Bob Kohn
140 E. 28th St.
New York, NY 10016
bob@bobkohn.com

May 30, 2012

Mr. John R. Read
Chief, Litigation III Section
Antitrust Division
U.S. Department of Justice
450 5th St. NW, Suite 4000
Washington, D.C. 20530

Via Priority Mail

RE: United States v. Apple, Inc., *et. al.*

Dear Mr. Read,

On April 11, 2012, the United States Department of Justice Antitrust Division ("DOJ") filed a complaint commencing this civil antitrust action against Apple, Inc. ("Apple") and several book publishers (the "Publisher Defendants"). *United States v. Apple, Inc. et. al.*, Civil Action No. 12-CIV-2826 ("Complaint").

On the same day, the DOJ filed a proposed Final Judgment against three of the Publisher Defendants (the "Settling Defendants") which, upon entry, would settle the case with respect to the Settling Defendants, together with a Competitive Impact Statement ("CIS") in support of the proposed judgment. Before entering any proposed judgment, the court must determine the entry of such judgment is in public interest. 15 U.S.C. Sec. 16(e)(1). (the "Tunney Act").

Pursuant to the Tunney Act, a notice inviting public comment on the proposed settlement has been issued ("Notice"). See**,** https://www.federalregister.gov/articles/2012/04/24/2012-9831/united-states-v-apple-inc-hachette-book-group-inc-harpercollins-publishers-llc-verlagsgruppe-georg. The undersigned respectfully submits these comments to the DOJ in response to the Notice.

SUMMARY OF COMMENTS

The government action against the Defendant Publishers and Apple in this case, in terms of economic importance and precedential value, is the most far-reaching antitrust matter affecting the exploitation of copyrighted works of authorship in more than a generation. Not since government action against Microsoft nearly 20 years ago (see, *United States v. Microsoft Corp*., 56 F.3d 1448 (D.C. Cir. 1995)) have the courts been challenged to exercise the greatest possible judicial scrutiny in order to secure the public interest in promoting innovation and competition.

The enormity of the task of balancing the interests of copyright law and antitrust law in setting the rules of the road affecting the creation and dissemination of works of literature, history, and science, cannot be underestimated.

Being that this matter is one of first impression, we mean no disrespect to the DOJ when we suggest in these comments that something has gone terribly wrong with the formulation and prosecution of this case.

Introduction

I am Bob Kohn, writing as a consumer of e-books, and I am responding to the Notice, because I believe that I can provide some important context that may be helpful to all concerned in their consideration of the issues in this proceeding. During the course of my 30-year career–working for entertainment, computer software, and internet companies–I have had responsibility and oversight for several high profile antitrust matters. These matters directly concerned the intersections between copyright and antitrust law as they relate to the public interest in promoting innovation and competition. Each case, like the present case before the Court, involved the adoption by consumers of technology products and copyrighted works, which operated in conjunction with each other, in a two-sided market prone to attempted monopolization by dominant systems providers.

I have testified before both the Department of Justice and the Federal Trade Commission on these matters:

> *See,* Testimony of Robert H. Kohn*, Hearings of the Federal Trade Commission on the Changing Nature of Competition* (panel on "*Networks, Standards, Foreclosure, Strategic Conduct*") http://www.ftc.gov/opp/global/bobkohn.shtm (Washington, D.C., November 29, 1995). Cited in, *Antitrust for High Tech Companies* (Prepared Remarks of Susan DeSanti, Director of Policy Planning, Federal Trade Commission) http://www.ftc.gov/speeches/other/desanti1.shtm (San Francisco, February 2, 1996).
>
> See, Testimony of Robert H. Kohn, *DOJ/FTC Joint Hearings on "Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy"* http://www.ftc.gov/opa/2002/02/ipsecond.shtm (Berkeley, California, February 27, 2002).

I am writing solely on my own behalf and solely to express my personal views on these proceedings. My interest runs in parallel with other consumers of e-books, the DOJ, the Court, and the letter and spirit of the Sherman Act and U.S. copyright law.

Procedural Context

This respondent is mindful of the District Court's recent Opinion & Order denying the motion to dismiss under Rule 12(b)6) in *In Re Electronic Books Antitrust Litigation,* 11 MD 2293 (DLC) (May, 15 2012) (hereinafter, "*Electronic Books Litigation*"). The timing of the Court's order in that case was unfortunate, as it was entered before members of the public could avail themselves of the full public comment period to express their reaction to the present case and provide the very kind of context-specific information a court must consider in ruling upon a motion to dismiss in complex matters such as antitrust—particularly where, as here, it involves <u>novel agreements</u> to license <u>copyrighted works for use in digital form</u>.

In describing the standard of review for a motion under Rule 12(b)(6), the Court cited *Ashcroft v. Iqbal*, 556 U.S. 662 (2009), but appears to have overlooked that decision's central point. In *Iqbal*, the Supreme Court reaffirmed its ruling in *Bell Atlantic v. Twombly*, 550 U.S. 544 (2007) that the claims made in a complaint must "cross the line from conceivable to plausible." In *Twombly*, the Supreme Court issued a <u>heightened pleading standard</u> that is particularly applicable in complex actions such as antitrust in which both the consequences and the cost of

litigation are so steep that a settlement may be coerced upon weak claims. See, *Smith v. Duffey*, 576 F.3d 336, 340 (7th Cir. 2009) (opinion by Circuit Judge Posner).

It was for this reason the Supreme Court ruled that "determining whether a complaint states a plausible claim is *context-specific*, requiring the court to draw on its *experience and common sense*." *Iqbal* at 557 (emphasis added). Thus, if the behavior alleged, even if conceivable as alleged, is more plausibly explained by lawful behavior, the motion to dismiss should be granted.

When in ruling on a 12(b)(6) motion a court must "draw all reasonable inferences" in plaintiff's favor (*McCarthy v. Dun & Bradstreet Corp.*, 482 F.3d 184, 191 (2d Cir. 2007)), but this is not a license to downplay the important *context-specific* task of determining the plausibility of the claims—particularly in a complex antitrust action concerning a novel copyright licensing arrangement. Pleadings must be construed so as to do justice. Federal Rules of Civil Procedure, Rule 8(e). Where claims in an antitrust complaint, under the light of common sense and experience, have not "crossed the line from conceivable to plausible," the complaint must be dismissed. *Twombly.* 550 U.S. 544.

Price Fixing Is Not Always Illegal

In the District Court's Order & Opinion in the *Electronic Books Litigation* (May 15, 2012), the Court ruled that "a claim for violation of law" was properly stated by allegations that "the defendants conspired to eliminate retail price competition and to raise the price of e-books above the $9.99 price set by Amazon." But nowhere in the Court's Opinion & Order in that case does the Court even contemplate the possibility that the alleged price fixing was more plausibly explained by lawful behavior.

This is all the more surprising given the fact that the same Court has presided over two ASCAP rate hearings, including most recently *In Re Application of MobiTV, Inc. (related to United States v. ASCAP)*, 712 F.Supp.2d 206 (2010). As the DOJ and the Court are well aware, ASCAP is a vehicle through which music publishers conduct an intricate horizontal conspiracy to fix prices. Nevertheless, the key assumption underlying the *MobiTV* rate hearing was that ASCAP's horizontal restraint of trade is completely lawful. *Broadcast Music, Inc. v. CBS*, 441 U.S. 1 (1979) (decision of the Supreme Court delivered by Justice White).

Were the District Court presented today with a case against ASCAP for price fixing and applied the reasoning it used to sustain the complaint the *Electronic Books Litigation*, the Court would have reached the same conclusion: **ASCAP's restraint of trade is unlawful *per se* "because it is, at root, a horizontal price restraint"** or is "**necessarily unlawful under the rule of reason**." See, District Court's Opinion & Order of May 15, 2012 (emphasis added).

Yet, determining whether a complaint sufficiently alleges a *plausible,* not just conceivable, claim for violating the Sherman Act is not that simple. To allege that the music publishers conspired to fix prices and succeeded in raising them is one thing. To allege this is a violation of Sherman Act is entirely another matter. In *Broadcast Music*, the Supreme Court recognized that, although horizontal restraints are generally less favorable than vertical restraints, they can and have been held to be legal—neither unlawful *per se* nor under the rule of reason—and for good reason.

This conclusion cannot be escaped by differentiating *Broadcast Music* from the present case on the facts.[1] To do so would miss the Supreme Court's critical point about applying antitrust law to markets in copyrighted works of authorship. As Justice White stated at the outset of the Court's opinion:

> We have never examined a practice like this one before; indeed, the Court of Appeals recognized that "in dealing with performing rights in the music industry we confront conditions both in copyright law and antitrust law which are sui generis."

Broadcast Music, at 14 (quoting, 562 F.2d at 132) (emphasis added). The Supreme Court's observation in that case mirrors precisely the challenge of the present proceeding. In dealing with the licensing of digital rights in the book industry, the court is confronted with conditions both in copyright law and antitrust law which are *sui generis*.

As the Supreme Court stated more recently,

> Just as the common law adapts to modern understanding and greater experience, **so too does the Sherman Act's prohibition on 'restraint[s] of trade' evolve to meet the dynamics of present economic conditions**.

Leegin Creative Leather Products, Inc. v PSKS, Inc., 551 U.S. 877 (2007) (opinion of the Court delivered by Justice Kennedy) (emphasis added).

To the DOJ, the factual allegations in this case may amount to price fixing in the literal sense, but the question of antitrust liability is "not simply of determining whether two or more potential competitors have literally 'fixed' a 'price'." *Broadcast Music* at 9. Price fixing that has a "redeeming virtue" is legal. Id.

Supported by Longstanding U.S. Antitrust Policy, Which the DOJ Neglected to Apply

This conclusion is supported by the DOJ's own antitrust enforcement guidelines. The antitrust policy of the United States with respect to the licensing of copyrighted works, such as e-books, is stated in the *Antitrust Guidelines for the Licensing of Intellectual Property* jointly issued by the U.S. Department of Justice and the Federal Trade Commission (April 6, 1995). See, http://www.justice.gov/atr/public/guidelines/0558.htm#t21 (hereinafter, the "Licensing Guidelines" or "Guidelines").[2]

The DOJ not only fails to mention the Licensing Guidelines in the CIS, it seems the DOJ has completely neglected them—and with it U.S. government antitrust policy—in its formulation of the Complaint and prosecution of this

---

[1] This respondent is well aware of the challenges faced by music publishers in licensing performances of their copyrighted works to thousands of restaurants and broadcasters. Al Kohn & Bob Kohn, *Kohn On Music Licensing, 4th Edition*, (Wolters Kluwer, 2010), pp. 1247-1282. Defendant Publishers have acted under a more challenging set of circumstances in light of today's economic realities. In contrast with the problem of licensing their copyrights to thousands of potential licensees, Defendant Publishers are faced with licensing their copyrights to a winner-take-all monopolist.

[2] The Licensing Guidelines are the most comprehensive source of law and policy regarding the appropriate antitrust principles to be applied when analyzing the legality of the licensing of intellectual property. They form the primary basis for advising clients on the antitrust boundaries of technology licensing and, though they are not binding upon the courts, the courts often look to them as persuasive authority. See Yee Wah Chin & Kathryn E. Walsh, *Antitrust Counseling in Intellectual Property Licensing*, 832 PLI/Pat 267, 275 (June, 2005); Richard J. Koskins & Zubin P. Khambatta, *Antitrust Law and Intellectual Property Licensing: An Overview*, 806 PLI/Pat 449 (October, 2004).

case. For example, the DOJ ignores the important characteristic that distinguishes copyrighted works, such as works of authorship in digital form, from other forms of property. Guidelines at 2.1. Consequently, the DOJ ignores the appropriate relevant markets that the Guidelines suggest must be considered in a case of antitrust involving copyrights (i.e., "markets for final or intermediate goods made using the intellectual property, or it may have effects upstream, in markets for goods that are used as inputs, along with the intellectual property, to the production of other goods"). Guidelines at 3.2.1.

As a Result, DOJ Arrived at the Wrong Relevant Market

As will be discussed at length in this response, e-books have no use or value in isolation. As such, an e-book is only "one component among many in a production process." See, Guidelines at 2.3. An e-book only derives value from its combination with a compatible device necessary to read it (and some e-commerce platform to deliver it to the device and service the consumer). By contrast, a printed book can be purchased off-the-shelf and does not need to be combined with anything for it to be consumed. As readers need to consume e-books through a particular e-book platform, the e-book market is best characterized as a two-sided market. Yabing Jiang, *e-Book Platform Competition in the Presence of Two-Sided Network Externalities*, 2012 45th Hawaii International Conference on Systems Sciences, IEEE Computer Society 4777 (2012).

The DOJ's Complaint defines e-books as "books sold to consumers in electronic form and read on a variety of electronic devices" (Complaint at 1) and then defines the relevant market simply as, "trade e-books" (Complaint at 99). By alleging that the relevant market in this case is the market for trade e-books, the DOJ treated the market for e-books as it would a market for any stand-alone good, such as handbags or grapefruits. But the DOJ's own Guidelines suggest otherwise: unlike leather goods or fruits–or printed books–*there is no market for e-books in isolation*. Being that an e-book is an "intermediate good made using intellectual property," the markets to be considered in a proper antitrust analysis of e-books must include the markets for "upstream" goods (or goods on the other side of the two-sided market), such as e-book reading devices. See, Guidelines at 2.3 and 3.2.1. Dismissal may be appropriate under Rule 12(b)(6) in the absence of a plausible explanation for why the market should be limited as it has been in the complaint. See, *In Re Wireless Telephone Services Antitrust Litigation*, 385 F.Supp. 2d 392 (S.D.N.Y. 2003) (decision by District Judge Cote, citing *Todd v. Exxon Corp.*, 275 F.3d 191,198 (2d Cir. 2001)).

Its failure to recognize these fundamental differences between copyrighted works, especially those marketed in digital form, and other forms of property, led the DOJ to misguide the Court as to the nature of the goods, and therefore the relevant markets, at issue in this case. Indeed, in its Opinion & Order (May 15, 2012) in the *Electronic Books Litigation*, the Court borrowed the DOJ's flawed characterization of the goods at issue:

> eBooks are digital versions of books. They can be read on a variety of hardware devices, including personal computers, mobile phones, dedicated handheld "eReaders" like the Amazon Kindle, the Sony Reader, the Barnes & Noble Nook, or multi-functional "tablets like Apple's iPad.

This is simply not correct. E-books cannot just be read on hardware devices; they must be read on hardware devices. E-books have no value or use to a consumer without the aid of machine or device. Every reader of e-books knows this. (If the DOJ can provide an example of how an e-book can be read without the aid of some form of hardware device, they are welcome to come forth and show it). By contrast, consumers can read printed books right off the shelf, standing alone, without the aid of any kind of device. Appreciating this critical distinction between e-books and printed books is crucial to this case. **E-books are not just digital versions of books**.

Failure to appreciate the nature of copyrighted works in digital form, such as e-books, and the context in which they are consumed, will inevitably lead to the mistake made by the DOJ, treating the market for e-books like the market for any non-system good, such as printed books. It is this central mistake that lead the DOJ to conclude that Defendants' alleged actions are anti-competitive when in fact they are manifestly pro-competitive. It was a mistake that could have been avoided had the DOJ simply followed its own Guidelines.

Defendants' Actions Constituted Lawful Behavior, Because It Promoted Competition

When Defendants' actions are considered in the context of their impact on the appropriate relevant market or markets—whether you characterize it as an "upstream" or "two-sided" market—the plausible conclusion to be reached, drawing upon common sense and experience, is that the Complaint's factual allegations demonstrate that Defendants' actions promoted competition in the e-book systems market and thereby constituted lawful behavior.

The purpose of this response is to shed some light on this important context.[3] While the body of this letter addresses it at length (with appropriate citations), the context may be less formally summarized as follows.

An e-book is a copyrighted work that has no value in isolation. It takes on value only as a component of an e-book system, which is also comprised of other components, such as an e-book reader device and a systems platform that supports the purchase, delivery and archival of e-books. Because a consumer purchases an e-book reader at one time and then purchases e-books to read on it at various intervals over time, publishers of e-books and providers of e-book systems compete in a two-sided market characterized by *positive feedback effects*. This means that consumer purchase decisions regarding e-book devices, and the e-books designed to work with them, are affected by consumer expectations about what other consumers will do. Consumers are attracted to systems products that are compatible with the greater number of users. This is because systems popular with a greater number of users are more likely to attract a greater variety and quality of components (e.g., e-books) and will be less likely to strand the consumer's investment in those components should the system provider fail in the market. The more consumers adopt a particular system, the more likely it is that other consumers will adopt the system. By the same token, each new consumer who adopts the system not only receives their own private benefits from using the system, but also confers benefits upon existing consumers of the system, who benefit from belonging to an increasingly popular system. These external benefits conferred on others by new purchasers are known as, *network externalities*. As a system becomes increasingly popular with consumers, the more other consumers are likely to adopt it. The more other consumers adopt a system, the less likely consumers already in the system will leave it. Markets characterized by these positive feedback effects arising from network externalities are prone to what is known as the "winner-take-all" scenario. The potential monopolistic rewards that may be reaped under such a scenario are so enormous they encourage participants in a systems market to attempt to monopolize the market by using strategies to "tip" it in their direction, accentuating the feedback effects that will further their market dominance. These strategies include employing measures to make the participant's proprietary technology the *de facto* industry standard, providing exclusive content not available through other systems, and temporarily

[3] Apple may have a conflict in bringing this context to the Court's attention, being that it (a) may have achieved a dominant position in the digital music systems market for some of the same reasons described below or (b) may desire to employ similar anticompetitive strategies to monopolize other markets. See, Miguel Helft, "IPad Service Draws Scrutiny," *New York Times* (February 17, 2011); Nick Bolton, "Government Weighing Possible Apple Antitrust Probe," *New York Times* (May 4, 2010). Accordingly, should all of the Defendant Publishers become parties to the proposed Final Judgment, the Court should allow consumers to intervene for purposes of filing an appeal, even if Apple is in a position to do so.

pricing components of the system, such as copyrighted works, artificially below cost. These strategies have been well documented in the economic literature.[4] For example, a monopolist will employ low prices to convince consumers that components (i.e., e-books) will be available at low prices in the future. Later, after consumers are locked-in to the monopolist's proprietary system, the monopolist will be tempted to raise prices to the monopoly level–which will be at least as high as the consumers' cost of switching to another system. Switching costs will be a function of the availability of competing systems that are compatible with the previous investments made by consumers in purchasing e-books (and associating with them bookmarks, highlights, notes, reading progress, ratings, and other information created by consumers and stored in the provider's "cloud" platform). At the time the events alleged in the Complaint took place, Defendants observed that Amazon controlled 90% of the market for e-books and 25% of the market for printed books, wielding demonstrable market power in both those markets, and having over $8 billion in cash with which to exercise that power. Defendants recognized the considerable, imminent potential for Amazon to succeed in using these well-documented tipping strategies to monopolize the e-book systems market. **The foregoing summarizes what the DOJ has been characterizing as, "the $9.99 problem."**

Defendant Publishers met to discuss the problem and explored ways to thwart Amazon's attempted monopolization. The resulting solution entailed wrestling back from the e-book systems providers—all of them—the right to set the price for each of Defendant Publisher's respective e-books–i.e., moving from the *retail model* to the *agency model*. Thus, rather than e-book systems providers having the ability to set and vary the price of each e-book, now the Defendant Publishers have the right to set and vary the price.

Economic Consequences of Defendants' Alleged Conduct
—Impact Upon Competition, Consumers, and the Public Generally

Consumers are better off if such pricing control resides in hands of the Defendant Publishers than in the hands of the e-book system providers, if for no other reason that it prevents an e-book system provider with market power from setting e-books prices at an artificially low level in an attempt to monopolize the e-book systems market. Otherwise, consumers should be indifferent as to whether the publisher sets the price or if the system provider sets the price. This change was carried out by voluntary market-based negotiations with competitors in the e-book systems market, including Amazon. As the Complaint alleges, each of the Defendant Publisher's could not effectively have taken these actions "by itself," and as the Court has found, "a critical mass of publishers was needed" to persuade Amazon to move to the agency model. Order & Opinion, *Electronic Book Litigation* (May 15, 2012).

Another economic consequence of the Defendants' actions was to promote a level playing field among competitors in the e-book systems market, effectively limiting any one e-book systems provider from using short-term artificial pricing strategies in an attempt to monopolize the market for e-book reader devices, e-books, and even printed books. Moreover, the agency model puts the largest e-books systems providers, such as Amazon, Apple, Google, and Barnes & Noble, in the same position as the smallest providers, including *new entrants* that do not yet exist, in acquiring content to market with their respective e-books systems. The public benefited from this change, because, by curbing the abuse of overwhelming market power of Amazon, it promoted competition among e-book systems and increased the likelihood of attracting new entrants to the market.

[4] Some of the more well-known economic references are cited below. A useful bibliography of materials is maintained by the Stern School of Business, *New York University* at http://www.stern.nyu.edu/networks/referenc.html.

Defendants' Actions Resulted in Increased Competition

The resulting impact on the e-book systems market was demonstrably successful. Within a month after Amazon agreed to the agency model, one analyst predicted that, *as a direct result of the agency model,* Amazon's market share would fall from 90% to 35% over five years. See, Matt Philipps, "Amazon e-Book Share to Fall From 90% to 35%, Analyst Says," *Wall Street Journal* (February 16, 2010).

That prediction has since been validated. By the end of 2011, it was estimated that Amazon's share of the e-book sales in the U.S. had, in fact, fallen to about 60%. Juliette Garside, "Apple's Struggle To Defeat Amazon Set to be Exposed by European e-book Enquiry," *The Guardian* (December 17, 2011). Interestingly, most of Amazon's lost market share was picked up not by Apple, who only managed to take only 5%, but by a smaller competitor, Barnes & Noble's Nook system, which saw its market share grow to 27% by the end of 2011. Id. See also, David Carr, "Amazon Low Prices Disguise a High Cost," *New York Times* (April 15, 2012) ("Remember, it was only after agency pricing went into effect that Barnes & Noble was able to gain an impressive 27 percent of the e-book market").

While it is difficult to precisely judge cause and effect, Defendant Publishers' move to the agency model arguably may have helped encourage a new entrant into the e-book systems market: Microsoft Corp. Michael J. De La Merced and Julie Bosman, "Microsoft to Take Stake in Nook Unit of Barnes & Noble," *New York Times* (April 30, 2012). Thus, the world's leading software company will help Barnes & Noble spin off its e-book systems business into a new entity, providing additional financing, thereby enabling the Nook e-book system to more effectively compete with Amazon's. Without having to respond to Amazon's market-tipping pricing strategy, Nook may now invest in product and system improvements to attract new consumers who might otherwise have been persuaded by artificially low e-book prices to feed Amazon's market dominance.[5]

Consumers Are Better Off as a Result of Defendants' Actions
—Increased Competition Will Result in Lower Prices for eBook Systems and More Innovation

Thus, the agency model, and the alleged concerted actions by the Defendants toward its adoption, has already paid off significantly for consumers of e-books. Common sense suggests that increased competition among e-book systems providers will result in increased innovation and lower prices for e-book reader devices and the system platforms that support the e-book process. Entry of the proposed Final Judgment, which would reverse the essential pro-competitive features of the agency model, would unwind these consumer benefits**.**

Moreover, the agency model serves as a means by which a systems provider with market power can be prevented from charging monopolistic prices for e-books in the future. As discussed above, a monopolist will employ artificially low prices to convince consumers that components (i.e., e-books) will be available at low prices in the future. Later, after consumers are locked-in to the monopolist's proprietary system, the monopolist will be tempted to raise prices to the monopoly level. Under the agency model, an e-book service provider is unable to either employ an artificial low-price strategy or raise e-book to the monopoly level, because control over prices under the agency model are in the hands of the book publishers. Since no publisher has the market power to monopolize the e-book systems market, consumers are better off where publishers are in control of pricing.

[5] The same can be said about Apple's entry into the e-book systems market. See, Apple's *Answer* to the Complaint in this action at paragraph 4 (filed May 22, 2012) ("Apple admits that absent the agency agreements it would not have entered eBook distribution, given the circumstances of the business as it existed prior to Apple's entry").

This does not mean an e-book service provider in a monopoly position could not raise other prices, such as the price of e-book reader devices or fees to access to their service platform, but this leads to another significant benefit consumers reaped from Defendants' alleged actions: to the extent their actions promoted competition in the e-book systems market, Defendants' helped avoid some of the most pernicious pitfalls of a monopoly in e-book systems.

For example, today, the system platforms that support storage and retrieval of e-books by consumers are offered for free. However, should a provider monopolize the market for e-book systems, it could not only raise the price of e-books (if operating under the retail model) and e-book devices, it could start charging consumers for the privilege of accessing their previously purchased e-books stored on the provider's online platform. This effectively raises the cost of a consumer desiring to purchase an e-book that works on a incompatible e-book platform.

To purchase an e-book that operates on a competitor's platform a consumer may incur significant *switching costs*. For example, a consumer on the Amazon system considering the purchase of an e-book from the Barnes & Noble Nook e-book system, and perhaps switching to the latter entirely, may be faced with the choice of (a) repurchasing all of the e-books previously purchased in the old system, (b) maintaining a library of e-books on each of the two e-book systems, or (c) simply abandoning the previously purchased e-books stranded in the cloud of the old e-book system (together with the consumer's bookmarks, highlights, notes, etc.). These costs will depend on a variety of factors that have nothing to do with the price of the e-book being offered by Amazon's competitor.

Moreover, because switching costs play such an important role in a consumer's decision to purchase an e-book, a monopolistic e-book service provider will have an <u>incentive to increase the consumer's switching costs</u>. For example, suppose a consumer of Amazon's e-book system started to use an alternative e-book system for purchasing new e-books. Amazon would soon know that the consumer has not purchased an e-book from them in some time. It may then start charging the consumer for access to the e-books he or she previously purchased from Amazon until the consumer resumes buying e-books from Amazon. In other words, <u>use them or lose them</u>.

The consumer may still own a copy of the e-book on his or her device, but the convenience offered by the e-book service provider's cloud—including storage of the e-books, together with the consumer's stored bookmarks, highlights, notes, ratings, etc.,—features offered when the consumer chose the system in the first place, would be at risk. The consumer would thus be faced with a choice between paying the access fee or abandoning the benefits of having his or her e-books (and the consumer's bookmarks, highlights, notes, etc.) stored on the Amazon "cloud" system. If the consumer has an interest in preserving that access, then the consumer's switching costs will have gone up by Amazon's new monthly access fee. Under such circumstances, a consumer may think twice about straying to another system for their next e-book purchase.

Thus, a competing e-book system provider may offer to sell a best-selling title under the retail model for $4.99, half the price charged by Amazon. Yet, a consumer locked-in to Amazon's system may choose to pay full price for that title from Amazon rather than suffer the inconvenience of dealing with two e-book systems—i.e., two incompatible libraries of e-books, bookmarks, highlights, notes, etc.—or worse, having to pay an access fee to Amazon as a penalty for disloyalty.

The import of the foregoing should be obvious: in a consumer's decision as to whether to purchase an e-book, switching costs may be far more important than price. In other words, experience and common sense suggest that <u>a consumer's decision to purchase a particular e-book may have little to do with the price of the e-book</u>.

The Object of Antitrust Law is Consumer Welfare
Judged by the Economic Consequences of Defendants' Conduct
—Not Whether Any Particular Set of Agreements Results in Higher Prices

It is thus highly plausible that consumers would prefer to pay higher prices for e-books in the short term for lower e-book prices in the long term, more innovative e-book devices and system platforms, and lower switching costs. Even if the result of Defendants' actions alleged in the Complaint were to raise some prices, any anti-competitive effects of higher prices are far outweighed by their pro-competitive effects. See, Licensing Guidelines at 3.4 and 4.2.

After a handbag manufacturer lost an $84 million verdict for illegal resale price maintenance, it hired former solicitor general, Theodore Olsen to argue the case before the Supreme Court. *Leegin Creative Leather Products, Inc. v PSKS, Inc.*, 551 U.S. 877 (2007). The scene before the high court has been artfully described as follows:

> Olson was no more than six sentences into his argument when the more liberal members of the court began to barrage him with skeptical questions. Justice Breyer warned that abandoning the per se rule against resale price maintenance would increase consumer prices on everything from prescription drugs to blue jeans. Justice Stevens expressed concern that dealers would conspire among themselves to force manufacturers to raise retail prices. Justice Ginsburg and Souter suggested that a change of such significance should be made by Congress rather than by the Supreme Court.
>
> Olsen was on the verge of being overwhelmed when Justice Scalia stepped in.
>
> **"Is the sole object of the Sherman act to produce low prices?"** Scalia asked rhetorically.
>
> "No," said Olson, grateful for the help.
>
> **"I thought it was consumer welfare,"** Scalia suggested, nudging Olsen back on track.
>
> "Yes, it is," Olson quickly agreed.
>
> **"And I thought some consumers would prefer more service at a higher price,"** Scalia continued.
>
> "Precisely," Olson replied.
>
> **"So the mere fact that it would increase prices doesn't prove anything,"** Scalia yet announced. **"If, in fact, it's giving the consumer a choice of more services at a somewhat higher price that would enhance consumer welfare, so long as there are competitive products at the lower price, wouldn't it?"**
>
> "That is absolutely correct," replied Olson, who then quickly sat down.

Gary L. Reback, *Free the Market: Why Only Government Can Keep the Marketplace Competitive* (Portfolio, 2009).

Likewise, the mere fact that Defendants' actions raised some e-book prices doesn't prove anything.[6] It should be manifestly clear that consumer welfare is more likely to be enhanced if consumers would prefer more innovative devices and services from e-book service providers, even if they had to pay higher prices for some of the components of the system (e.g., a few best-selling e-book titles). This is especially true, if, as suggested above, a consumer's decision to purchase a particular e-book may have little to do with its price (e.g., more to do with the cost of adopting or switching to a new e-book system).

It has been suggested that, once a monopoly is created by virtue of positive feedback effects, only the government can return competitiveness to the marketplace. Reback, *Free the Market.* However, past government attempts to thwart attempted monopolization attained through exploiting those feedback effects have not been particularly effective. Id., and see discussion below. William H. Page & John E. Lopatka, *The Microsoft Case: Antitrust, High Technology, and Consumer Welfare* (Univ. of Chicago Press, 2007). *See also*, Wendy Goldman Rohm, *The Microsoft File: The Secret Case Against Bill Gates* (Times Books, 1998). *See, generally, United States v. Microsoft Corp*., 56 F.3d 1448 (D.C. Cir. 1995).

A winner-take-all monopoly over the digital gateway to works of literature, history, and science—which the proposed Final Judgment, if entered, would only promote—will increase prices in e-book systems and slow innovation in those systems. **The CEO of Amazon could not have framed the problem better: "[E]ven well meaning gatekeepers slow innovation." Jeff Bezos, *Letter to Our Shareholders* (April 13, 2012).**

The Complaint alleges sufficient facts to show that the "the $9.99 problem" was Amazon's attempted monopolization of the e-book systems market and, with the aid of common sense and experience, supports the conclusion that the Defendant Publishers engaged in behavior that was pro-competitive. In effect, the Complaint alleges facts that plausibly demonstrate that the Defendants engaged in lawful, not unlawful, behavior. Further by alleging that none of the Defendant Publishers could take action "by itself," the Complaint makes it clear that the Defendant Publishers had no choice but to take action to promote competition on a collective basis. Assuming all the factual allegations are true, the facts alleged simply do not constitute an antitrust violation under Section 1 of the Sherman Act, 15 U.S.C. 1.

"The term 'restraint of trade' in the Sherman Act, like the term at common law before the statute was adopted, refers not to a particular list of agreements, but to a particular **economic consequence**, which may be produced by quite different sorts of agreements in varying times and circumstances." *Business Electronics Corp. v. Sharp Electronics Corp*., 485 U.S. 717, 731 (1988). A "literal" approach to the factual allegations in the Complaint risks a simplistic and "overbroad" result. See, *Broadcast Music* at 9. ("The Court of Appeals' literal approach does not alone establish that this particular practice is [*per se* illegal] or that it is 'plainly anticompetitive' and very likely without 'redeeming virtue.' Literalness is overly simplistic and often overbroad"). (Emphasis added).

The literal approach taken in the formulation of this action makes too much of the specter of secret meetings in private dining rooms, exchange of information, and collaboration, which the Complaint takes pains to demonize, and too little of the true economic consequences of Defendants' behavior.

---

[6] *Leegin* may have involved a vertical, rather than horizontal restraint, but Justice Scalia's point cannot be ignored in the consideration of any matter under Section 1 of the Sherman Act. The mere fact that even a horizontal restraint may result in higher prices "doesn't prove anything." In fact, as will be shown below, the DOJ fully agrees with this and is on the record saying so.

As the Supreme Court has suggested repeatedly, the "economic consequences" of the alleged violations should first be thoroughly explored and action taken to correct attempts at monopolization should come only after the public has "considerable experience" with the business relationships an antitrust action would disrupt. *Leegin*, *Business Electronics, Broadcast Music (*citing, *United States v. Topco Associates, Inc*. 405 U.S. 596, 607-608 (1972). This should be especially true when the agreement under attack—such as the agreement implementing the agency model—is novel. See, *Arizona v. Maricopa County Med. Soc'y*, 457 U.S. 332, 364 (1982). Put in its most favorable light, this action is, at best, premature.

Proposed Final Judgment is Not in the Public Interest

It is therefore submitted that the licensing of digital rights in copyrighted works of authorship under the agency agreements at issue in this matter involve conditions both in copyright law and antitrust law which are *sui generis* to the courts. The factual allegations in the Complaint are plausibly explained by lawful behavior aimed at increasing competition in the market for e-book systems. The Court's entry of the proposed Final Judgment is not in the public interest, because the judgment would undo the pro-competitive effects of Defendants' actions.

Accordingly, the undersigned recommends that the DOJ:

A. Withdraw its consent to the proposed Final Judgment, and

B. Dismiss the Complaint under Rule 41(1)(A)(i) of the Federal Rules of Civil Procedure.

Should the DOJ decline to do so, it is respectfully submitted that the Court:

A. Hold that the proposed Final Judgment is not in the public interest, and

B. Consider the context presented in this response when ruling, at the appropriate time, upon a Defendant's motion for judgment on the pleadings under Rule 12(b)(6) or motion for summary judgment under Rule 56, if any.

C. Should none of the Publisher Defendants file either a motion under Rule 12(b)(6) or Rule 56, or if all Publisher Defendants should become parties to the proposed Final Judgment, the Court should, at the appropriate time, either:

1. **Grant summary judgment in favor of all Defendants, including Settling Defendants, under Rule 56(f), or**

2. **Grant leave to interested consumers to intervene for the purpose of filing a motion under Rule 12(b)(6) or Rule 56, and/or for filing an appropriate appeal. 15 U.S.C. 16(f)(3).**

To do otherwise risks the promotion of an unlawful monopoly in the e-books systems market to the detriment of e-book consumers and the public generally—a result that would be entirely at odds with the purpose of both the Sherman Act and the Copyright Act, and one that would be very difficult to undo by the Defendant Publishers themselves (should they survive) or even by government action. **In short, this action should never have been brought in the first place**.

TABLE OF CONTENTS

COMMENTS

I. Background

I am currently Chairman & CEO of RoyaltyShare, Inc., a Silicon Valley-backed startup company which I co-founded in 2005. RoyaltyShare provides technology solutions and enterprise services to record companies and book publishers (including one of the Settling Defendants).[7]

I am also the co-author of *Kohn On Music Licensing* (Wolter Kluwer, 4th Ed. 2010), an 1,800 treatise on the business and legal aspects of the music business, which follows earlier editions published in 1992, 1996, and 2002. The book was cited by the U.S. Supreme Court in *Eldred v. Ashcroft*, 57 U.S. 186 at fn 21 (2003), and other courts, including *Fred Ahlert Music Corp. v. Warner/Chappell Music*, 958 F.Supp. 170 (S.D.N.Y. 1997), *Woods v. Bourne*, 60 F.3d 978 (2d Cir. 1995), *Boosey & Hawkes v. Buena Vista Home Video*, 145 F.3d 481 (2d Cir. 1988), and *Bridgeport Music v. Dimension Films*, 410 F.3d 792 at fn 18 (6th Cir. 2005).

In December, 1997, I co-founded eMusic, the first digital music download service to sell digital music files for 99 cents per track, music that was fully-licensed for sale in the MP3 format by their record label and music publisher owners. See, David Kushner, "The Beat Goes Online, and Sometimes It's Legal," *New York Times* (June 17, 1999). eMusic, by then a public company whose shares were traded on NASDAQ, was sold to Universal Music Group in May, 2001. Andrew Zipurn, "Universal Music Group to Purchase Emusic.com," *New York Times* (April 10, 2001). (Two years later, Apple launched the iTunes digital music store. David Pogue, "Online Piper, Payable by the Tune," *New York Times*, May 1, 2003).

From 1996 to 1997, I was Senior Vice President and General Counsel of Pretty Good Privacy, Inc. (aka, “PGP”), a developer of encryption software.

From 1987 to 1996, I was Senior Vice President of Corporate Affairs and General Counsel of Borland International, Inc., a leading developer and marketer of personal computer software, including Turbo Pascal, Borland C++, dBASE, Paradox, Quattro Pro, and Sidekick. (I subsequently served Vice Chairman of the company’s Board of Directors from 2002 to 2005). As general counsel of Borland, I was responsible for overseeing the six-year litigation of *Lotus Development Corp. v. Borland International, Inc.*, 516 U.S. 233 (1996), a case in which the courts grappled with the extent to which the protection of copyright extended to the menu-command structure of Lotus 1-2-3 spreadsheet product. See, Reback, *Free The Market*, pp. 107-120. A divided Supreme Court let stand the 1st Circuit decision that the menu-command structure was an uncopyrightable 'method of operation.' *Lotus Dev. Corp. v. Borland Int'l, Inc.*, 49 F.3d 807 (1st Cir. 1995). The court adopted the "network externalities" theory raised by Borland and amicus curiae brief on appeal. The theory suggests that a single product may emerge as the *de facto* standard in a market, giving the standard's proprietor a monopoly over which it may exercise market power over competitors. William H. Page and John E. Lopatka, “Network Externalities,” *Encyclopedia of Law & Economics 952, 969 (1994)*.

---

[7] RoyaltyShare also provides services to the *New York Times* under which the *Times* accesses data that RoyaltyShare compiles with the permission of two other Defendant Publishers, which the *Times* uses to corroborate other data used to compile the New York Times Best Seller List for e-books. Julie Bosman, "Times Will Rank Ebook Bestsellers," *New York Times*, November 10, 2010).

From 1985 to 1987, I was associate general counsel to Candle Corporation, a leading supplier of IBM mainframe software. From 1983 to 1985, I was corporate counsel to Ashton-Tate, known for its dBASE line of database management software, later acquired by Borland. Prior to Ashton-Tate, I was an associate attorney at the law offices of Milton A. "Mickey" Rudin, an entertainment law firm whose clients included Frank Sinatra, Liza Minnelli, Cher, Warner Bros. Music, Warner Bros. Pictures, 20th Century Fox, and others. I am a graduate of Loyola Law School, Los Angeles. While in law school and for several years thereafter, I served as part-time Associate Editor of the *Entertainment Law Reporter* .

I am licensed to practice law in California and I am a member in of the State Bar of California. I have taught law at Monterey College of Law, Monterey, California, and I have served as an expert witness for entertainment organizations, including most recently on behalf of ASCAP in *In Re Application of AOL, RealNetworks and Yahoo!* (related to *United States v. ASCAP), 559 F.Supp. 332,* No. Civ. A 41-1395, 2008 WL 1967722 (SDNY 2008) (a rate hearing in which I provided testimony to the late District Judge William C. Conner on how music is used and marketed on the Internet, http://www.ascap.com/~/media/Files/Pdf/members/ratecourtdecision.pdf).

To be clear, the views expressed in these comments do not necessarily reflect the views of any of my current or past employers or any clients or customers of those employers. I have drafted this response without legal or other professional assistance of any kind. Moreover, I have not been in contact with any of the Defendants with respect to this response or its preparation. The first time they are hearing of it is today.

II. Standard of Review

The Tunney Act establishes the procedure and standard of review applicable to the proposed settlement of an antitrust case brought by the DOJ:

> (1) Before entering any consent judgment proposed by the United States under this section, *the court shall determine the entry of such judgment is in public interest*. For the purpose of such determination, the court *shall* consider–
>
> > (A) the competitive impact of such judgment, including termination of alleged violations, provisions for enforcement and modification, duration of relief sought, anticipated effects of alternative remedies actually considered, *whether its terms are ambiguous,* and any other competitive considerations bearing upon the adequacy of such judgment *that the court deems necessary to a determination of whether the consent judgment is in the public interest*, and
> >
> > (B) the impact of entry of such judgment *upon competition in the relevant market or markets*, upon the public generally and individuals alleging specific injury from violations set forth in the complaint including consideration of the public benefit, if any, to be derived from a determination of the issues at trial.

15 U.S.C. Sec. 16(e)(1). (Emphasis added).

The emphasis above, in italics, highlights language added by *The Antitrust Criminal Penalty Enhancement and Reform Act of 2004* ("2004 Tunney Reform Act"). Pub. L.. 108-237 (2004). Emphasis is added for several reasons.

The Tunney Act now *requires* the court to take each of the enumerated factors into account in its review of a proposed antitrust settlement. The 2004 Tunney Reform Act specifically amended the Tunney Act to substitute "court shall" in place of "court may," so now the court *must* consider the listed factors in its review. It is not optional. 15 U.S.C. Sections 16(e)(1)(A) and (B). Pub. L. 108-237 (2004).

In the CIS, the DOJ suggests that the court's inquiry is "necessarily a limited one," citing *United States v. Microsoft Corp*., 56 F.3d 1448, 1461 (D.C. Cir. 1995). That case was decided nearly a decade before the 2004 Tunney Reform Act was passed by Congress. In fact, the legislative history of the 2004 Tunney Reform Act is replete with evidence that, because of the District of Columbia Circuit's handing of the *Microsoft* case, an overwhelming majority of Congress was concerned that the Circuit had adopted a set of standards that produced a judicial "rubber stamp" for proposed consent decrees.

The DOJ also suggests that the Court may approve a settlement that may be "within reaches" of the public interest, citing *United States v. KeySpan Corp*., 763 F.Supp. 2d 633, 637 (quoting *United States v. Alex Brown & Sons, Inc.*, 963 F.Supp. 235, 238 (S.D.N.Y. 1997). Leaving aside the fact that *Alex Brown* was also decided years before the 2004 Tunney Reform Act, that is simply not what the Tunney Act says: "...the court shall determine the entry of such judgment is in public interest," not "within reaches" of it.

In enacting the 2004 Tunney Reform Act, Congress specifically reiterated that the purpose of the reform "is to effectuate the original Congressional intent in enacting the Tunney Act and to ensure that the United States settlements of civil antitrust suits are in the public interest." Pub.L. 108-237, title II, Sec. 221(a), June 22, 2004, 118 Stat. 668. If Congress accepted a "limited" role for the Court in these matters or to have the Court approve settlements merely "within reaches" of the public interest, it certainly could have said so. In fact, Congress pointed the courts toward the opposite direction: "Congress finds ... (B) that it would misconstrue the meaning and Congressional intent in enacting the Tunney Act to limit the discretion of the courts to review antitrust consent judgments solely to determining whether entry of those consent judgments would make a 'mockery of the judicial function'." Id.

Moreover, the 2004 Tunney Reform Act made it a requirement that Court consider not only the competitive impact of the judgment, but, <u>for the first time</u>, the impact of entry of the judgment "upon competition in the <u>relevant market or markets</u>" and "any other competitive considerations" bearing upon the adequacy of the proposed judgment. These requirements did not exist before 2004.

While the Court need not conduct an evidentiary hearing, it may take testimony, appoint a special master, authorize participation of interested persons, including allowing appearance of amicus curiae and allowing others to intervene as parties to the action pursuant to the Federal Rules of Civil Procedure, examine witnesses or documentary materials, or allow other forms of participation in any other manner and extent which serves the public interest as the court may deem appropriate. 15 U.S.C. Sections 16(e)(2) and (f). Federal Rules of Civil Procedure, Rule 24.

As this response hopes to demonstrate below, the proposed Final Judgment does not pass muster under the standard of approval set forth in the Tunney Act.

III. The Proposed Final Judgment Is Not in the Public Interest

Under the Tunney Act, the DOJ is required to file with the Court a "competitive impact statement," which must include, among other things, an "explanation of . . . the anticipated effects on competition" resulting from the relief requested. 15 U.S.C. 16(b)(3). The Competitive Impact Statement filed with the Court is hopelessly deficient in its compliance with the Act.

The CIS fails to fundamentally address what the DOJ believes is the competitive impact of the proposed Final Judgment, as it is devoid of any discussion of the relevant competitive considerations or any of the economic consequences of the requested relief. The CIS describes some of the objectives of several of the terms and conditions of the proposed judgment, but even those are listed only in the most conclusory terms. For example, the CIS asserts that the provisions of Sections IV.A and IV.B; IV.D; and V.A. and V.B; would, respectively,

- "restore competition to the e-books marketplace,"
- "ensure Settling Defendants' compliance with the proposed Final Judgment," and
- "allow competition to return to the market."

These mere conclusions hardly constitute the "explanation" of the "anticipated effects on competition" required by the Tunney Act, let alone what a Court would require in a determination of whether the proposed Final Judgment is in the public interest.

The Court, in carrying out its responsibilities under the Tunney Act, is not confined to the facts alleged in the Complaint or the government's conclusions as to the competitive impact of such judgment. 15 U.S.C. 16(e)(1). The Court is directed by the statute to consider what *the Court*, not the DOJ, shall determine is "the competitive impact of such judgment," and "any other competitive considerations." 15 U.S.C. 16(e)(1)(A).

Note also, that, notwithstanding the Complaint's allegations of *per se* violations, the Tunney Act directs the Court to specifically consider the impact of entry of such judgment upon the competition in the relevant market *or markets* and upon the *public generally*. 15 U.S.C. 16(e)(1)(B). (Emphasis added).

The CIS is devoid of any discussion of the impact of the proposed judgment on even the flawed relevant market the DOJ alleged in the Complaint. As discussed above, sound antitrust practice under the DOJ's own Licensing Guidelines, if not common sense, would require the DOJ to consider "upstream" markets for e-books in the market for goods used in combination with e-books, such as e-book reader devices and the systems services that support them. Guidelines at 3.2.1.

Nor does the CIS shed any light on how the DOJ approached its analysis of the impact upon competition in this case. On the contrary, the DOJ's conclusory assertions ignore or contradict the DOJ's own policies on how the agency *should* conduct antitrust analysis where the goods and services under considerations are copyrightable works of authorship.

While the DOJ is not bound to follow its own Guidelines, the Court is bound by "experience and common sense." *Bell Atlantic v. Twombly*, 550 U.S. 544 (2007). Certainly, in a case such as this—with such far-reaching implications in promoting innovation and competition—the Court would seem obliged to exercise its greatest possible judicial scrutiny of the Complaint and the proposed settlement.

As the remainder of this response will show, the factual allegations in the Complaint are plausibly explained by lawful behavior aimed at increasing competition in the market for e-book systems. The Court's entry of proposed Final Judgment is not in the public interest, because the judgment would undo the pro-competitive effects of Defendants actions.

IV. The DOJ Neglected Its Own Antitrust Enforcement Policies With Respect to Copyrighted Works

The antitrust enforcement policy of the United States government, as announced jointly be the DOJ and FTC with respect to the licensing of copyrighted works, such as e-books, is stated in the Licensing Guidelines. See, *Antitrust Guidelines for the Licensing of Intellectual Property* (April 6, 1995). The Guidelines are applicable to this action, because the e-books controlled and licensed by the Defendant Publishers to the e-book systems providers are copyrightable works of authorship.

The CIS not only makes no mention of the Licensing Guidelines, it seems the DOJ has neglected them entirely in the formulation of the Complaint and in the prosecution of this case. Though the Guidelines are not binding upon the DOJ or the courts, they shed light on how the DOJ conducts its analysis of antitrust matters, or at least how the department *should* conduct such analysis. Moreover, the Guidelines were specifically intended "to assist those who need to predict whether the [DOJ or FTC] will challenge a practice as anticompetitive." Id.[8]

The Guidelines are replete with policies that the DOJ ignored in conducting its prosecution of this case. At the top of the list, the Guidelines recognize that intellectual property has important characteristics that distinguish it from many other forms of property. Id. at Sec. 2.1. Antitrust analysis must take these difference into account in evaluating specific market circumstances in which transactions occur. Id.

Intellectual property typically is one component among many in a production process and derives value from its combination with complementary factors. Id. at Sec. 2.3. The owner of intellectual property has to arrange for its combination with other necessary factors to realize its commercial value. Id. Often, the owner finds it most efficient to contract with others for these factors, to sell rights to the intellectual property, or to enter into a joint venture arrangement for its development, rather than supplying these complementary factors itself. Id.

As touched upon above, and as shall be discussed at length below, e-books have no use or value in isolation. An e-book only derives value from its combination with a compatible device necessary to read it and a service platform to deliver it to the device. By contrast, a printed book can be purchased off the shelf and does not need to be combined with anything for it to be consumed. Thus, unlike a printed book, an e-book is only "one component among many in a production process and derives value from its combination with complementary factors." Id.

It should be common knowledge that book publishers "arrange for the combination" of their e-books with the "other necessary factors" (e.g., e-book devices and e-commerce systems) in order to "realize [the] commercial value" of the e-books, rather than choosing to develop and supply these necessary "complementary factors" themselves. Again, these complementary factors are necessary, because, without them, e-books have no use or value to consumers.

[8] That the DOJ neglected to apply the Guidelines should be unsettling to anyone interested in the fair application of U.S. antitrust laws.

Failure to appreciate this crucial distinction lead the DOJ to treat the market for e-books the same as the market for any non-system good, such as printed books. It is this central mistake that lead the DOJ to conclude that Defendants' alleged actions are anti-competitive when in fact they are manifestly pro-competitive.

As the Guidelines state,

> A restraint in a licensing arrangement may have competitive effects in markets for final or intermediate goods made using the intellectual property, or it may have effects upstream, in markets for goods that are used as inputs, along with the intellectual property, to the production of other goods.

Id. at 3.2.1.

The DOJ alleges in its Complaint that, where defendants have engaged in a *per se* violation of the Sherman Act, no allegations with respect to the relevant product market is required. The Tunney Act nevertheless requires the Court to consider the impact "upon competition in the relevant market or markets" in its determination of whether a proposed judgment is in the public interest. 15 U.S.C. 16(e)(1)(B).

The CIS is devoid of any discussion of the contours of the relevant market or markets. However, a definition of the relevant market or markets is contained in the Complaint:

> 99. ...the relevant product market for the purposes of this action is trade e-books.[9] The anticompetitive acts at issue in this case directly affect the sale of trade e-books to consumers. No reasonable substitute exists for e-books. There are no technological alternatives to e-books, thousands of which can be stored on a single small device. E-books can be stored and read on electronic devices, while print books cannot….

In attempting to differentiate e-books from printed books, the DOJ betrays a fundamental misunderstanding of the goods at issue in this matter. Again, to have any value at all to human beings, e-books not just can, but must be stored and read on electronic devices.

In ignoring its own Guidelines, the DOJ failed to bring to the Court's attention the important distinction between copyrighted works and other forms of property. Thus, the Court in the *Electronic Books Litigation* replicated the DOJ's fundamental mistake. See, Opinion & Order (May 15, 2012).

As noted above, e-books are not just digital versions of books. To have any value whatsoever, e-books must be read with the aid of hardware devices. Printed books, by contrast, may be read off the shelf, standing alone, without the aid of a machine or device. Appreciating the distinction between e-books, which require complementary products to give them value, and printed books, which have value on their own, is crucial to this case.

---

[9] *Trade books* are defined as "general interest fiction and non-fiction books" (Complaint at 27) as distinguished from *non-trade books*, which are all other books, including children's picture books, academic textbooks, and the like (Complaint at footnote 1).

V. The Complaint Alleges the Wrong Relevant Market

A complaint must allege a relevant market in which the anticompetitive effects of the challenged activity can be assessed. *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 9 (1984) (decision of the Supreme Court delivered by Justice Stevens) ("Illegal power must be appraised in terms of the competitive market for the product"); *Nifty Foods Corp. v. Great Atlantic & Pac Tea Co.*, 614 F.2d 832, 840 (2d Cir. 1984); *Re-Alco Industries, Inc. v. Nat'l Ctr. for Health Educ., Inc.*, 812 F.Supp. 387, 391 (S.D.N.Y 1993).

To survive a Rule 12(b)(6) motion to dismiss, an alleged product market must bear a rational relation to the methodology courts prescribe to define a market for antitrust purposes. See, *In Re Wireless Telephone Services Antitrust Litigation*, 385 F.Supp. 2d 392 (S.D.N.Y. 2003) (decision by District Judge Cote, citing *Todd v. Exxon Corp.*, 275 F.3d 191,198 (2d Cir. 2001)). Dismissal may be appropriate under Rule 12(b)(6) in the absence of a plausible explanation for why the market should be limited as it has been in the complaint. Id.

Plaintiff must "explain why the market it alleges is in fact the relevant, economically significant product market." *Re-Alco Industries*. This is true even if the complaint alleges a *per se* antitrust violation. See, *Fresh Made, Inc. v. Lifeway Foods, Inc.*, No. 01-4252, 2002 Trade Cas. Para 73,779 (E.D. Pa. August 9, 2002). Absent an adequate market definition, it is impossible for a court to assess the anticompetitive effect of challenged products. See, *Re-Alco*.

Whether or not the Complaint alleges, or the Court rules, the actions of Defendants constituted a *per se* violation of the antitrust laws, the Court is bound by the Tunney Act to consider the relevant market *or markets* affected by the settlement. 15 U.S.C. 16(e)(1)(B). Moreover, being that the Court is now directed to conduct an independent evaluation of the proposed judgment under the Tunney Act, the Court is not bound by the relevant market alleged in the Complaint in determining whether the proposed judgment is in the public interest.

The DOJ's Complaint defines e-books as "books sold to consumers in electronic form and read on a variety of electronic devices" (Complaint at 1) and then defines the relevant market simply as, "trade e-books" (Complaint at 99). By alleging that the relevant market in this case is the market for trade e-books, the DOJ treated the market for e-books as it would a market for any stand-alone good, such as handbags, grapefruits, or printed books.

But, under the DOJ's own Licensing Guidelines, the relevant market cannot be solely the market for e-books or trade e-books. Because there is no market for e-books in isolation, an e-book must be an intermediate good. Therefore, as the DOJ's own Guidelines suggest, being that an e-book is an "intermediate good made using intellectual property," the markets to be considered in a proper antitrust analysis of e-books must include the markets for "upstream" goods (or goods on the other side of the two-sided market), such as e-book reading devices. See, Guidelines at 2.3 and 3.2.1.

This formulation of the relevant market concerning e-books has now been confirmed in the economic literature. "As readers need to consume e-books through a particular e-book platform, the e-book market is best characterized as a two-sided market with network externalities." Yabing Jiang, *e-Book Platform Competition in the Presence of Two-Sided Network Externalities*, 2012 45th Hawaii International Conference on Systems Sciences, IEEE Computer Society 4777 (2012). The other side of the market (or the "upstream" market) is the market for e-book reader devices necessary for consumers to make use of e-books and the "cloud" platform services that bring

e-books with their compatible devices together. The two-sided market is referred to below as, the *e-book systems market*.

As will be discussed below, the pro-competitive effects of moving to the agency model upon the upstream markets should not only be obvious to common sense and experience, but have, in fact, become in the aftermath of Defendant's actions, significant and proven. Yet none of these effects have been considered by the DOJ in this case (or by the Court in its ruling on the motion to dismiss in the *Electronic Books Litigation*).

Moreover, the DOJ's own policies specifically instruct that such effects be considered. The DOJ & FTC's stated approach in analyzing a copyright licensing restraint is

> ...to inquire whether the restraint is likely to have anticompetitive effects <u>and, if so, whether the restraint is reasonably necessary to achieve procompetitive benefits that outweigh those anticompetitive effects</u>.

Id at 3.4 (emphasis added) (citing *Broadcast Music*, among other cases and a leading treatise on antitrust law).

The Guidelines continue:

> If the [DOJ & FTC] conclude that the restraint has, or is likely to have, an anticompetitive effect, they will consider whether the restraint is reasonably necessary to achieve procompetitive effects. If the restraint is reasonably necessary, the [DOJ & FTC] will balance the procompetitive efficiencies and the anticompetitive effects to determine the probable net effect on competition <u>in each relevant market</u>.

Id. at 4.2. Emphasis is added to note the Guidelines refer to "each" relevant market. That is because it is assumed throughout the Guidelines that copyrighted works often act as components of a market containing other components with which they need to operate if they are to have any value at all.

Copyrighted works, such as e-books, are part of a two-sided market, only one of which was considered by the DOJ in its analysis. By failing to consider the impact of Defendant's actions upon upstream markets, or the other side of the market, (i.e., the market for e-book reader devices and other components of e-book systems) the DOJ's analysis is a flawed one, at best, and a disastrous one for consumers and the general public.

VI. Collective Action by Competitors to Fix Prices Is Not Always Illegal

Before proceeding with the primary argument of this response, it is important to first put the atmospherics emanating from the Complaint in context. The Complaint alleges that beginning in September 2008, the CEOs of the Publisher Defendants met privately once per quarter:

> 39. ...These meetings took place in <u>private dining rooms of upscale Manhattan restaurants</u> and were used to discuss confidential business and competitive matters, including Amazon e-book retailing practices. No legal counsel was present at any of these meetings.

Later in the Complaint, we learn the name of the now infamous restaurant where at least two of these dinner meetings were held, *Picholine*, a French restaurant located near Lincoln Center. Complaint, at 49. In fact, we even

learn from the Complaint that the Defendant Publisher CEOs dined in the restaurant's private dining room, "The Chef's Wine Cellar." [10] Id.

To put these meetings in context, we need to roll back the clock nearly 100 years. In 1914, nine prominent men of Tin Pan Alley were seated in a remote corner of The Lamb's Club in mid-town Manhattan discussing the state of the music business. Songwriters, Victor Herbert (composer of *Babes In Toyland*, *The Red Mill*), Gustav Kerker (composer, *The Belle of New York*), Glen MacDonough (lyricist, *Babes in Toyland*), among others, and music publishers Jay Witmark (head of M. Witmark & Sons, the largest U.S. music publisher), George Maxwell (U.S. representative of G. Ricordi & Co. of Milan, the largest European music publisher), and Nathan Burkan, a New York lawyer who represented Witmark, and several other music publishers.

The backdrop of their discussion was the Copyright Act of 1909, by which Congress for the first time conferred upon the owners of nondramatic musical works the exclusive right to publicly perform their copyrighted songs. The problem was that, despite the new law, singers and musicians continued to perform copyrighted musical works in public without paying for the right to do so. Victor Herbert was particularly incensed over witnessing a recent performance of his song, *Kiss Me Again*, at the *Shanley Cabaret* in Times Square. Beside the fact the singer was “crooning atrociously,” his song was being performed illegally.

A memoir concerning the period recalls what happened next:

> Absorbed in their discussion, these men paid little heed to the passing time. Minutes raced into hours, and twilight was giving way to night when [Victor] Herbert gave a sudden new turn to the parley. He suggested a dinner at *Lüchow's*, where in the privacy of their own dining-room they could continue the discussion. The response was unanimous. In a few moments the nine were in the horse-drawn hacks of the period, hastening to the historic Fourteenth Street restaurant. And here ASCAP—as the society came to be widely known—was born.

Isadore Witmark, *From Ragtime to Swingtime* (Lee Furman, Inc. 1939), pp 373-374.

One can only imagine the course of the conversation over that dinner! What, Victor, do you think a single performance of one of your songs in a nightclub is worth? What would you charge, Jay? Nathan, help us out here with the legal aspects. What should be the terms of the license? It’s duration? It’s scope? Should we charge the performers or the restaurant? George, how do the publishers charge for performances in Europe? Should we charge a flat fee performance? A flat fee for the evening? The year? A percentage of the evening's till? What do we think the market will bear? Should we negotiate separately with each restaurant? How do we know what songs are performed? How do we collect the money? How do we divide the proceeds? How can we prevent some music publishers or other organizations from circumventing our terms or creating their own organization in competition with ours?

The conspiracy to limit competition and fix prices that was set in motion that evening was spectacularly successful. The group successfully sued *Shanley Cabaret* for its illegal performance of Victor Herbert's music. *Herbert v. Shanley*, 242 U.S. 591 (1917) (opinion of the Court delivered by Justice Oliver Wendell Holmes). A pricing regime was established on a collective basis to extract fees from restaurants, nightclubs and cabarets across the country

[10] Zagat, while raving about *Picholine*'s "off-the-charts French-Med cuisine," rather prophetically warned, "it can sure strain your budget, but it's bound to be a memorable experience." Zagat, *New York City Restaurants* (2011).

for the performances of copyrighted music. The group later brought suit against radio stations, requiring them to start paying for the broadcast performances of their music. *M. Witmark & Sons v. L. Bamburger & Co.*, 291 F. 776 (D.N.J. 1923). Today, ASCAP's annual revenues exceed $1 billion.

The point here is: So what? So what if there were secret meetings in private dining rooms, conversations about business models, direct evidence of a conspiracy, and even increased prices?

In 1979, the Supreme Court was asked to determine whether the scheme used by BMI on behalf of their composer and music publisher members to collectively fix the fees they charged for performances of their copyrighted songs constituted price fixing that is *per se* unlawful under the Sherman Act. Despite undisputed facts showing a conspiracy to fix prices that go far beyond meetings of CEOs in private dining rooms, the Court held that the horizontal restraint of trade in that case did not constitute a *per se* violation of the Sherman Act. *Broadcast Music, Inc. v. CBS*, 441 U.S. 1 (1979) (opinion of the Court delivered by Justice White).

It took 65 years for the antitrust issue arising from that dinner at *Lüchow's* in 1914 to reach the U.S. Supreme Court. Both the music publishing industry and consumers of popular music are fortunate that the government did not rush to judgment over the clear and unambiguous acts of price fixing among music publishers after that famous dinner at *Lüchow's*.

Indeed, Justice White recognized that whether a horizontal constraint is a violation of the Sherman Act "is not simply a question of determining whether two or more potential competitors have literally 'fixed' a 'price'."

> To the Court of Appeals and CBS, the blanket license involves "price fixing" in the literal sense: the composers and publishing houses have joined together into an organization that sets its price for the blanket license it sells. <u>But this is not a question simply of determining whether two or more potential competitors have literally "fixed" a "price.</u>" As generally used in the antitrust field, "price fixing" is a shorthand way of describing certain categories of business behavior to which the per se rule has been held applicable. <u>The Court of Appeals' literal approach does not alone establish that this particular practice is one of those types or that it is "plainly anticompetitive" and very likely without "redeeming virtue." Literalness is overly simplistic and often overbroad</u>.

Id at 9. (Emphasis added). Moreover, the DOJ is on the record as being in full agreement with this. For decades, the DOJ was not only fully aware of the overt acts of price fixing by the music publishers, the DOJ defended those efforts in the courts. In an *amicus curiae* brief filed on behalf of the United States in *Broadcast Music*, the DOJ elaborated on the proper application of antitrust laws in this area:

> The Sherman Act has always been discriminatingly applied <u>in light of economic realities</u>. There are situations in which competitors have been permitted to form joint selling agencies or other pooled activities, subject to strict limitations under the antitrust laws to guarantee against abuse of the collective power this created.

Id. at 14 (emphasis added). In fact, it has long been the position of the DOJ that the conspiracies to fix prices by organizations like ASCAP and BMI on behalf of their members are neither a *per se* violation <u>nor an unreasonable restraint of trade</u>. *Memorandum for United States as Amicus Curiae on Pet. for Cert. in K-91, Inc. v. Gershwin Publishing Corp.*, O.T. 1967, No. 147, pp. 10-11.

The allegations set forth in the Complaint describing Defendant Publishers' meetings in private dining rooms, telephone conversations, emails, exchanges of information, and alleged opportunities to discuss prices, do not come close to the acts of outright price fixing facilitated by the "joint selling agency" operated by the composers and music publishers since 1914. On the contrary, the Complaint fails to allege one single price of any single e-book that was "fixed" by Defendants; it merely alleges the establishment of an alternative pricing model, one which was manifestly pro-competitive considering the true relevant markets at issue in this case.

The literal approach taken in the formulation of this action makes too much of the specter of secret meetings in private dining rooms, exchange of information, and collaboration, and too little of the true economic consequences of Defendants' behavior.[11] As the Supreme Court has repeatedly stated, the courts must look to the "economic consequences" of the Defendants' actions. *Leegin*, *Business Electronics, Broadcast Music (*citing, *United States v. Topco Associates, Inc*. 405 U.S. 596, 607-608 (1972). This should be especially true when the agreement under attack—such as the agreement implementing the agency model—is novel. See, *Arizona v. Maricopa County Med. Soc'y*, 457 U.S. 332, 364 (1982).

"The term 'restraint of trade' in the Sherman Act, like the term at common law before the statute was adopted, refers not to a particular list of agreements, but to a particular **economic consequence**, which may be produced by quite different sorts of agreements in varying times and circumstances." *Business Electronics Corp. v. Sharp Electronics Corp*., 485 U.S. 717, 731 (1988).

Thus, the DOJ is on record that the Sherman Act should be discriminately applied "in light of economic realities" and, accordingly, whether a horizontal constraint is a violation of the Sherman Act is not simply a question of whether competitors collectively fixed a price and that prices increased as a result. This is a view consistent with the DOJ's own Licensing Guidelines and certainly aligned with Supreme Court's view of the matter: "lower prices" is not the sole object of the Sherman Act. The mere fact that an action would increase prices "doesn't prove anything." It bears repeating, price fixing that has a "redeeming virtue" is legal. *Broadcast Music*, 441 U.S. at 9.

VII. The Nature of Markets for Systems and Their Components

The nature of "systems products," and the phenomenon that affects competition in the markets for them, is fundamental to the determination of whether the proposed Final Judgment in this case is in the public interest.

The classic explanation of the phenomenon at work in these markets starts with the recognition that the first telephone has no value, but a second telephone establishes a network system that gives rise to value in both telephones. Michael L. Katz and Carl Shapiro, *Network Externalities Competition and Compatibility*, The American Economic Review, Vol. 75, No. 3 (June, 1985), pp. 424-440 (hereinafter, "Katz & Shapiro 1985"). When a consumer buys the third telephone, that purchase not only confers benefits on the person buying the telephone, but on everyone else who already owns a phone in the network. Thus, each new user of a telephone in the network derives private benefits, but also confers *external* benefits on existing users, who now have an additional person

[11] Defendants' conduct is not legal, *because* the conduct of music publishers in *Broadcast Music* is legal. *Broadcast Music* stands here for the proposition that not all horizontal price fixing is illegal and to take a literal approach—e.g., Defendant's "agreement in restraint of trade is unlawful per se, because it is, at root, a horizontal price restraint" (Electronic Books Litigation, May 15, 2012)—is "overly simplistic" and will lead to "overbroad" results. See, *Broadcast Music* at 9.

on the network with whom they may communicate by telephone. These external benefits conferred on others by new purchasers have been called *network externalities*. Id.

A "systems product" may be defined as a collection of two or more components, each of which have little or no value in isolation, together with an interface that allows the components to work together. Michael L. Katz and Carl Shapiro, *Systems Competition and Network Effects* , The Journal of Economic Perspectives, Vol. 8, Issue 2 (Spring 1994,), pp. 93-115 ("Katz & Shapiro 1994"). Examples of systems products include nuts and bolts, which together provide fastening services; facsimile machines and their associated communications protocols, which together provide fax services; personal computers and computer software, which together provide a variety of personal productivity services; video players and motion pictures, which together provide audiovisual entertainment services. Id.

E-books and e-book readers (with their associated service platforms that support the purchase, delivery, storage and retrieval of e-books and related consumer data) is another example of a systems product. A printed book is not a systems product. One of the fundamental differences between an e-book and a printed book is that an e-book has no use or value without a compatible device necessary to read it and an e-commerce platform to deliver it to the device.

The key characteristic of systems products is that the utility that a consumer derives from consuming the product increases with the number of other users of the product. For example, the value that a consumer places on a telephone depends upon the number of households or businesses that have joined the telephone network. Katz & Shapiro 1985. Similarly, the value a user of Facebook derives from their use of the Facebook social network system increases with the number of Facebook users, particularly the user's Facebook "friends," because each new user or friend is an additional person with whom the existing user may now communicate.

This same phenomenon occurs where the devices are not necessarily connected. Katz & Shapiro 1994. A consumer looking to purchase a PC or tablet computer will be concerned with the number of users of the same kind of device and the amount and variety of software programs, "apps," e-books and other content, that will be available for use with the device. Consumers also fear being locked-in to a system only to later find their investment in software and other programming stranded should the system they chose not succeed in market.

Purchase decisions concerning these systems products and their components (e.g., software, apps, movies, e-books, etc.) will thus depend, in part, upon consumer *expectations* about the decisions made by other consumers. Id. As discussed below, they will also depend upon decisions made by system providers and suppliers of components of the system that affect the relative success of competing systems products—decisions concerning product compatibility, pricing, and the availability of components.

As will be explained below, because of the positive external feed-back effects influencing the adoption of systems products, markets for these products are prone to being "tipped" in favor of a single provider of a system. Since systems competition is prone to tipping, there are likely to be strong winners and strong losers in the systems market. Katz & Shapiro 1994, p. 111. For this reason, markets for systems products are commonly referred to as, “winner-take-all.”

Sophisticated system providers have employed strategies to tip such markets in their direction in an attempt to monopolize the market for the systems product. Having won the systems war, the monopolist will be tempted to

raise the price of the system and its components to the monopoly level. Id. At 98-99. A system provider will also have the incentive to increase switching costs, thereby locking-in consumers even more to its system, and even leverage their market power to gain monopolies in adjacent markets.

Moreover, in the absence of intense competition in the systems market, the monopolist has less incentive to make the investments necessary to introduce innovations in the dominant system. Antitrust regulators have grappled with the challenges associated with such monopolies, but have had mixed success. Reback, *Free The Market*; Page & Lopatka, *The Microsoft Case*; Rohm, *The Microsoft File. See, generally, United States v. Microsoft Corp*., 56 F.3d 1448 (D.C. Cir. 1995).

As general counsel of Borland, I oversaw and settled on behalf of Borland the antitrust action brought by the DOJ to stop Borland's acquisition of Ashton-Tate in 1991, an acquisition which the DOJ alleged would provide Borland overwhelming market share in database management software. In exchange for allowing the acquisition to proceed, the DOJ accepted Borland's offer to not enforce any copyright rights in the dBASE programming language for five years. The DOJ accepted Borland's theory that, without the ability to enforce any rights it may have had in the dominant database programming standard at the time, Borland would not be able to use the effects of network externalities to tip the database management market entirely in its favor.

During that time, I was also called in by both the DOJ and Federal Trade Commission on several occasions in connection with the government's antitrust investigation of Microsoft Corp. See, Testimony of Robert H. Kohn (1995); Wendy Goldman Rohm, *The Microsoft File: The Secret Case Against Bill Gates* (Times Books, 1998). Beginning in the early 1990's, Borland claimed that Microsoft was leveraging their monopoly in the operating system for personal computers to gain an illegal competitive advantage in the market for applications software, such as word processors, spreadsheets, database management, and programming language software. While the DOJ took action against Microsoft for monopolizing the operating system market (see, *United States v. Microsoft*, supra), the DOJ failed to seek a remedy for Microsoft's leveraging of its monopoly in operating systems to eliminate competition in the applications software market.

The government at that time failed, in my view, to grasp how network externalities could be used by a monopolist in operating system software to tip or monopolize the market in components—i.e., applications software, such as WordPerfect, Lotus 1-2-3, dBASE–in favor of the monopolist's applications products (i.e., Word, Excel, and Access). Neither the DOJ nor the FTC took action. As a result, the demise of WordPerfect, Lotus 1-2-3, and dBASE was swift, and by the end of the 1990's, complete. Consumers locked-in to the Microsoft operating system have been suffering the slow pace of innovation in office productivity software ever since.

The past, I fear, is prologue: the DOJ's failure to recognize how a monopolist in e-book systems (including e-book reading devices and the web-based service essential to support them)–such as Amazon–could use strategies to tip the market for e-book systems toward a monopoly in its favor. Later, they may use that monopoly to raise prices to consumers, increase the costs of users desiring to switch to competitive systems, and attempt to gain a monopoly in adjacent markets—including the sale of printed books and book publishing itself—making Amazon a single gatekeeper for the dissemination of new works of authorship.

Not only has the DOJ offered nothing to address these potential threats to consumers and the public generally, the proposed Final Judgment, if approved by the Court, would seem to assure these things will come to pass. See, David Streitfeld, "Cut in E-Book Pricing by Amazon Is Set to Shake Rivals," *New York Times* (April 11, 2012) (leading

with, "The government's decision to pursue major publishers on antitrust charges has put the Internet retailer Amazon in a powerful position: the nation's largest bookseller may now get to decide how much an e-book will cost, and the book world is quaking over the potential consequences").

VIII. Competition in the Market For E-Book Systems

Before describing the pro-competitive, redeeming virtues of Defendants' actions in this matter, it will be first helpful to review some of the important characteristics of e-books and the market in which they are consumed, something which is entirely lacking in the DOJ's Complaint and the Competitive Impact Statement.

Many products have little or no value in isolation, but generate value when combined with others. Katz & Shapiro 1994. An e-book is one of those products, because it has no value without an e-book reader device and the means to deliver it to the device. *See*, Yabing Jiang, *e-Book Platform Competition in the Presence of Two-Sided Network Externalities*, 2012 45th Hawaii International Conference on Systems Sciences, IEEE Computer Society 4777 (2012) ("As readers need to consume e-books through a particular e-book platform, the e-book market is best characterized as a two-sided market with network externalities").

For this reason, (a) an e-book reader device, (b) an e-book that is formatted to work on it, and (c) the web-based services necessary to bring them together, are each necessary components of a system. We can call that system, an *e-book system*. For example, Amazon has an e-book system comprised of e-book reader devices (e.g., its Kindle device), web-based services (i.e., its Kindle store and service platform for the purchase, storage, and retrieval of consumers' e-books, bookmarks, notes, highlights, book ratings and other information created by the consumer), and e-book content (i.e., containing literary works, etc.) licensed from third parties such as the Publisher Defendants, other book publishers, and authors (or taken from the public domain). Apple, Barnes & Noble, and a number of other firms have similar e-book systems. These systems compete with each other.

Market competition between systems products, as opposed to market competition between individual products, give rise to well known competitive phenomena that are influenced by the decisions made by (a) consumers, (b) system providers (e.g., Amazon, Apple, etc.), and (c) component providers (e.g., book publishers), Katz & Shapiro 1994.

A. Decisions by Consumers

One key to appreciating competition in systems markets is to understand how consumers make decisions about which systems product to purchase.

One of the important characteristics of a system product is that the components of the system (e.g., e-books) are purchased over a period of time. For example, a person purchases an e-reader device one day, and then purchases e-books that operate on that device at various intervals in the future. As a result, consumers must form *expectations* about availability, price and quality of the *components* of the system that they will be buying in the future. See, Katz & Shapiro 1994.

Because a consumer purchases an e-book reader at one time and then purchases e-books to read on it at various intervals over time, providers of e-book systems compete in a market characterized by *positive feedback effects*. Id. This means that consumer purchase decisions regarding e-book devices, and the e-books designed to work with

them, are affected by consumer expectations about what other consumers will do. Id. Consumers are attracted to systems products that are compatible with the greater number of users. This is because systems popular with a greater number of users will be (a) more likely to attract a greater variety and quality of components (e.g., e-books) and (b) less likely to strand the consumer's investment in those components should the system provider fail in the market.

The more consumers adopt a particular system, the more likely it is that other consumers will adopt the system. By the same token, each new consumer who adopts the system not only receives their own private benefits from using the system, but also confers benefits upon existing consumers of the system, who benefit from belonging to an increasingly popular system. These external benefits conferred on others by new purchasers are called, *network externalities*. Katz & Shapiro 2985. Meanwhile, the more popular a system becomes, the more consumers are likely to adopt it. By the same token, the more additional consumers adopt the system, the less likely consumers already on the system will leave it. Thus, a consumer's decision as to which e-book system to invest or remain in will also depend on their expectations about what other consumers do. Katz & Shapiro 1994.

For example, when the consumer purchases an e-book reading device, the consumer will begin to make investments in e-books that may work only with that device and its e-book service platform. (See discussion in the following section, regarding incompatibility). Consumers who purchase e-books that only work within the environment of a certain e-book system have a concern about being stranded in a system without a means to use their purchased e-books on alternative systems. E-books purchased by the consumer for use within one system may not necessarily operate on the alternative e-book systems available, leaving stranded the e-books purchased for use on the previous system.
Even though an e-book purchased for use on one device (e.g., Kindle) might be readable on another device (e.g. iPad) with the aid of proprietary software (e.g., offered by Amazon for that purpose), the consumer still remains locked-in to the Amazon e-book system. The attributes and quality of the web-based software platform is important. It allows the consumer to purchase new e-books, store purchased e-books, download purchased e-books to his or her several devices, including replacement devices (e.g., the latest model), and make use of a variety of advanced services offered by the e-book system provider, such as the ability to store bookmarks, highlights, and personal notes, book ratings, and the ability to share reading progress and preferences with others in the e-book provider's network.

Switching system providers (e.g., from the Amazon Kindle e-book system to the Barnes & Noble Nook e-book system) may be costly. For example, a consumer desiring to maintain his or her library of e-books may be faced with the choice of (a) repurchasing from the new system all of the e-books previously purchased in the old system, (b) maintaining the respective portions of the library on each of the two e-book systems, or (c) simply abandoning the previously purchased e-books stranded in the old e-book system (together with the consumer’s bookmarks, highlights, notes, etc.).

These switching costs play an important role in a consumer's decision to purchase an e-book. In fact, as discussed below, <u>switching costs may be far more important than the price of the e-book in a consumer's purchase decision</u>. A competing e-book system provider may offer to give away a best-selling title for free, but a consumer locked-in to a competing e-book system may choose to pay full price for that title rather than suffer the inconvenience of dealing with two e-book systems—i.e., two incompatible libraries of e-books, bookmarks, highlights, notes, etc.

B. Decisions by Systems Providers

Another key to appreciating the competitive phenomena of systems markets concerns the decisions made by systems providers.

As we have seen, consumers are attracted to a technology that is compatible with a greater network of users, a technology that attracts a greater variety and quality of compatible components (e.g., software, e-books), and a technology that will less likely leave their investment in those components stranded. Id. Thus, consumers tend to place a higher value on the more popular system. As a result, positive feedback effects permit a first entrant to a market to achieve domination of that market by getting a head start in building an installed base of users, each addition to which increases the value of the first entrant's product. *Testimony of Robert H. Kohn* before FTC (November 29, 1995).

The more a system dominates a market, the more consumers are likely to adopt the system. Thus, in markets exhibiting positive feedback effects, there is a natural tendency toward *de facto* standardization, which means everyone using the same system. Katz & Shapiro 1994. In other words, systems markets are prone to "tipping," which is the tendency of one system to pull away from its rivals in popularity once it has gained an initial edge. Katz & Shapiro 1994. A market that settles on a single system is said to be "tipped." Page & Lopatka 1999. The business opportunity for a system provider has been described as, "winner-take-all."

To the extent a systems provider can do something to increase the number of consumers who adopt their system over a competing system, that systems provider may accelerate the tipping of a market in its favor. Besides early entry into the market, there are at least three strategies a system provider can employ in attempt to tip the market in its favor and monopolize the market: (1) using proprietary standards, (2) offer to consumers exclusive content not available on competitors' e-book systems, and (3) pricing components of the system aggressively.

By the time Defendant Publishers began to formally recognize "the Amazon problem," Amazon had already begun aggressively employing all three of these strategies in an attempt to monopolize the market for e-book systems.

Tipping Strategy 1: Base the Systems Product on Proprietary Standards That Are Incompatible With Systems Products of Potential Competitors

An early decision a system provider must make is whether to base its system's technology on proprietary standards not available to competitors or adopt an industry standard that each competitor may use. Adopting an industry standard is referred to as *compatibility* and adopting a proprietary standard is referred to as, *incompatibility*.

For systems that are compatible, the locus of competition shifts from the overall package (including the network size) to the specific cost and performance characteristic of each component individually. Katz & Shapiro 1994 p.110 (citing Carmen Matutes & Pierre Regibeau, "Mix and Match: Product Compatibility Without Network Externalities," *Journal of Industrial Economics*, Vol. 37, pp 359-371 (1988) and Nicolas Economides, "Variable Compatibility without Network Externalities," Discussion Paper No. 145, *Studies in Industry Economics*, Stanford University (1988)). This general principle implies that if one firm has a distinctly superior overall package, including its product offering, its installed base, and its reputation, that firm is likely to prefer incompatibility and may in fact spend resources to block compatibility. Id.

Thus, incompatibility chosen at an early stage of the market by a strong participant will make it more likely that participant will succeed in monopolizing the market. By contrast, compatibility tends to prevent one firm from gaining control of a market and intensifies competition in the long run. Id. If a firm is confident it will be the winner, that firm will tend to oppose compatibility. Id. at 111.

It should be no surprise that Amazon, an early entrant in the e-book systems market with a large installed base of users of its e-commerce platform and a reputation built upon selling physical books, chose to employ the incompatible approach, building e-book technology upon their own proprietary standards rather than adopting or helping build a compatible industry standard.[12]

Tipping Strategy 2: Provide Exclusive Content Not Available On Other E-Book Systems

As we have seen, consumers are attracted to systems that offer a greater variety and quality of components. Thus, in choosing an e-book system, the consumer will want assurances that a variety of quality of e-books will be available on the system.

Because competition between e-book systems occurs in a two-sided market (e.g., one side being e-books and the other e-book readers and their associated online systems services), the availability of content between and among e-book systems can be tipped in favor of one system over another. See, Yabing Jiang, *e-Book Platform Competition in the Presence of Two-Sided Network Externalities*, 2012 45th Hawaii International Conference on Systems Sciences, IEEE Computer Society 4777, 4781 (2012).

As will be discussed below, Jiang's research suggests that the commitments that book publishers make in terms of making total content available on a platform are critical to consumers' platform adoption decisions. Id at 4781.

[12] By contrast, a new entrant with no reputation or installed base of users in a new market might take a different path. For example, when we founded eMusic in 1997, a start-up company with no previous customers, reputation or market share in a non-existent market for digital music downloads, eMusic chose compatibility. When eMusic opened the first online store to sell downloads of music in July, 1998, the company chose to sell its digital music files in the MP3 format—the *de facto* open standard which users of digital music were using at the time (albeit illegally)--rather than a proprietary or DRM-protected format that was incompatible with the MP3 standard. DRM is the acronym for *digital rights management* technology, which purports to thwart an end user's ability to make unauthorized copies of the digital files. See, Al Kohn and Bob Kohn, *Kohn On Music Licensing* (4th Edition, 2010), pp. 38-46. The eMusic team was convinced that DRM technologies were fundamentally flawed and that the company would more likely succeed by adopting the open standard. Unfortunately, while over 1,000 independent record labels agreed to license their copyrighted recordings to eMusic for sale in the MP3 format, the major record companies refused to license to eMusic, reluctant to make their recordings available for download sale unless the digital files were wrapped in one or more untested DRM technologies of the time. Several years later, when the major record companies licensed their recordings to Apple Computer in 2003, they demanded that Apple use DRM in the digital files they sold. Apple agreed, but the majors made the critical mistake of failing to require Apple to make their proprietary technology standards freely available to every provider of music systems. Had the majors done so, consumers of the iTunes music store would not be locked-in to the iTunes digital music system. At the time, and to a large extent today, a consumer could not purchase a track from an Apple competitor, such as the Microsoft Zune digital music store, and use it on an Apple iPod. Nor could a consumer purchase a track from the iTunes music store and use it on a competitor's incompatible music player. To this day, Apple maintains a near monopoly in digital music sales, controlling by some estimates more than 85% of permanent digital download sales, with Amazon a distant second with about 9% share and eMusic about 2%.

The publishers' "decisions of making a title [or titles] available on [a] platform can influence the total e-book device ownership due to the two-sided network effect." Id.

This suggests that the adoption rate of a particular e-book system can be influenced by publishers' decisions as to the number of titles, and timing of the release of popular best-selling titles, to the respective e-book systems providers. By the same token, if an e-book system provider can convince the publishers to provide it titles on an exclusive basis, this should tip the adoption rate in the provider's favor.

Obtaining titles on an exclusive basis, not available to other e-book system providers, is a strategy that Amazon began in the Fall of 2009. Unable to persuade any of the Defendant Publishers to offer them titles on an exclusive basis, Amazon began taking substantial steps to achieve the equivalent result on its own—along the lines of, "if you can't beat 'em, join 'em."

Amazon's first move was to start licensing e-book editions of best-selling works of popular authors who claimed they reserved e-book rights to the works licensed to Defendant Publishers under their original publishing agreements. Brad Stone & Motoko Rich, "Top Author Shifts E-book Rights to Amazon," *New York Times* (December 14, 2009) (referring to "one of the most successful business authors of the last two decades," Stephan R. Covey, whose books, such as *The 7 Habits of Highly Effective People,* were originally published in hardcover by Simon & Schuster, one of the Defendant Publishers). Amazon's agreement to publish e-book editions of works published by Defendant Publishers were made over the objections of the publishers, but no lawsuits have yet been filed against Amazon to prevent the practice.[13]
On December, 9, 2009, Amazon began offering Covey's best-seller on its Kindle e-book system <u>on an exclusive basis</u>. To this day, the e-book is on the top of Amazon's list of top 100 "exclusive" e-books and, to this day, Amazon does not make Mr. Covey's e-book available on any competing e-book system. See, Amazon.com, *Best Sellers in Exclusive Content* (May 25, 2012).

Amazon's next move was alleged in the Complaint,

> 70. While the Publisher Defendants were discussing e-book distribution terms with Apple during the week of January 18, 2010, Amazon met in New York City with a number of prominent authors and agents to unveil a new program under which copyright holders could take their e-books directly to Amazon—cutting out the publisher—and Amazon would pay royalties of up to 70 percent, far in excess of what publishers offered.

The following year, Amazon established its own book publishing organization to accelerate their effort to sign top authors on an exclusive basis. Julie Bosman, "Agent and Former Publisher to Lead New Imprint for Amazon," *New York Times* (May 23, 2011). Within 90 days, Amazon signed a publishing agreement with Timothy Ferris, the "wildly popular" self-help author whose previous best-selling books were published by Random House, the largest trade book publisher. David Streitfeld, "Amazon Set to Publish Top Author," *New York Times* (August 16, 2011). Under the agreement, Amazon obtained the right to publish Ferris's next work as a hardcover, an e-book, and an audio book. Id. Amazon has not announced whether it would offer the e-book edition for sale on competing e-book systems or whether it will hold back, or "Window," the release of the e-book, giving it an "exclusive" for a period of time.

---

[13] For an analysis of whether the right to publish a work "in book form" covers the right to publish e-book editions, and an examination of one court's opinion on the subject (*Random House, Inc. v. Rosetta Books LLC*, 150 F.Supp.2d 613 (S.D.N.Y. 2001)), see *Kohn On Music Licensing* at pp. 1231-1237.

If the adoption rate of Amazon's Kindle e-book system can be tipped in its favor by publishers' decisions to give Amazon a greater number of titles or preferential treatment on the timing of the release of popular best-selling titles, Amazon had found a way to do it themselves. Amazon, it is submitted, would not have been able to accomplish this but for leveraging its market power (e.g., selling 90% of all e-books and 25% of all printed books). As Mr. Ferris explained to the *New York Times*, his previous publisher (Crown, a division of Random House) did not get a chance to match the offer because, in his view, it never could have. Id.

Tipping Strategy 3: Artificially Price Complementary Components of the System Aggressively in the Short Term

How consumers form their *expectations* about the price of components, such as e-books, is a critical issue in the market for systems and the competition among systems providers. See, Katz & Shapiro 1994, pp 98-99. A monopolist would like to convince consumers that components (e.g. e-books) will be available at low prices in the future. Id. Then, after consumers are locked in, this same monopolist may be tempted to raise price to the monopoly level. Id.

It should therefore have been no surprise to that Amazon employed this powerful tipping strategy, artificially pricing the e-books it offered for use in the Kindle e-book system at significantly below cost. Providing a market with a product at significantly below cost when consumers may be willing to pay a higher price may seem irrational, but in the presence of strong network externalities, a vendor may find it optimal to subsidize the purchases of components in the short term to encourage adoption of the provider's system over systems offered by its competitors. M. Gallaugher and Yu-Ming Wang, *Network Effects and the Impact of Free Goods: An Analysis of the Web Server Market*, International Journal of Electronic Commerce, Vol.3, No. 4, Summer, pp. 67-88 (1999).

Under the retail model, if the suggested retail price of an e-book is $26, the wholesale price to Amazon would typically be $13. If Amazon sells the book for $9.99, Amazon is losing $3.01 per e-book. Thus, if Amazon sold 1 million books per month at this price, it would lose over $3 million per month. For a company sitting on $8 billion of cash and having operating income exceeding $100 million per month, losing $3 million per month may seem a small investment to make in an attempt to monopolize and assume the winner-take-all position in the e-book systems market (and potentially, the e-book and printed book market, as well).

The CIS makes reference to the agency model's preventing an e-book system provider from offering e-books under an "all-you-can-read" subscription model where consumers would pay a flat monthly fee. CIS, Section C ("Effects of the Illegal Agreement"). Under the retail model, this would effectively mean that Amazon would be charging substantially less than $9.99 per e-book. For example, if a consumer paid $6.58 per month (about the price of the $79 annual subscription to the "Amazon Prime" service) and downloaded only one book per week under this service, the effective price per e-book to the consumer would be $1.65.

Unless Amazon negotiates with the book publishers a reduced wholesale price—something which is entirely within the publishers' discretion, even under the retail model[14]—Amazon would still have to pay the publisher $13 per book downloaded under the Amazon Prime subscription service. Thus, Amazon would lose $11.35 per e-book under this model.

[14] When Amazon licenses e-books from authors directly—where it has far higher leverage—it obtains the right to publish the e-books under the Amazon Prime subscription model under a substantially reduced per-unit royalty.

If Amazon would be willing to lose $11.35 much per e-book, and risk that some consumers might download hundreds of books per month under the "all you can eat" model, Amazon would either (a) not include Defendant Publishers' e-books in the Amazon Prime subscription model or (b) have to find a way to recoup the enormous potential losses by other means.

If Amazon chooses not to include Defendant Publishers' e-books in the Amazon Prime subscription service, then the DOJ is completely wrong in its assertion in the CIS that the agency model "prevented" Amazon from "offering e-books under 'all-you-can-read' subscription model. See, CIS at Section C ("Effects of the Illegal Agreement"). Even Amazon could not be able to afford as much as $13 per book under a model where consumers can download as many books as they wish. Any one consumer could put dent in their plans by writing a macro to download millions of books automatically.

Alternatively, if Amazon, in fact, decides to absorb such enormous losses, it would support the position taken in these comments that Amazon's doing constitutes a use of market power in an attempt to monopolize the e-book systems market. In effect, under the subscription model, Amazon would be potentially offering each of Defendant Publishers' e-books for a price that is only a fraction of a penny.

Would they actually do this? Perhaps. Amazon could virtually give away Defendant Publishers e-books under the retail model to persuade consumers (a) to form expectations that if they adopt Amazon's e-books system, e-books will be virtually free to them forever (of which Amazon offers no guarantee), and/or (b) to sign up to *Amazon Prime*, which has an entirely different purpose in an entirely different market.

Since the $79 annual cost of Amazon Prime includes free shipping on any physical goods that Amazon sells, Amazon would be using artificially reduced e-book pricing in an attempt to monopolize the market for online merchandise (which includes printed e-books). Once that market is tipped in its favor, it could extract huge monopoly profits by simply raising the annual cost of Amazon Prime. Consumers of e-books, once locked-in to the Amazon system, may find that the cost of switching to another e-book system or even another source of printed goods, prohibitive and would have no choice but to pay higher monopoly prices for the subscription service, individual e-books, printed books, or just about anything else from Amazon.

C. Decisions by Providers of Complementary Components of the System

A third key to appreciating the competitive phenomena in systems markets concerns the decisions made by suppliers of complementary components of the system—in this case, the Defendant Publishers and other publishers of e-books.

For example, the more popular a particular e-book system becomes, the more likely it is that owners of e-book content (e.g., book publishers) will agree to make their e-books available for sale as part of the system. Making e-books available for a particular e-book system platform is not cost free. The cost of license negotiations, preparation and delivery of the e-books and associated metadata that meet the appropriate technical specifications of the e-book system provider, the costs of supporting the accurate electronic ingestion of incompatible sales reports from the e-book system provider,[15] and the cost of monitoring and auditing the system provider, forces book publishers to make important commercial decisions as to which e-book systems to support.

[15] A service provided by RoyaltyShare to book publishers and record companies.

It should be clear that the decisions that consumers and book publishers make over time will have positive feedback effects on each other. For example, the more e-books available on a particular e-book system, the more likely the consumer will adopt that system. By the same token, the more consumers adopting a particular e-book system, the more likely the book publishers will make their e-book content available on that system. System adoption decisions made by consumers will depend upon decisions made by publishers, and the reverse.

IX. The Impact of a Tipped Market Upon Consumers

In the previous section, we said that a monopolist will attempt to convince consumers that components will be available at low prices in the future, and later, after consumers are locked in, the monopolist will be tempted to raise price to the monopoly level. Katz & Shapiro 1994, pp. 98-99.

How much more could such a monopolist charge? An opportunistic seller can raise his price for e-books above his competitors by an amount almost equal to the consumer's switching costs. Joseph Farrell & Carl Shapiro, "Dynamic Competition with Switching Costs," *Economics Working Papers 8865*, University of California, Berkeley (1988), p. 1. Aided by network effects inherent in a market and the investments that users make in the standard, a market leader may substantially raise the cost to consumers of switching to alternative product offerings of subsequent market entrants, even where those alternatives may be better, cheaper, and more innovative. *Testimony of Robert H. Kohn* before FTC (November 29, 1995).

Suppose a consumer buys a Kindle device for $189.00, subsequently purchases 10 e-books. Assuming Amazon is selling the Kindle at cost, Amazon would have lost $40.10 (i.e., $4.01 x 10) on these transactions in the short run. The consumer, however, has made an investment of nearly $289.00 (i.e., $189 for the purchase of the Kindle reader device plus the cost of 10 books at $9.99 each). One day, the consumer learns about a new best-selling book he or she would like to buy and discovers that, under the retail model, Amazon's competitor is offering the same e-book for $4.99, half the cost for which Amazon is offering it.

The consumer's cost of purchasing the book from Nook is not $4.99; it is something greater than $4.99, because you must add the switching costs of the consumer's decision. Switching costs could include the cost of buying a new e-book reading device, such as the Nook, that is compatible e-books offered by the competitor. Switching costs are also a function of the value the consumer places on the various features of the competing e-book "cloud" platforms. This is because the consumer's own time and resources may be affected by the cost and inconvenience of maintaining two sets of e-book libraries that operate, respectively, on two incompatible platforms (including any bookmarks, highlights, notes, ratings, etc. stored in the platform). Finally, switching costs may include any additional costs of switching that may be imposed by the system provider.

It should also be clear that, should Amazon succeed in monopolizing the e-book systems market, it could exact monopolistic pricing not only for e-books, but <u>it could also raise the consumers' switching costs</u>. For example, suppose a consumer started to use an alternative e-book system for purchasing new e-books. Amazon will soon know that the consumer has not purchased an e-book from them in some time. It may then start charging the consumer for access to the Amazon cloud platform, in which the e-books he or she previously purchased are stored, until the consumer resumes buying e-books from Amazon. (This may be a function of Amazon's user agreement, which most consumers do not read. In any event, e-commerce providers typically reserve the right to modify their user agreements). The consumer would thus be faced with the choice of paying the access fee or

abandoning his or her library of books (together with the consumer's bookmarks, highlights, notes, etc.) stored in the Amazon cloud system. If the consumer has an interest in preserving online access to the previously purchased books, then the consumer's switching costs will have gone up by the Amazon's new monthly access fee.

Thus, a competing e-book system provider may offer to sell a best-selling title under the retail model for $4.99, half the price charged by Amazon. Yet, a consumer locked-in to Amazon's system may choose to pay full price for that title from Amazon rather than suffer the inconvenience of managing two e-book systems—i.e., two incompatible libraries of e-books, bookmarks, highlights, notes, etc.—or worse, having to pay an access fee to Amazon as a penalty for disloyalty.

It should be obvious, at this point, that the price of an e-book may have little to do with the consumer's ultimate purchase decision. The consumer's switching cost may be for more important, and those switching costs are determined entirely be the e-book systems provider, not the Defendant Publishers.

X. Strategies to Prevent a Systems Provider from Monopolizing a Systems Market

As there are several strategies a systems provider may employ to force-"tip" or attempt to monopolize the market by accentuating positive feedback effects, there are several strategies available to thwart such attempts and promote a competitive systems market. These include (a) encourage systems compatibility among competing systems, (b) control the amount, or timing of the release, of copyrighted content made available to the various systems providers, and (c) prevent any one system provider from manipulating the market price of components in the short term in an attempt to monopolize the long term market for the system product.

Counter-Strategy A: Encourage compatibility among systems

When in late 2007, the major book publishers licensed their books for use in Amazon's Kindle e-book system, they made the same mistake, in my view, the major record companies made several years before when first dealing with Apple: the publishers' licensed their book content in digital form to Amazon without requiring compatibility among competing e-books systems. Perhaps the publishers had no more leverage than the record industry had. For whatever reason, Amazon's early entry in the e-book market combined with their proprietary standard set the stage for the overwhelming market share that was to come.

Once a systems provider achieves a monopoly position using proprietary standards, it is very difficult, even for government antitrust regulators to apply remedies to reverse the monopoly. See, Reback, *Free The Market*; Page & Lopatka, *The Microsoft Case;* Rohm, *The Microsoft File.* In 1995, independent developers of PC word processing, spreadsheet and database applications software provided to the DOJ and FTC documented evidence (of the smoking gun variety) that Microsoft was intentionally withholding from their competitors technical information about the MS-DOS, OS/2 and Windows operating systems necessary to build applications that operated on those systems.

Microsoft's competitors argued that the best means of promoting competition in the market for applications software was to put the operating system supplier, Microsoft, on a level playing field with respect to the development of those applications. The remedy proposed was a compulsory license requiring Microsoft to make available the source code of the Windows operating system to software engineers working at Borland, Lotus Development, and Word Perfect so that they may gain access to technical information about Microsoft Windows

at the same time Microsoft gave such information to its own developers of applications software (e.g., Microsoft Access, Excel, and Word). See, *Testimony of Robert H. Kohn*, FTC (November 29, 1995); *Prepared Remarks of Susan DeSanti* (February 2, 1996). Needless to say, the government refused to act. The result was Microsoft achieving a near complete monopoly in word processing, spreadsheet and database application software, a market Microsoft dominated for over a decade.

It is hoped that Amazon shall never attain a position over the e-book systems market to the extent of Microsoft's monopoly over the personal computer operating systems in the 1990s. Should incompatibility play a role in doing so, history is bound to repeat itself: the DOJ and the FTC will be asked to compel Amazon to freely license the standards underlying its e-book system to allow competitors and new entrants an opportunity to compete. Whether the DOJ or FTC would take action under those circumstances, any more than it did 20 years ago, remains to be seen.

Encouraging compatibility among e-books systems may not necessarily require government action. While the publishers cannot turn back the clock and require Amazon to license its proprietary technology, press reports suggest that book publishers are exploring the other means of promoting compatibility. One potential strategy is for the publishers to abandon the requirement that e-book systems providers use DRM. See, for example, "Sci-fi publisher Tor Books says it's scrapping DRM," *TGDaily.com* (April 26, 2012) (DRM prevents readers "from using legitimately-purchased e-books in perfectly legal ways, like moving them from one kind of e-reader to another" said Tom Doherty, president and publisher of Tor).

Without DRM, consumers should theoretically be able to move their e-books for use on one e-book provider's platform to another. The drawback is that without DRM, unscrupulous consumers may be tempted to illegally share their e-books with others, exacerbating a growing e-book piracy problem. In addition, even though other e-book system providers could sell DRM-free e-books, there is no assurance that Amazon would abandon the very proprietary technology it uses today to lock their current customers into their e-book system. Moreover, it is not certain whether the Amazon e-book system or others will support these out-of-system e-books with advanced features that may be desirable to consumers, such as the online storage of bookmarks, highlights, notes, etc.

In any event, it is not the evolution of e-book systems standards or fate of the book publishers that the Court should be concerned about—it is with consumers of e-books and the public generally.

Counter-Strategy B: Control the Size of Catalog or Timing of Release of Content, "Windowing"

The Complaint, without comment, alleges that, after the Defendant Publishers entered their respective agency agreements with Apple, Macmillan presented Amazon with a choice:

> 80. ...adopt the agency model *or lose the ability to sell e-book versions of new hardcover titles for the first seven months of their release.*

(emphasis added). By threatening to delay the license to Amazon of new releases for seven months after publication, Macmillan was employing one of the other few means publishers have to promote competition among e-book systems providers. The publishers realized that they may influence the consumer adoption of an e-book platform by strategically controlling the amount and quality of the content available on the platform.

This technique was recently validated in the economics literature. Yabing Jiang, *e-Book Platform Competition in the Presence of Two-Sided Network Externalities*, 2012 45th Hawaii International Conference on Systems Sciences, IEEE Computer Society 4777, 4781 (2012).

Due to the two-sided network effect in the e-book/e-book systems market, book publishers' commitments to e-book platforms in terms of total content available on a platform is critical to platform adoption.[16] Id. While windowing, or delaying the publication of new releases in the e-book format, may be an effective means of price discrimination (see discussion in below) and providing exclusive advantages to one e-book system platform over another may allow publishers to favor one e-book systems provider over another, the problem with delaying the release of titles is that doing so would be inconsistent with traditional practices in the book publishing industry. Unlike the motion picture industry, which routinely windows the availability of its full-length motion pictures—first to theatrical release, then on-demand TV, then pay TV, etc.—the book industry has tended to make all new titles in hardcover and e-book form available to all sales channels simultaneously.

More important, consumers expect that they will be able to purchase a book on a single publication date at any retailer. Thus, employing this strategy is not an optimal way to promote competition, because it may discriminate unfairly against all consumers of e-books or certain consumers (i.e., those who adopted the most popular e-book system). Thus, to withhold the release of e-books could alienate e-book consumers, particularly those no longer willing to purchase physical books. This may only serve to increase the likelihood that consumers would turn to illegal piracy platforms to obtain delayed e-books not otherwise legally available in digital form on their system or at all.

Counter-Strategy C: Discourage Any System Provider from Artificially Reducing the Price of Components as a Means to Monopolize the Systems Market

Since the retail model enables e-book service providers with market power to sell e-books below cost in an attempt to monopolize the market, a model that shifts control over pricing back to the publisher will disable such attempts. The virtues of the agency model for all concerned with the online marketing and delivery of digital goods (e.g., downloadable music, digital recordings, e-books, e-videos) should be obvious, whether the systems in the market are characterized as compatible[17] or incompatible.

---

[16] This phenomenon was borne out by events in the 1998-2001 timeframe, when the major record companies refused to license their content to eMusic. See, *Kohn On Music Licensing* at 38-46. After Napster entered the market with a download service that illegally facilitated the unauthorized copying and sharing of digital music files, adoption of the eMusic platform faltered. One reason for eMusic's troubles may have been that, while it was charging 99 cents per track, users of the illegal Napster platform did not have to pay for their digital music files. eMusic was convinced that consumers will pay for better services and high quality files, but, as Yabing's research points out, there was another reason for the lopsided playing field. While eMusic only offered catalogs made available to them from independent record labels, the Napster system offered both the indie music as well as recordings from the majors (even though they hadn't obtained licenses for any of them). *A&M Records, Inc. v. Napster, Inc.*, 239 F.3d 1004 (2001). For this reason, it was the major's failure to license to eMusic that more likely caused eMusic's demise than Napster's illegal facilitation of mass music piracy. eMusic believed it could compete against a price of zero with better quality goods and services, but it could not compete without a full complement of recordings.

[17] When eMusic executives met with the major record companies during the 1998 to 2000 timeframe, we not only implored the majors to license their recordings in the open MP3 format, but to issue those licenses under what we were calling a "commission model." *Kohn On Music Licensing*, at 41. At the time, several executives at the major record

By the same token, the virtues of the retail model in providing lower prices to consumers has been greatly overestimated by the DOJ. As has been said, once consumers are locked in to an e-book system (especially one that is characterized as incompatible, such as the Kindle system), a monopolist will be tempted to raise prices to the monopoly level. Under the retail model, the monopolist may raise the price of e-books to levels even above the suggested retail price, as long as the price does not exceed the consumer's switching costs. This cannot happen under the agency model.

While the agency model will not prevent the monopolist from raising prices of e-book reader devices or access to the system platforms that support them, it can be used to prevent the e-book system provider from selling e-books at above-market (i.e., monopoly levels), since the publisher controls the price, not the monopolist.

In 2003, when the major record companies licensed their recordings to Apple Computer for sale through the iTunes store, they did so under the *retail model*, charging Apple 70 cents per download. Apple began selling these recordings for 99 cents each. As would be expected, Apple never had to compete with other systems providers on price, because consumers became locked into Apple's proprietary digital music system—a consumer could not purchase a track on iTunes and listen to it on a competitor's music player. Nor could a consumer purchase a track from a competitor, such as the Microsoft Zune store, and listen to it on an Apple iPod. Since the majors had not (until 2007) licensed their recordings in the open MP3 format, Apple had effectively locked-in their customers and the positive feedback effects described above allowed them to achieve their monopoly position.

The point to be understood here is that *the retail model made no difference*; Apple's decision with the major record companies in 2003 to offer downloads to consumers in an incompatible, proprietary format, sufficiently

---

companies expressed dismay that eMusic was (1) selling individual tracks, rather than requiring the consumer to purchase the entire album and (2) selling the tracks at the low cost of 99 cents each. The head of new media at one major record company insisted that his studies showed consumers would pay $1.73 per track. The eMusic executives believed they were competing with zero (i.e., online piracy) and that they had to make the music "easier to buy than to steal." For this reason, eMusic felt strongly about the 99 cent per track price point. eMusic's model with the independent labels at the time was a commission model. Selling the music download for 99 cents and then, after deducting certain defined costs off of the top (e.g., cost of mechanical license, cost of patent license) eMusic paid the rest to the record label less 50% (and in some instance, 40%). It was not fully an agency model, because eMusic determined the retail price to be charged, not the label. Since one of the problems the majors had with eMusic was the 99 cent price point, the compromise that eMusic offered them was that the majors could tell eMusic what price to charge and eMusic would keep a reduced 20% commission on the sale--in essence, the agency model. *Id.* We believed that such a model would be far healthier for digital music service providers like us. Id. Because the Internet offers consumers perfect information about comparative pricing, competition among digital music service providers would drive all retail prices down to or near the wholesale price. For example, if the majors sold us a track under a retail model for 70 cents, then every digital music service provider in a fully compatible market could end up selling the track for 71 cents. It would be too easy for consumers to perform price comparison, and if a consumer could buy a track from one provider and use it on any compatible MP3 player made by any manufacturer, the digital music providers like eMusic would have unhealthy margins and an unsuccessful business. Because eMusic refused to adopt any of the experimental DRM technologies existing at that time, and the majors continued to insist upon them, a deal was never reached with the majors for their full repertoire. The majors finally licensed their repertoire in an open MP3 format in 2007, when Amazon launched their MP3 music download service.

tipped the market to Apple indefinitely.[18] This demonstrates that, if an e-book system provider succeeds in monopolizing the market for e-books systems, it does not have to reduce prices to consumers, even if they have the power to do so under the retail model.

When in late 2007, the major book publishers licensed their books for use in Amazon's Kindle e-book system, they offered licenses to their book content to Amazon under the retail model. Perhaps the book publishers had not anticipated that Amazon would execute a well-documented strategy for tipping the market. Katz & Shapiro 1994 at 98-99. Perhaps the book publishers were misled by their observations of Apple, which never discounted the iTunes files to consumers. But Apple had already achieved unassailable market dominance in the digital music market. By contrast, Amazon may not yet have considered their 90% market share as unassailable. For example, Amazon's executives may or may not have anticipated Apple's entry into the e-book market, but they were certainly aware of Google's plans. Google was already publicly preparing entry into the e-book market by scanning millions of books into their web-based platform. See, *Author's Guild v. Google, Inc.* 770 F.Supp. 2d 666 (S.D.N.Y. 2011).

Seeing what was on the horizon, Amazon must have realized that it could not sufficiently tip the market in their direction relying solely on its early entry and incompatibility strategy. They had to do something else. It was only natural for the book publishers to thwart Amazon's attempt to monopolize the e-book market with its $9.99 pricing strategy. The vehicle for this was the agency model.

XI. Defendants Acted to Make the E-Book Systems Market More Competitive

The Complaint alleges facts that demonstrate that the economic consequences of Defendant's acts were to make the e-book market more competitive, a significant redeeming virtue of Defendant's actions. Accordingly, the factual allegations in the Complaint are more likely explained by lawful behavior.

A. Defendant Publishers Explore Ways to Make the E-Book Systems Market More Competitive

As stated above, Defendant Publishers had several potential tools to thwart the attempted monopolization of the e-book systems market—not only by Amazon, but by anyone trying to accentuate positive feedback effects to tip the e-book systems market in their direction: (a) encourage compatibility among competing systems, (b) control the timing of release of new e-books, and (c) prevent any one system provider from charging artificially low prices for e-books in the short term in an attempt to monopolize the entire e-book systems market.

In considering these tools, Defendant Publishers knew, of course, they would be acting to further their self-preservation. Equally true, however, is that, if the economic consequence of their action is increased competition in the e-book systems market, the consumer would enjoy the ultimate benefits. If the public benefit was the result of the Defendant's collective action, and those benefits exceeded the costs of temporary higher prices for certain e-books, that action is lawful under Section 1 of the Sherman Act. Licensing Guidelines at 4.2.

[18] As noted below, by 2011, four years after Amazon launched its MP3 download service with aggressively priced downloadable music acquired under the *retail model*, Amazon was still unable to have an impact upon Apple's dominance in the market for permanent downloads of digital music.

Having provided licenses to early entrants in the e-book systems market (e.g., Sony, Amazon) without demanding compatibility at a time when they had the leverage to demand it, Defendant Publishers had little leverage to demand it now. Large investments have been made by multiple systems providers in technology based primarily on incompatible proprietary standards. While the industry continues to consider dropping DRM in an effort to encourage compatibility, there is considerable doubt whether that will level the playing field as hoped and there are considerable fears that dropping DRM may facilitate the kind of widespread piracy, a problem about which Steve Jobs was all too aware. See discussion below.

"Windowing," the common practice of controlling the timing of the release of theatrical motion pictures, has not been traditionally practiced by book publishers. To use the strategy for the release of e-books could alienate consumers and might only encourage copyright infringement.

The best strategy available to Defendants to promote competition at hand was to adopt a business model that would eliminate Amazon's (or any e-book platform provider's) ability to use short-term artificial pricing practices in an attempt to monopolize the market for e-book systems. This was the agency model, a model that would have drawn no government scrutiny had it been adopted at the outset.

As the Supreme Court noted in *Leegin*,

> [I]t is a flawed antitrust doctrine that serves the interest of lawyers—by creating legal distinctions that operate as traps for the unwary—more than the interests of consumers—by requiring manufacturers to choose second-best options to achieve sound business objectives.

B. Defendant Publishers Had to Act In Concert

The Complaint alleges that the Defendant Publishers began meeting to discuss "the future of e-books and Amazon's potential role in that future" (Complaint at 41), to discuss "the growth of e-books and Amazon's role in that growth" (Complaint at 42 and 43), and to "communicate about e-books" (Complaint at 44). The Complaint does *not* allege, at the time the Defendant CEOs began meeting about these issues in late 2008, that the CEOs discussed price, only that they had "an opportunity" to discuss "the $9.99 problem," a phrase the DOJ repeatedly uses to characterize the problem the publishers faced.

> 45. These private meetings provided the Publisher Defendant CEOs the *opportunity to discuss* how they collectively could *solve "the $9.99 problem".*

(Emphasis added). Stripped of the DOJ's own speculation as to that the CEOs were thinking, and what problems they met to discuss, the Complaint only alleges that the Defendant Publishers were concerned about "the future of e-books and Amazon's potential role in that future."

Common sense suggests that the CEOs were unsure about the future of the e-book market and had concerns that Amazon could leverage its already dominant position—90% market share in e-books—to extend its monopoly and make its position unassailable. These CEOs could not have been blind to what has happened in the music business, which has not only suffered from copyright infringement on a massive scale, but as a result of measures intended to impede piracy, has been languishing under the market dominance of Apple.

What the facts in the Complaint suggest the CEOs were concerned about, and had every reason to be concerned about, was that Amazon was attempting to accomplish in the e-book market what Apple had accomplished in the digital music market. How Amazon was attempting to tip the e-book market in its favor—significant below-cost pricing of the e-book components--was simply a detail of the far larger problem with which the Defendant Publishers were gravely confronted.

The Complaint alleges dramatic facts that specifically support the existence of the problem about which Defendant Publishers were so concerned. After Defendant Macmillan signed its agency agreement with Apple (during the week of January 24, 2010), it presented Amazon with a choice: adopt the agency model or lose the ability to sell e-book versions of new hardcover titles for the first seven months of their release. Amazon's response, as alleged in the Complaint, was a striking demonstration of the market power it had achieved:

> 80. ...To resist Macmillan's efforts to force it to accept either the agency model or delayed electronic availability, Amazon effectively stopped selling Macmillan's print books and e-books.

On Friday, January 29, 2010, Amazon removed the "buy" buttons from thousands of books published by Macmillan. Brad Stone, Amazon Pulls Macmillan Books, *New York Times* (January 29, 2010) http://bits.blogs.nytimes.com/2010/01/29/amazon-pulls-macmillan-books-over-e-book-price-disagreement/. It is important to note that not only did Amazon stop selling Macmillan's e-books, it stopped selling all of Macmillan's *printed books*, as well.

At the time it took this extraordinary action, Amazon accounted for over 20% of all physical book sales in the United States. Jeffrey A. Trachtenberg, "Borders Wants Suppliers to Accept IOUs," *Wall Street Journal* (January 5 2011) (citing estimates from the Institute for Publishing Research, run by Fordham University Pro. Albert N. Greco). And Amazon represented 90% of the market for e-book sales. Rory Maher, *Here's Why Amazon Will Win The eBook War: Kindle Already Has 90% eBook Market Share* (BusinessInsider.com, January 13, 2010).

If Amazon had continued its boycott of Macmillan's e-books for several weeks, it could have crippled Macmillan's business. Leaving aside the significant loss of revenues (i.e., an estimated 20% or more of its printed book revenues and 90% of its e-book revenues), new authors and their agents, fearing their e-books would not be available on the Amazon platform, might not have submitted proposals for new books to Macmillan. Third party publishers using Macmillan for e-book distribution would have grounds to terminate their agreements and resign with Macmillan's competitors.

The exercise of market power by Amazon was breathtaking, but how the DOJ perceives the expected reaction of Macmillan's competitors is telling:

> 81. When Amazon stopped selling Macmillan titles, other Publisher Defendants did not view the situation as an opportunity to gain market share from a weakened competitor. Instead, they rallied to support Macmillan.

Since the Complaint already alleges that each Publisher Defendant "recognized" that it could not solve the problem "by itself," the publisher's reaction to support Macmillan is exactly what one would expect.

More important, by alleging that each Publisher Defendant could not solve the problem "by itself," the Complaint is, in fact, alleging that the problem *must necessarily* be solved by collective action. Logically, this could be

collective action that is conducted either among one or more of the Publisher Defendants or with the help of others (e.g., a large device manufacturer, etc.). In fact, the Court has since found that "a critical mass of publishers was needed" to persuade Amazon to move to the agency model. Order & Opinion, *Electronic Book Litigation* (May 15, 2012).

Accordingly, if the problem *must* be solved by collective action, and "the problem" is to prevent a potential monopolization of the e-book market, then the collective actions taken by the Defendants is more plausibly explained by lawful behavior. *Broadcast Music; Iqbal* , 556 U.S. 662 (2009). If the collective action taken by the Defendants is lawful, then the proposed settlement with the Settling Defendant cannot be in the public interest.

It is axiomatic that the monopolization of a market is not good for consumers. But it should be no surprise either that the Defendant Publishers found that Amazon's attempted monopolization of the e-book market was not good for them either. The Complaint is particularly elegant in making the point that Defendant Publishers were extremely concerned about the affect of Amazon's attempted monopoly on their own businesses. In an August 4, 2009 strategy memo for the board of directors of Penguin's parent company, Penguin Group CEO addressed the problem directly:

> 49. ..."Competition for the attention of readers will be most intense from digital companies whose objective may be to disintermediate traditional publishers altogether. This is not a new threat but we do appear to be <u>on a collision course with Amazon, and possibly Google as well</u>. It will <u>not be possible for any individual publisher to mount an effective response, because of both the resources necessary and the risk of retribution</u>, so the industry needs to develop a common strategy."

This CEO's message was as blunt as it was prophetic. As Macmillan sadly experienced, this risk of retribution was very real.

This, of course, is a threat about which the Defendant Publishers were aware. Unbeknownst to the Defendant Publishers, other anti-competitive threats were being concocted, such as this tidbit alleged in the Complaint:

> 51. ...In addition to considering competitive entry at that time, <u>Apple also contemplated illegally dividing the digital content world with Amazon</u>, allowing each to "own the category" of its choice—audio/video to Apple and e-books to Amazon.

Indeed, even though there is no allegation this threat was communicated to either Defendant Publishers or Amazon, the Complaint establishes sufficient facts that the Defendant Publisher's fears of attempted monopolization of the e-book market were palpable and well founded. The facts alleged in the Complaint, simply do not square with the conclusions reached by the DOJ.

Nor do they even square with other allegations in the Complaint, such as one that would have us believe the publishers have been scheming to monopolize the e-book market all along:

> 53. ...Hachette and Harper Collins took the lead in working with Apple to capitalize on this <u>golden opportunity</u> for the Publisher Defendant's to achieve their goal of raising and stabilizing retail e-book prices...

In a word, ridiculous. The only "golden opportunity" the Publisher Defendant's seized upon was to take action to make the e-book systems market more competitive.

C. Market Participants Voluntarily Changed the Pricing Model from Retail to Agency

The Complaint, from paragraphs 50 through 84, describes a dramatic and fascinating account of how through voluntary negotiations between the concerned parties, including Amazon, the Defendant Publishers succeeded in establishing the agency model and, in doing so, promoted a competitive market for e-book systems. Defendants' actions were lawful at every step.

According to the Complaint, shortly after Apple approached the six major book publishers in December, 2009 to seek licenses to resell the publisher's e-books via its e-book system, two of the Defendant Publishers communicated to Apple their desire to use the agency model for the distribution of their e-books. Complaint at 53. Within a week, Apple was in discussions with all Publisher Defendants regarding the agency model. Complaint at 58.

Apple responded that the agency model would only make commercial sense if it applied equally to all retailers of e-books. Id. Ironically, treating each retailer of goods at the same level of a distribution chain under the retail model is precisely the objective of another basic tenet of anti-trust law. See, Robinson-Patman Act: Section 2(a) of the Clayton Act. ("[I]t shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, . . . where the effect of such discrimination may be . . . to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them: . . .").

If the agency model was not applied equally to all retailers, then the Defendants would have been in a position to destroy competition by injuring Amazon (or any other e-book service provider) by permitting Apple to sell e-books at a price significantly below what the publishers would require Amazon to charge. The effect of Apple's request, therefore, was pro-competitive.

Publisher Defendant's reaction to Apple's proposal was positive. Eddy Cue, the Apple executive managing the negotiations, reported to Steve Jobs:

> 59. ...the three publishers with whom he had met saw the "plus" of Apple's position as "solv[ing the] Amazon problem."

While the Complaint continually interjects the DOJ's own conclusion that "the Amazon problem" was really a cover for capitalizing on "a golden opportunity" to raise e-book prices and in the process end Amazon's $9.99 pricing practices, what the facts demonstrate is just the opposite: putting the book publisher's in control of setting the prices of e-books has the effect of stopping Amazon from using its control over prices in the short term in an attempt to make its near monopoly in the e-book systems market complete and unassailable. The DOJ's conclusions about the agency model are misplaced. Applying the agency model equally to all retailers is more likely explained by lawful behavior.

Eddy Cue also reported what the Publisher Defendants viewed as the "negative":

> 59. ...The "negative" was that Apple's proposed retail prices—topping out at $12.99 for newly released and bestselling e-books—were a "little less than [the publishers] would like." Likewise, Mr. Jobs later informed an executive of one of the Publisher Defendant's corporate parents that "[a]ll major publishers had told Apple that "Amazon's $9.99 price for new releases is eroding the value perception of their products in customer's minds, and they do not want this practice to continue for new releases.

The last sentence of paragraph 59 gratuitously suggests that, "likewise," the publishers objected to the $12.99 maximum because they feared that low prices threatened to erode the perceived value of their books. Whether that is the case or not, it has nothing to do with an objection to the $12.99 maximum price.

What DOJ fails to recognize is the very practical business reason for the publisher's objection to the maximum price. What if a particular book was a 600-page history book that would typically retail for $34.99. Taking an extreme example, the printed edition of *Kohn On Music Licensing* (4th Edition, 2010) retails for $369.00. How, then, could the publishers realistically be expected to accept a maximum price of $12.99 for all books under circumstances where the value of the content of each book is different?

In fact, it would be surprising if the publishers did not completely object to any restraint on how much they can charge for each of their e-books, but no such fact is alleged in the Complaint. In any event, it should be clear that the fact alleged here is more plausibly explained by lawful behavior.

The Complaint alleges that "Apple saw a way to turn the agency scheme into a highly profitable model for itself." As discussed above, any retailer of digital goods—e-books, digital music, digital video—in a competitive market would always prefer the agency model over the retail model, provided they are not in a position to use price in an attempt to monopolize the market. The former guarantees a fair commission; the latter guarantees low or negative margins. The only survivors in a retail model would be reseller of e-books who have found other ways to make money—for example, selling e-book reader devices, web-based services, etc. Stand-alone retailers of e-books would be driven out of the market, because they could not survive in an environment of low margins, no margins, or negative margins without other ways to make up the difference (e.g., profits on the sale of e-book reader devices, tablets, merchandise, etc.).

Accordingly, Apple's enthusiasm for the agency model is more plausibly explained by lawful behavior.

The Complaint then alleges:

> 60. ...Apple knew that it had significant leverage in negotiations with Publisher Defendants. Apple exercised that leverage to demand a thirty percent commission—a margin significantly above the prevailing competitive margins for e-book retailers.

The DOJ got this part right. It is hard for this respondent to imagine a world in which a company providing highly scalable technology services for content, the delivery of which has virtually no marginal cost, can earn margins that exceed the royalty earned by the author who created the content in the first place. (The typical royalty to authors on the sale of e-books is 25% of the book publisher's net revenues received after the agent's commission.

Thus, on an e-book sold to a consumer for $12.99, Apple will retain $3.89 and the author will be paid a royalty of $2.27).

Nevertheless, this allegation merely demonstrates the enormous leverage the e-book systems providers had over the Defendant Publishers, which only supports their pro-competitive objective of assuming control over e-book pricing decisions. At the end of the day, it was a voluntary negotiation and the publishers can only hope that, some day, they may have the leverage to reduce the size of the commission and, perhaps, negotiate other favorable terms, such as the right to receive customer data for use in promoting new releases.

Apples exercise of its leverage, while to the disadvantage to book publishers and authors, is more plausibly explained by lawful behavior.

The Complaint goes on to allege the details of the negotiation process. Paragraphs 61 and 62 allege how "Apple kept each Publisher Defendant informed of the status of the negotiations with the other Publisher Defendants," and so forth. If the Defendant's activities were lawful, these allegations are irrelevant.

As we know, composers and music publishers actually created a well-staffed organization through which they have been engaging in price fixing for years. By the same token, it would have been perfectly legal for the Defendant Publishers to have set up a "war room" in which the CEOs and their licensing lawyers could have met together—who had the roast beef?—to exchange information and jointly negotiate their arrangement with Apple, then Amazon, and then all the other e-book system providers.

Paragraph 63 summarizes in term sheet form the lawful result of the arduous negotiations with Apple as of January 4 through 6, 2010.

Paragraph 64 alleges that Apple drafted the proposed written agency agreement and emailed them to each of the Defendant Publishers.

Paragraph 65 alleges that, in the proposed drafts, Apple introduced two important new terms to the term sheet: (a) that Defendant Publishers provide Apple with their complete e-book catalogs, including all new e-book releases without delay behind its print release, and (b) that Defendant Publishers adopt a most favored nations pricing provision that required each publisher to guarantee that it would lower the retail price of each e-book in a systems provider store to match the lowest price offered by any other retailer, "even if the Publisher Defendant did not control that other retailer's ultimate consumer price" (i.e., not under the agency model, but the retail model).

In other words, the publisher's would be prohibited from "windowing" their e-books. With respect to making all titles, including new releases, available equally to all e-book systems providers, Apple, in effect, was seeking to neutralize the publishers' ability to affect competition among system providers by exercising their control over the availability of e-books. See, discussion of this response regarding, Yabing Jiang, *e-Book Platform Competition in the Presence of Two-Sided Network Externalities.* Thus, making it a condition to the agency agreement, which would apply to all e-book system providers, Apple protected <u>all the e-book system providers</u> from Defendant Publisher's using the technique described by Yabing.

As discussed, the "windowing," or delaying the release of titles to one e-book system provider over another is one the publishers were quite ready to abandon in favor of the agency model, because it is not in the interest of

consumers of e-books and it may only serve to encourage e-book piracy. Thus, the prohibition against windowing is more plausibly explained by lawful behavior.

With respect to the MFN provision, since the publishers had already agreed under the term sheet to charge the same prices to each agency/retailer of e-books, the MFN provision was merely a mechanism to assure that all agency/retailers of e-books would be treated equally with all retailers of e-books who were not under the agency model.

Paragraph 66 of the Complaint alleges facts corroborating this by demonstrating that without the MFN, the Publisher's could circumvent their agreement to treat e-book systems providers equally.

For example, without the MFN provision, the Defendant Publishers could, individually or collectively, establish their own e-book system, charge it a low wholesale price, and thereby offer consumers e-books at a significantly lower prices than that available through the agency/retailers. The Complaint alleges that several of the Publisher Defendants had already established a joint venture, which could be used for just such a purpose. The MFN protected all e-book system providers under the agency model against such a tactic. See, Robinson-Patman. Whether or not Robinson-Patman applies to licenses for digital content, the principal of treating all e-book system providers alike—whether they operated under the agency model or not—is more plausibly explained by lawful behavior.

The introduction of the new provisions at this point in the negotiations was an unfortunate turn of events for the publishers, but as the Complaint suggests, the Defendant Publisher didn't have sufficient leverage over Apple to oppose the provision. Complaint at 60.

Remarkably, the DOJ concludes that, "The purpose of these provisions was to work in concert to enforce Defendants' agreement to raise and stabilize retail e-book prices." Complaint at 66. Further, the Complaint bizarrely suggests that these new provisions were something that both "Apple and Publisher Defendants" together desired. Id. As noted above, the new provisions worked against the Defendant Publishers. Moreover, in the very next paragraph, the Complaint itself alleges that the Publishers argued against the MFN:

> 67. In negotiating the retail price MFN with Apple, "some of [the Publisher Defendants]" asserted that Apple did not need the provision "because they would be moving to an agency model with [the other e-book retailers,]" regardless.

On January 16, 2010, via Mr. Cue, Apple finally proposed terms that reflected economic reality of the book business—that not all trade books are sold at the same price. Apple, acting effectively on behalf of all agency/retailers of e-books, agreed that Publisher Defendants could charge as high as $16.99 or $19.99, depending upon the hardcover price. For e-book versions of bestsellers bearing list prices of $30 or less, the publishers could set a price up to $12.99; for best sellers bearing list prices between $30 and $35, the e-book price cap would be $14.99. Complaint at 68.

These maximum prices were clearly intended as a mechanism to keep e-book prices competitive with their corresponding print editions, which continued to be sold under the *retail model*. Thus, the price tiers served the same essential purpose as the MFN. The allegations concerning the tiers are therefore no less lawful than the MFN itself. The Publisher Defendants, rather than as the Complaint alleges, were not in favor of these tiers and did not

conspire with Apple to set them. At the end of the day, the pricing tiers were merely a consequence of voluntary negotiations between the parties in an effort to promote competition in the e-book systems market.

If the Defendant Publishers felt they had any leverage to resist the new terms being proposed by Apple at this juncture, they quickly lost it:

> 70. While the Publisher Defendants were discussing e-book distribution terms with Apple during the week of January 18, 2010, Amazon met in New York City with a number of prominent authors and agents to unveil a new program under which copyright holders could take their e-books directly to Amazon—cutting out the publisher—and Amazon would pay royalties of up to 70 percent, far in excess of what publishers offered.

The Complaint does not recite the fact that Amazon was seeking rights to these e-books on an exclusive basis, but it does allege the publishers' natural reaction:

> 70. ...The Publisher Defendants reacted immediately. For example, Penguin USA CEO David Shanks reported being "really angry" after "hav[ing] read [Amazon's] announcement. After thinking about it for a day, Mr. Shanks concluded, "[o]n Apple I am more convinced that we need a viable alternative to Amazon or this nonsense will continue and get much worse."

Revealingly, the Defendant Publishers' reaction was not, "I am more convinced than ever we need to raise and stabilize e-book prices."

Perhaps the DOJ has more examples, but from the face of the Complaint, it is clear that the publishers' reaction is poignantly *inconsistent* with the narrative the Complaint tries to build (i.e., "golden opportunity to fix prices"). The DOJ's fixation on "the $9.99 problem" and the publishers' "golden opportunity" serves only to unfairly obfuscate the Defendant Publisher's real problem, Amazon's attempt to monopolize the market for e-book systems, and their solution to the problem, the agency model.

Paragraphs 71 cleverly edits Steve Job's email message to publishing executive to hide two key issues that Mr. Job's knew the publishers were concerned about: (a) the threat of Amazon's exercising its monopoly power and (b) the problem of piracy in digital goods. Of course, these concerns do not drive the DOJ's "golden opportunity" narrative. In outlining the publisher's alternatives, here is what Mr. Jobs really said:

> 2. Keep going with Amazon at $9.99. You will make a bit more money in the short term, but in the medium term Amazon will tell you they will be paying you 70% of $9.99.[[19]] They have shareholders too.

[19] Mr. Job's warning was prophetic. Two years later, Amazon refused to renew its agreement to publish e-books distributed by IPG on behalf of independent book publishers unless the publishers agreed to terms more favorable for Amazon. Upon the expiration of the agreement, Amazon pulled from its Kindle store all e-books published by these independent book publishers. Michael Cader, "Amazon Removes Kindle Version of IPG Books After Distributor Declines to Change Selling Terms," *PublishersLunch.com* (February 22, 2012). The titles remained banned from Amazon until the dispute was settled three months later. Michael Cader, "Standoff Ends: IPG and Amazon Agree to Terms on eBooks and Titles are Restored," *PublishersLunch.com* (May 25, 2012). Terms of the new arrangement were not disclosed, but IPG president, Mark Suchomel, announced to his independent book publisher clients, "I only regret that we weren't able to make up for all the lost revenue when your Kindle titles were not available" and agreed to waive IPG's distribution fee on Kindle sales for the following three months. Id.

> 3. Hold back your books from Amazon. Without a way for customers to buy your e-books, they will steal them. This will be the start of piracy and once started, there will be no stopping it. Trust me, I've seen this happen with my own eyes.

See, Proposed Second Amended Complaint at 82, *Electronic Books Litigation*, 11-md-02293 (DLC).

Paragraph 72 and 73 allege more facts pertaining to the Publisher Defendant's virtual "war room." Again, if these activities were no more illegal than the collective price fixing of composers and music publishers through their BMI joint venture, they are irrelevant.

Paragraph 74 of the alleges that beginning January 24, 2010, a mere six days after Amazon declared war on the book publishing industry, the Defendant Publishers began executing their agency agreements with Apple. What this plausibly demonstrates is highly competitive, and therefore, behavior.

Paragraph 75 through 79, stripped of conclusory and inflammatory labels like "conspiracy" and "lockstep," state the obvious.

Paragraph 80, we have addressed. Amazon initially resisted the agency model by making a dramatic demonstration of its market power, ceasing the sale of all of Macmillan's printed books and e-books. When it was clear that Macmillan was not going to back down, Amazon conceded.

Somehow, according to the Complaint, from the evening of Friday, January 29 when it pulled Macmillan's books to the afternoon of Sunday, January 31, when it restored them, Amazon "quickly came to fully appreciate that not just Macmillan but all five Publisher Defendants had irrevocably committed themselves to the agency model." Complaint at 84. While the Complaint alleges that other publishers expressed their support of Macmillan to Macmillan (Complaint 81, 82, and 83), there is no allegation that any such publishers expressed anything to Amazon over that weekend.

A plausible reading of these factual allegations is that Amazon may have realized over the weekend, after the CEO of Macmillan posted a public blog on Amazon's action, that it may have made a crucial error. By instantaneously wiping out the 25% of the print book revenues and 90% of the e-book revenues of the sixth largest book publisher in the United States, Amazon had just provided demonstrable evidence that it had acquired the kind of monopoly power the publishers had feared and such evidence could be used to justify the actions taken by the Defendants.

Alternatively, whether or not Amazon knew the other publishers would stand behind Macmillan, Amazon had no guarantee that by Monday morning the four other Defendant Publishers, and perhaps many others, would immediately cease or delay submitting new e-book releases to Amazon and announce that they would not renew their distribution agreement with Amazon upon their expiration.

Faced with the choice of adopting the agency model or lose the ability to sell e-book versions of new hardcover titles for the first seven months of their release, Amazon made a business decision to accept the agency model. Complaint at 81, 84. This they did voluntarily, there was nothing unlawful about it, and it was in the immediate public interest.

XII. Economic Consequences of Defendants' Alleged Conduct—Impact Upon Competition, Consumers, and the Public Generally

A. Defendants Succeeded in Making the E-Book Market More Competitive

Within a month after Amazon agreed to the agency model, one analyst predicted that, *as a direct result of the switch to the agency model*, Amazon's market share would fall from 90% to 35% over the next five years. See, Matt Philipps, "Amazon e-Book share to fall from 90% to 25% Analyst Says," *Wall Street Journal* (February, 16, 2010) (quoting Credit Suisse Analyst, Spencer Wang, "Near term, we suspect that the iPad and the new eBook agency pricing model, which requires that Amazon increase retail prices to be more consistent with Apple's pricing, will provide Kindle with the most market share headwind. Going forward, we can envision a scenario where Apple, Amazon, and Google eventually split the market. Therefore, we expect Amazon's share of eBooks business to fall from 90% currently to about 35% over the next five years").

By the end of 2011, it was estimated that Amazon's share of the e-book sales in the U.S. had, in fact, fallen to about 60%. Juliette Garside, "Apple's Struggle To Defeat Amazon Set to be Exposed by European e-book Enquiry," *The Guardian* (December 17, 2011). Interestingly, most of Amazon's lost market share was picked up not by Apple, who only managed to take only 5%, but by a smaller competitor, Barnes & Noble's Nook, which saw its market share grow to 27% by the end of 2011. Id. See also, David Carr, "Amazon Low Prices Disguise a High Cost," *New York Times* (April 15, 2012) ("Remember, it was only after agency pricing went into effect that Barnes & Noble was able to gain an impressive 27 percent of the e-book market").

Consumers of e-book systems, and the public generally, clearly benefited from the increased competition. e-book reader prices have come down, features of web-based services that support them have improved, and innovations in e-book readers devices have been coming to market quickly. See, David Streitfeld, "Cut in E-Book Pricing by Amazon Is Set To Shake Rivals," *New York Times* (April 12, 2012)

While it is difficult to precisely judge cause and effect, Defendant Publishers' move to the agency model arguably may have helped encourage a new entrant into the e-book systems market, Microsoft Corp. Michael J. De La Merced and Julie Bosman, "Microsoft to Take Stake in Nook Unit of Barnes & Noble," *New York Times* (April 30, 2012). Thus, the world's leading software company will help Barnes & Noble spin off its e-book systems business into a new entity, providing additional financing, thereby enabling the Nook e-book system to more effectively compete with Amazon's.[20] Without having to respond to Amazon's market-tipping pricing strategy, Nook may now invest in product and system improvements to attract new consumers who might otherwise been persuaded to feed Amazon's market dominance.

The resulting impact on the e-book systems market was demonstrably successful. Within a month after Amazon agreed to the agency model, one analyst predicted that, *as a direct result of the agency model,* Amazon's market share would fall from 90% to 35% over five years. See, Matt Philipps, "Amazon e-Book Share to Fall From 90% to 35%, Analyst Says," *Wall Street Journal* (February 16, 2010).

[20] Ironically, Microsoft announced plans to include e-book reader software compatible with e-books designed to work on the Nook into its release of the Windows 8 operating system. Whether Microsoft will be able to use its market power in operating system software to tip the e-book market in its direction remains to be seen.

The same can be said about Apple's entry into the e-book systems market. See, Apple's *Answer* to the Complaint in this action at paragraph 4 (filed May 22, 2012) ("Apple admits that absent the agency agreements it would not have entered eBook distribution, given the circumstances of the business as it existed prior to Apple's entry").

B. Consumers Are Better off as a Result of Defendants' Actions to Institute the Agency Model for E-Books

The agency model, and the alleged concerted actions by the Defendants toward its adoption, has have paid off significantly for consumers of e-books and the public generally. Not only have Defendants' actions made the e-book systems market more competitive, the agency model will impede the attempted monopolization of the e-book systems market in the future. As a result, Defendants' actions promoted competition among e-book systems providers, thereby promoting innovation and lower prices for all components of the two-sided market for e-book systems.

1. Agency Model Impedes the Attempted Monopolization of Systems Markets in the Future

As we have seen, control of e-book prices by e-book publishers is an important means by which competition in the e-book market can be promoted rather than perverted by an attempted monopolist's efforts to use artificial prices in the short term to tip a systems market in its direction. Recent experience suggests that the move to the agency model did, in fact, succeed in making the e-book systems market more competitive. If the setting of e-book prices continues to remain in the control of the book publishers, the agency model will continue to prevent e-book service providers from using artificially low prices in an attempt to monopolize the market for e-book systems in the future.

2. The Retail Model Never Guaranteed Lower Prices for Consumers of E-Books

As discussed above, a service provider operating a system that is incompatible with those of competitors does not need to discount components, even under a retail model. For the privilege of selling digital downloads of recorded music from its iTunes store, which has enjoyed a steady 80% market share for several years, Apple has been successful charging 99 cents per track while paying a wholesale price of only 70 cents to record companies. That is an effective markup of 41 percent.

For years, Amazon has deeply discounted the digital music files it sells in its MP3 store. Such discounting, however, has not improved Amazon's market share nor has it any effect on Apple's market share. Alex Pham, "Price War! Amazon Launches 69-cent MP3 Store for Top Selling Tunes," *Los Angeles Times* (April 28, 2011) ("Amazon, which in March launched a cloud music locker service, has tried over the years to chip away at Apple's dominance in the digital music download business by pricing most of its songs below what they go for at iTunes. So far, however, Amazon's market share remains where it has been the last two years, around 10%, while Apple continues to have about 70% of the digital download music market, according to Russ Crupnick, digital music analyst at the NPD Group, which no longer publicly releases market share data.")

Should Amazon have been able to accomplish in the e-book market what Apple accomplished in the digital music market, it too would be in a position to maintain high prices for e-books. During the short run, however, it engaged in artificially pricing its e-books several dollars below cost in order to tip the e-book systems market in its favor.

There is no allegation in the Complaint suggesting that Amazon would have continued its low price strategy once it gained an impenetrable position of market power. Economists and common sense suggest the contrary. A monopolist would like to convince consumers that components (e.g. e-books) will be available at low prices in the future. Katz & Shapiro 1994. Once consumers are locked-in, the monopolist may raise prices to the monopoly level or the level at which it would be cheaper for the consumer to pay rather than switch providers. Id.

It is clear, then, that the retail model does not guarantee lower prices for consumers any more than the agency model guarantees higher prices.

3. The Agency Model Keeps E-Book Service Providers with Market Power from Charging Consumers Monopoly Prices for E-Books in the Future

As noted, once consumers are locked-in, the provider would otherwise be able to not only stop selling e-books for below cost, but start raising the price of e-books to the monopoly level. Since the agency model places control over prices in the hands of the e-book publishers, an e-book service provider will be unable to raise e-book prices on consumers to the monopoly level. That is, the agency model prevents e-book system providers from creating consumer expectations about future e-book prices on the provider's system by setting e-book prices at an artificially low level to attract and lock consumers into their system.

This does not mean an e-book service provider in a monopoly position could not raise other prices. Even under the agency model, the service provider could still raise the prices of compatible e-book reader devices or charge for access to their service platform without any control or influence by the book publishers.

4. The Agency Model Made it Less Likely that Consumers Would be Charged Monopoly Prices for E-Book Readers and Access to E-Book Service Platforms

The foregoing discussion leads to another significant benefit consumers reaped from Defendants' alleged actions: to the extent their actions promoted competition in the e-book systems market, Defendants' helped avoid some of the most pernicious pitfalls of a monopoly in e-book systems.

For example, today, the system platforms that support e-book storage and retrieval of e-books by consumers are offered for free. However, should a provider monopolize the market for e-book systems, it could not only raise the price of e-books (if operating under the retail model) and e-book devices, it could start charging consumers for access to its online platform. This effectively raises the cost of a consumer desiring to purchase an e-book that works on an incompatible e-book platform.

To switch platforms, or adopt a second platform compatible with an e-book purchased from a competitor, may entail significant *switching costs*. Switching system providers (e.g., from the Amazon Kindle e-book system to the Barnes & Noble Nook e-book system) may be costly. For example, a consumer desiring to maintain his or her library of e-books may be faced with the choice of (a) repurchasing from the new system all of the e-books previously purchased in the old system, (b) maintaining the respective portions of the library on each of the two e-book systems, or (c) simply abandoning the previously purchased e-books stranded in the old e-book system (together with the consumer's bookmarks, highlights, notes, etc.).

Because switching costs play such an important role in a consumer's decision to purchase an e-book, a monopolistic e-book service provider will have an incentive to increase the consumer's switching costs. For example, suppose a consumer started to use an alternative e-book system for purchasing new e-books. Amazon will soon know that the consumer has not purchased an e-book from them in some time. It may then start charging the consumer for access to the e-books he or she previously purchased from Amazon until the consumer resumes buying e-books from Amazon.[21] The consumer would thus be faced with a choice between paying the access fee or abandoning his or her library stranded on the Amazon system. If the consumer has an interest in preserving access to the previously purchased books (together with the consumer's stored bookmarks, highlights, notes, etc.), then the consumer's switching costs will have gone up by the Amazon's new monthly access fee. Under such circumstances, a consumer may think twice about straying to another system for their next e-book purchase.

What the foregoing suggests is that switching costs may be far more important than the price of the e-book in a consumer's purchase decision. In other words, common sense would suggest that a consumer's decision to purchase a particular e-book may have little to do with the price of the e-book.

A competing e-book system provider may offer to sell a best-selling title under the retail model for $4.99, half the price charged by Amazon. Yet, a consumer locked-in to Amazon's system may choose to pay full price for that title from Amazon rather than suffer the inconvenience of dealing with two e-book systems—i.e., two incompatible libraries of e-books, bookmarks, highlights, notes, etc.—or worse, having to pay an access fee to Amazon as a penalty for disloyalty.

5. Consumers Are Better Off By E-Book Pricing Being Controlled By Book Publishers, Rather Than By System Providers

Beyond its pro-competitive effect on the market for e-book systems, and its use in keeping e-book service providers from charging monopolistic prices for e-books, the agency model does shifts the power to set and vary retail prices from the system provider to the e-book publisher. The difference it makes is that the e-book publishers, rather than the system provider, get to set prices, run promotions, and take such other actions deemed necessary to promote their titles and maximize sales. The consumer should not care one way or the other who exercises this control.

The setting and changing of prices to maximize sales and margins is driven by a practice called, "price discrimination." It is a perfectly legal practice that has been the bread and butter of retailing since the advent of modern retailing. The objective is to identify which consumers are sensitive to price changes and which ones are not. Then, the seller charges a lower price to consumers who are more sensitive to price and a higher price to those who are less sensitive. By doing so, the seller will sell more goods to more consumers than he or she otherwise would have sold—in other words, more commerce, more voluntary exchanges than would otherwise have occurred.

In the meantime, consumers who are price sensitive will pay a lower price, enabling to purchase products that they would not otherwise afford. Those lower prices are subsidized by consumers who pay a higher price, but those who pay a higher price are not harmed unreasonably, because they are not as sensitive to the higher prices.

[21] This may be a function of Amazon's user agreement, which most consumers do not read. In any event, e-commerce providers typically reserve the right to modify their user agreements.

By charging a lower price to price-sensitive consumers and a higher price to consumers who are not price-sensitive, a seller can sell more goods and make higher total margins on their sales than if they did not engage in the practice.

Retailers use a variety of techniques to distinguish between consumers who are price-sensitive from those who are not. For example, seller put goods "on sale" for this purpose. People who are price sensitive tend to wait for a “sale" before making their purchase; those who are less price-sensitive are more willing to pay the full retail price, regardless of the timing of the sale. Some retailers offer coupons offering discounted prices knowing that consumers willing to take the trouble to collect, clip and redeem coupons tend to be people who are more price sensitive than those who don't. Consumers who wait for "sales" and clip coupons pay lower prices for goods than others. This is fair and good result for all concerned.

Amazon engages in price discrimination every day with respect to products it buys and sells under the retail model. It constantly changes the price of goods, such as hardcover books purchased under the retail model, to promote sales and maximize its margins. How Amazon determines the price sensitivity of each visitor to its website must be a closely guarded secret. It necessarily involves sifting through vast amount of data flowing through its system, including not only information about when consumers buy goods, but when they search for goods, but do not buy, or when they fill their online shopping cart, but do not consummate the sale. Amazon uses this data and employs computer software algorithms to vary prices on their system to optimize sales.
The agency model—solely as it pertains to e-books—took that ability away from all of the e-book retailers and gave it back to the publishers.[22] Price discrimination is not new to book publishers. They have practiced it for years. Publishers initially release their books in hard cover form at a relatively high price. Several months later, they release the same book, but in trade paperback form, which carries a far lower price (even though it is not significantly cheaper to print than the hard cover version). By holding off the sale of the trade paperback edition for several months, it is effectively separating readers who are sensitive to the price of books from those who are not. Those who are less price-sensitive will tend to purchase the book upon its hardcover release; those who are more price-sensitive will tend to wait for the trade paperback edition to be released.

Again, what the agency model does is simply shift the ability to engage in price discrimination for e-books from the e-book system provider to the book publisher. There is no evidence, and certainly no allegation in the Complaint or the CIS, that consumer will be worse off if publishers can engage in price discrimination rather than the system providers.

All else being equal, consumers should be neutral as to whether the e-book publishers’ or the e-book system providers’ control retail prices. But all else is not equal. As we have seen, control of e-book prices by e-book publishers is an important means by which (a) competition in the e-book market can be promoted rather than perverted by an attempted monopolist's efforts to manipulate prices in the short term to tip a systems market in its direction and (b) e-book service providers can be prevented from charging monopoly prices for e-books in the future.

The agency model is an important tool to promote competition in the market for e-book systems. Because the proposed Final Judgment would upend the essential pro-competitive features of the agency model, the judgment is anti-competitive and not in the public interest.

[22] Under the particular agency agreement struck with the e-book systems providers, the publisher's flexibility to set prices was made subject to certain practical limitations.

CONCLUSION & RECOMMENDATIONS

In complex litigation involving antitrust—where the consequences and the cost of litigation are so steep that a settlement may be coerced upon weak claims—the claims in the complaint must "cross the line from conceivable to plausible." Determining whether a complaint states a plausible claim is context-specific, requiring the court to draw on its *experience and common sense*. If the behavior alleged, even if conceivable as alleged, is more plausibly explained by lawful behavior, the motion to dismiss should be granted.

The factual allegations in the Complaint are plausibly explained by lawful behavior, the economic consequences of which were increased competition in the market for e-book systems. The Court's entry of proposed Final Judgment is not in the public interest, because the judgment would undo the pro-competitive effects of Defendants' actions.

This action concerns the most far-reaching issues in antitrust matter affecting the exploitation of copyrighted works in more than a generation. The digital rights in copyrighted works under the agency agreements at issue in involve novel conditions in both copyright law and antitrust. At risk here is the public interest in innovation and competition in the entire e-book systems market, not just one component of it.

The Supreme Court has repeatedly suggested that action taken to correct attempts at monopolization should come only after the public has "considerable experience" with the business relationships that an antitrust action would disrupt. This should be especially true when the agreement under attack is novel.

The essential features of the agency model with respect to the Settling Defendants will undo a carefully thought through, market-based solution to the anti-competitive effects that had been operating in the market for e-book systems. To undo the status quo would promote a monopoly in favor of a "winner-take-all" system provider that would be very difficult for anyone to challenge, even the U.S. government. For this reason, this action, and the entry of the proposed Final Judgment, is entirely at odds with the purpose of both the Sherman Act and the Copyright Act.

For reasons stated above, the undersigned respectfully recommends that the DOJ:

A. Withdraw its consent to the proposed Final Judgment, and

B. Dismiss the Complaint under Rule 41(1)(A)(i) of the Federal Rules of Civil Procedure.

Should the DOJ decline to do so, it is respectfully submitted that the Court:

A. Hold that the proposed Final Judgment is not in the public interest, and

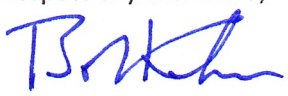
B. Consider the context presented in this response when ruling, at the appropriate time, upon a Defendant's motion for judgment on the pleadings under Rule 12(b)(6) or motion for summary judgment under Rule 56, if any.

C. Should none of the Publisher Defendants file either a motion under Rule 12(b)(6) or Rule 56, or if all Publisher Defendants should become parties to the proposed Final Judgment,[23] the Court should, at the appropriate time, either:

1. **Grant summary judgment in favor of all Defendants, including Settling Defendants, under Rule 56(f), or**

2. **Grant leave to interested consumers to intervene for the purpose of filing a motion under Rule 12(b)(6) or Rule 56, and/or for filing an appropriate appeal. 15 U.S.C. 16(f)(3).**

Respectfully submitted,



Bob Kohn

cc: Defendant Publishers
Apple, Inc.

[23] Should all of the Defendant Publishers agree to become parties to the proposed Final Judgment, the Court should allow consumers to intervene for purposes of filing an appeal, even if Apple is in a position to appeal entry of the proposed settlement. As suggested above, Apple might refrain, for practical reasons, from making some of the context-specific arguments set forth above.