 5 J. COMPETITION L. & ECON. 581 (2009); Geoffrey A. Manne & Joshua D. Wright, *Innovation and the Limits of Antitrust*, 6 J. COMPETITION L. & ECON. 153 (2010).

125. Spratling, *supra* note 41.

#### **IV. Conclusion**

Unless the DOJ decides to publicly reveal the details of its decision making process, it will never be completely clear what exactly motivated the DOJ to bring a civil case against Apple and the publishers. Concerns about public perception of antitrust enforcement, concerns about over deterrence and chilling effects in high-tech industries, the deterrence efficacy of criminal sanctions, and the availability of civil injunctions seem the likeliest explanations. But it remains to be seen whether the decision will prove a one-time exception (and possibly go unexplained), or a harbinger of long-term changes in antitrust policy.

Regardless of whether the case proves to be an outlier and what the specific reasons were for choosing to bring a civil case, the Division needs to maintain transparency about its antitrust enforcement policies—especially those concerning the choice of whether to pursue civil or criminal sanctions. Not only is transparency in decision-making key to maintaining public trust in law enforcement, it is also central to antitrust deterrence: generally, in providing clear guidelines about what conduct is legal and what is proscribed; and more specifically in encouraging cooperation from antitrust offenders. Transparency leads to predictability, and the Division's leniency program depends on transparency in prosecution standards. If prospective cooperating parties cannot predict the likelihood of prosecution, or cannot be certain of their treatment following cooperation, they will not come forward.

Finally, there are good reasons to speculate the decision to bring a civil case against Apple and the publishers was motivated by positive changes in how the DOJ views the high-tech industry, as well as the need for a more flexible approach toward complicated arrangements in emerging markets. It would be a good thing if this case reflected a general shift in that direction. And simply explaining why exactly it was that no criminal case was brought against Apple and the publishers would be a step in that direction.