How Lawyers Use Economics, Law 248.6

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**Assignment 1**:

Do both exercises, and come to class on August 22, 2013, prepared to discuss your answers. All materials for this course can be found in bSpace Resources.

1. Read the Friend and Hockett pieces on eminent domain as applied to underwater mortgages. Form a preliminary view on why, as is claimed, the takings could make everyone better off.
2. Read the Crovitz and Hamblett pieces on the Apple antitrust case, hot off the press this month, and the excerpts below. Form a preliminary view on whether Crovitz’s skepticism is justified, and understand why the transition from a wholesale pricing model (Amazon) to an agency model (Apple iBookstore) might have had the effect of raising price. (We also posted the full opinion in bspace Resources. It is entertaining, but long, so you need not read it.)

SUMMARY OF FINDINGS (from *U.S. v. Apple Inc.*, 2013 DCNY Lexis 96424 p. 3+)

The Plaintiffs have shown that the Publisher Defendants conspired with each other to eliminate retail price competition in order to raise e-book prices, and that Apple played a central role in facilitating and executing that conspiracy. Without Apple’s orchestration of this conspiracy, it would not have succeeded as it did in the Spring of 2010.

There is, at the end of the day, very little dispute about many of the most material facts in this case. Before Apple even met with the first Publisher Defendant in mid-December 2009, it knew that the “Big Six” of United States publishing -– the Publisher Defendants and Random House (collectively, the “Publishers”) -- wanted to raise e-book prices, in particular above the $9.99 prevailing price charged by Amazon for many e-book versions of New York Times bestselling books (“NYT Bestsellers”) and other newly released hardcover books (“New Releases”). Apple also knew that Publisher Defendants were already acting collectively to place pressure on Amazon to abandon its pricing strategy.

At their very first meetings in mid-December 2009, the Publishers conveyed to Apple their abhorrence of Amazon’s pricing, and Apple assured the Publishers it was willing to work with them to raise those prices, suggesting prices such as $12.99 and $14.99. Over the course of their negotiations in December 2009 and January 2010, Apple and the Publisher Defendants educated one another about their other priorities. Apple strongly hoped to announce its new iBookstore when it launched the iPad on January 27, 2010, but would only do so if it had agreements in place with a core group of Publishers by that date, could assure itself it would make a profit in the iBookstore, and could offer e-book titles simultaneously with their hardcover releases. For their part, if the Publisher Defendants were going to take control of e-book pricing and move the price point above $9.99, they needed to act collectively; any other course would leave an individual Publisher vulnerable to retaliation from Amazon.

Apple and the Publisher Defendants shared one overarching interest -- that there be no price competition at the retail level. Apple did not want to compete with Amazon (or any other e-book retailer) on price; and the Publisher Defendants wanted to end Amazon’s $9.99 pricing and increase significantly the prevailing price point for e-books. With a full appreciation of each other’s interests, Apple and the Publisher Defendants agreed to work together to eliminate retail price competition in the e-book market and raise the price of e-books above $9.99.

Apple seized the moment and brilliantly played its hand. Taking advantage of the Publisher Defendants’ fear of and frustration over Amazon’s pricing, as well as the tight window of opportunity created by the impending launch of the iPad on January 27 (the “Launch”), Apple garnered the signatures it needed to introduce the iBookstore at the Launch. It provided the Publisher Defendants with the vision, the format, the timetable, and the coordination that they needed to raise e-book prices. Apple decided to offer the Publisher Defendants the opportunity to move from a wholesale model -- where a publisher receives its designated wholesale price for each e-book and the retailer sets the retail price -- to an agency model, where a publisher sets the retail price and the retailer sells the e-book as its agent.

The agency agreements that Apple and the Publisher Defendants executed on the eve of the Launch divided New Release e-books among price tiers. The top of each tier, or cap, was essentially the new price for New Release e-books. The caps included $12.99 and $14.99 for many books then being sold at $9.99 by Amazon.

The agreements also included a price parity provision, or Most-Favored-Nation clause (“MFN”), which not only protected Apple by guaranteeing it could match the lowest retail price listed on any competitor’s e-bookstore, but also imposed a severe financial penalty upon the Publisher Defendants if they did not force Amazon and other retailers similarly to change their business models and cede control over e-book pricing to the Publishers. As Apple made clear to the Publishers, “There is no one outside of us that can do this for you. If we miss this opportunity, it will likely never come again.”

Through the vehicle of the Apple agency agreements, the prices in the nascent e-book industry shifted upward, in some cases 50% or more for an individual title. Virtually overnight, Apple got an attractive, additional feature for its iPad and a guaranteed new revenue stream, and the Publisher Defendants removed Amazon’s ability to price their e-books at $9.99. A detailed explanation of how Apple facilitated this conspiracy and changed the face of the e-book industry follows.

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Excerpt from *U.S. v. Apple Inc.*, 2013 DCNY Lexis 96424 on why Apple chose the “agency model.” (p. 11)

… the Publishers were searching for an alternative to Amazon’s pricing policies and excited about Apple’s entry into the e-book industry and the prospect that that entry would give them leverage in their negotiations with Amazon. Apple appreciated that, in the words of Macmillan’s Sargent, the Publishers viewed Apple as “offer[ing] the single best opportunity [they] would ever have to correct the imbalance in our e-book market.”

Apple settled on an agency model with a 30% commission, the same commission it was using in its App Store. Agency would give the Publishers the control over e-book pricing that they desired, and ensured that Apple would make a profit from every e-book sale in its iBookstore without having to compete on price. Apple realized, however, that in handing over pricing decisions to the Publishers, it needed to restrain their desire to raise e-book prices sky high. It decided to require retail prices to be restrained by pricing tiers with caps. While Apple was willing to raise e-book prices by as much as 50% over Amazon’s $9.99, it did not want to be embarrassed by what it considered unrealistically high prices.

The agency model presented one significant problem. Apple wanted its iBookstore to be a rousing success. For that to happen, Apple needed not only content but also customers. Apple realized that if it moved to an agency model with the Publishers, Apple would be at a competitive disadvantage so long as Amazon remained on the wholesale model and could price New Releases and NYT Bestsellers at $9.99, or even lower to compete with Apple. Since it was inevitable that the Publishers would raise e-book prices when given the opportunity –- indeed, Apple expected the Publishers to raise the prices to the tier caps -- e-books priced at $9.99 by Amazon would doom the iBookstore. Why would a consumer buy an e-book in the iBookstore for $14.99 when it could download it from Amazon for $9.99?

To ensure that the iBookstore would be competitive at higher prices, Apple concluded that it needed to eliminate all retail price competition. Thus, the final component of its agency model required the Publishers to move all of their e-tailers to agency. Apple expected that this proposal would appeal to the Publishers. After all, it would allow them to “fix” their “problem” with Amazon’s pricing.