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Apple Found Liable for Price Fixing E-Books: New Level of Legal Complexity for Vertical Price Restraints

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After a lengthy bench trial before Judge Denise Cote, U.S. District Court Judge for the Southern District of New York, Apple, Inc. ("Apple") was found liable for price fixing trade electronic books ("e-books") in the United States. At first glance, this case appears to be no different than the many horizontal price-fixing cases that have come before it. But this case presents a unique legal twist worthy of untwisting. Judge Cote found that Apple's participation in the horizontal price-fixing conspiracy between five book publishers constituted a *per se* violation of Section 1 of the Sherman Act. Apple, however, was not a book publisher; rather Apple's role in the e-book market was as that of a retailer. As such, Apple was vertically related to each book publisher. This legal alert explores the various horizontal-vertical legal issues raised by *U.S. v. Apple, Inc*.

A. Background

The civil suit was originally filed on April 11, 2012, by the Antitrust Division of the U.S. Department of Justice on behalf of the United States (the "Antitrust Division") and separately by 33 states and U.S. territories (the "States") (collectively, the "Plaintiffs") against Apple and five book publishing companies: Hachette Book Group, Inc.; HarperCollins Publishing LLC; Hotzbrinck Publishing LLC d/b/a Macmillan; Penguin Group (USA), Inc.; and Simon & Schuster, Inc. (the "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 state antitrust statutes. Civil, nationwide class-action lawsuits were also filed and consolidated with the Antitrust Division and States' complaints before Judge Cote. Prior to trial, the Plaintiffs resolved their claims against the Book Publishers, leaving Apple as the sole defendant at trial.

Prior to Apple's entry into the U.S. e-book market, the Book Publishers used the traditional "wholesale model" of retailing e-books. Under the wholesale model, the Book Publishers sold e-books (as well as hard cover and paperback books) to retailers at wholesale prices, who in turn sold e-books to the public at retail prices. Because the Book Publishers transferred all title and risk of loss to the retailers, the retailers were free to set retail prices to the public. Amazon, the largest online book retailer, began to severely discount the retail prices of e-books, even setting retail prices far below wholesale prices. Enter Apple.

Apple was a new entrant and thus had little to no market share in the e-book market. Apple was considering adding a new online bookstore, called iBooks, as part of its upcoming iPad launch in January of 2010. As a new entrant, Apple looked at transforming the consumer's e-reading experience through innovative changes in e-reading software, enabling consumer self-publication, color viewing, audio and video capabilities, and significantly expanding the e-book market through its extensive distribution network. Apple, however, took dim view of the wholesale model and in its place proposed an "agency model." Under the agency model, the Book Publishers retain title and risk of loss to all e-book and Apple would simply sell 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, and thus Apple, would have been aware of the Book Publishers' retail prices since that is how commissions were paid. Given that, Apple required a retail most-favored-nation provision ensuring that Apple would be offering the lowest available price in the e-book market. Apple eventually entered into separate agency agreements with each Book Publisher. During this same period, the Book Publishers and Amazon entered into similar agency agreements on e-books. Eventually other retailers contemplated or entered into similar agreements with the Book Publishers.

The Plaintiffs' primary contention at trial was that the Amazon-Book Publishers' agency model was forced upon Amazon (the dominant player in the e-book market) through collusion between Apple and the Book Publishers with the primary aim and direct result of the conspiracy was to raise e-book retail prices to consumers. Judge Cote found that because the Plaintiffs proved a horizontal price-fixing conspiracy between the Book Publishers, Apple's vertical participation in that horizontal conspiracy amounted to a *per se* violation of Section 1 of the Sherman Act. As a vertical player, however, should Apple's conduct have been judged under the rule of reason instead of the *per se* rule?

B. Legal standards applicable to judge "unreasonable" restraints

1. Rule of reason as primary standard to judge restraints

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. It 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. U.S.*, 221 U.S. 1 (1911); *Board of Trade of Chicago v. U.S.*, 246 U.S. 231 (1918).

2. Rise of* per se *rule

Over time, however, 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. As such, as to these classes of restraints the need for a full-blown factual investigation into actual market effects – as demanded by the rule of reason – was unnecessary. These classes of restraints were referred to as unreasonable *per se*. 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 participants in the price restraint. See *Dr. Miles Medical Co. v. Park & Sons Co.*, 220 U.S. 373 (1911) (vertical minimum price agreements); *U.S. v. Trenton Potteries Co.*, 273 U.S. 392 (1927) (horizontal minimum price agreements); *Interstate Circuit, Inc. v. U.S.*, 306 U.S. 208 (1939) (horizontal and vertical minimum price agreements); *U.S. v. Socony-Vacuum Oil. Co.*, 310 U.S. 150 (1940) (horizontal minimum price agreements); and *Albrecht v. Herald Co*, 390 U.S. 145 (1968) (vertical maximum price agreements).

3. Erosion of **per se** *rule as to vertical restraints*

Beginning with *White Motor Co. v. U.S.*, 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 U.S. 36 (1977) (overruling *U.S. 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 U.S. 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. Enter *U.S. v. Apple, Inc.*

4. Rule of reason in mixed horizontal and vertical restraints

Prior to *Kahn* and *Leegin*, in price restraint cases where the actors were both vertically and horizontally related, courts found it useful to determine the existence of the horizontal agreement first, and then look to determine whether the vertical participant knowingly participated in that horizontal agreement. If so, then the vertical actor became a conspirator in the horizontal agreement. See *Interstate Circuit, Inc. v. U.S.*, 306 U.S. 208 (1939). During this period, of course, vertical and horizontal price-fixing agreements were equally

judged under the *per se* rule, thus there was no reason to judge the different actors differently. In the post-*Leegin* world, however, vertical price restraints are to be judged under the rule of reason. *Leegin*, 551 U.S. at 907. As such, how should post-*Leegin* courts apply different standards to different actors in a mixed horizontal and vertical restraint case? Some indication can be gleaned from *Leegin* itself. The majority's opinion, in *dictum*, recognized this possibility and addressed it this way:

> 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 U.S. at 893. Judging the vertical actor under the rule of reason and the horizontal actors under the *per se* rule makes some sense since it preserves the proper use of both standards. If a vertical actor has indeed violated the Sherman Act, the rule of reason should ferret that out. That, of course, was the intended purpose of the rule of reason in the first place. See *Leegin*, 551 U.S. at 885-86.

C. Effect of *U.S. v. Apple, Inc.* on vertical price restraints

U.S. 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, regardless of level, may be subject to more stringent antitrust treatment than had been contemplated after *Leegin*. While this case will surely find its way up to the Second Circuit, and potentially to the Supreme Court, the outcome is uncertain. In the meantime, vertical actors should take pause and perhaps reexamine their vertical price relationships.

View the case opinion here.