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E-book publishing leads to court clash

When Amazon introduced the Kindle in 2007, I was of the opinion that e-books would never catch on. Why would anyone want to spoil the enjoyment of reading a good book by doing it on an odd-looking, gray-toned screen? Certainly the tactile and olfactory joy of opening the fresh new pages of "The Great Gatsby" or "A Confederacy of Dunces" could never be matched by a digital screen.

A few years later, after lugging around a 1,296-page hardbound copy of "War and Peace" in my briefcase for six months, I began to see the merits of an electronic version, though I still thought that the category of books weighing close to 4 pounds was too small a niche to make e-books successful.

Of course, I was wrong. The number of people reading e-books is significant and rising rapidly. A report issued by the Pew Research Center in April of this year tells us that one-fifth of American adults (21 percent) had read an e-book in the past year, compared to 17 percent in December 2011. There are four times more people reading e-books on a typical day than was the case two years ago, according to Pew. This is confirmed by my completely unscientific observations while riding the Metra Milwaukee District North Line train every day.

The publishing industry's response to the public's increasing acceptance of e-books has been interesting to say the least, leading to a clash of two digital titans — Apple, Inc. and Amazon.com. And now, as we shall see, the U.S. government has stepped into the fray.

Before the digital age, the book publishing industry distribution model had not changed much in the prior century. Publishers sold books to retailers using the "wholesale model." Under this model, publishers sold books to bookstores at a wholesale price,

which was stated as a percentage discount (for example, 40 percent) off the cover price. The bookstore would then charge the customer whatever it wanted, whether the list price or a sale price. When Amazon entered the e-book distribution market, the publishers sold the titles to it under this wholesale model. Because of lower distribution costs, the publishers typically set their wholesale prices for e-books lower than those for physical books. After it launched the Kindle, Amazon instituted a pricing strategy that rocked the traditional publishing industry, charging just \$9.99 for newly released e-books. This was much less than the price of hardcover books and often was less than the wholesale price Amazon had paid. This strategy boosted sales of the Kindle and made Amazon a dominant party in the market for e-books and reading devices.

By the autumn of 2009, the major publishers came to see the significant increase in e-books sales as a threat to the traditional publishing model, in which hardcover book sales are the most profitable product for both the publishers and the brick-and-mortar bookstores. The availability of new releases in electronic form for just \$9.99 exerted substantial pressure on publishers and retailers to lower prices for physical books. It also exerted pressure on other prospective entrants into the e-book market, such as Apple, to set low e-book prices in order to meet the competition.

How did Apple and most of the major publishers respond to Amazon's tactics? By conspiring. At least that's what the government says. In April 2012, the Department of Justice filed a civil antitrust action claiming that five of the six largest publishing companies in the U.S. together with Apple, entered a conspiracy to raise the price of e-books. The suit alleges that the publishers and Apple agreed to

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take steps to eliminate price competition in the market for e-books by jettisoning the old wholesale model and using a new sales model formulated by Apple known as the "agency model." Under the agency model, retailers do not set prices or make sales. Instead, the publisher sets the price of the e-book and sells it directly to the consumer, using the retailer (such as Apple) as an agent. The retailer receives a percentage (in Apple's case, 30 percent) of the sales price as a commission.

In January, 2010, the five publishers entered agency agreements with Apple, just as Apple was preparing to release its new tablet computer, the iPad, which functions as an e-book reader. The publishers agreed to the agency model even though they would make less money per e-book sale because it enabled them to eliminate price-cutting by Amazon. That is because after signing the Apple agreements, the five publishers simultaneously threatened to withhold e-books from Amazon unless Amazon signed the agency contract. Though Amazon initially resisted, by April it had capitulated and agreed to the agency model.

The impact of this industry shift was immediate — the price of new best-selling e-books increased by 40 percent on average, even though there had been no corresponding increase in costs.

The defendants deny that there was any conspiracy and have argued in a motion to dismiss that the government has not adequately alleged that there was an "agreement" among the publishers and Apple. They contend that what happened was merely "parallel conduct," not a conspiracy.

The district court denied the motion to dismiss. It found that the complaint plausibly alleged that each publisher's decision to sign the agency agreement with Apple and demand that Amazon accept the agency model "would have contravened each publisher's self-interest in the absence of similar behavior by its rivals." The court also noted that in order to compel Amazon to make the switch, a critical mass of publishers was needed. No single publisher would have had sufficient leverage over Amazon. And without collective action, Apple would have faced stiff competition in opening its digital bookstore. *In re Electronic Books Antitrust Litigation* (S.D.N.Y. 2012). Three of the publishers have settled. Apple and two publishers, Macmillan and Penguin, will continue to battle in court.

As a consumer (some day, inevitably) of e-books, it's hard to know which side to take. I'm all in favor of lower prices, but not if the result is to close local bookstores and make real books disappear. The prospect of Amazon dominating the market and forcing other e-books retailers out of the market is not an appealing prospect either. The government's answer is that we can't look the other way in the face of price-fixing allegations. Let's just hope our real books don't suffer the same fate as some of our real newspapers.