13-3741-cv(L),

13-3748(CON), 13-3783(CON), 13-3857(CON), 13-3864(CON), 13-3867(CON)

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

UNITED STATES OF AMERICA, *et al.*,
Plaintiffs-Appellees,

v.

APPLE INC., *et al.*,
Defendants-Appellants.

On Appeal from the United States District Court
for the Southern District of New York, No. 12 Civ. 2826(DLC)

BRIEF OF ECONOMISTS AS *AMICI CURIAE* IN SUPPORT OF APPELLANT APPLE AND URGING REVERSAL

MICHELLE D. MILLER
JAMES C. BURLING
WILMER CUTLER PICKERING
HALE AND DORR LLP
60 State Street
Boston, MA 02109

ARI SAVITZKY
WILMER CUTLER PICKERING
HALE AND DORR LLP
7 World Trade Center
250 Greenwich Street
New York, NY 10007

LEON B. GREENFIELD
JONATHAN CEDARBAUM
DAVID SLUIS
WILMER CUTLER PICKERING
HALE AND DORR LLP
1875 Pennsylvania Avenue, NW
Washington, DC 20006
(202) 663-6000

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INTEREST OF *AMICI*[1]

Amici are economists whose work focuses on industrial behavior, including business strategy, risk, and competition. *Amici* often write about and serve as economic experts with respect to industrial behavior, including in the antitrust context. As economists and scholars, *amici* have a strong interest in the application of the antitrust laws for their intended purposes: to promote efficient, vigorous, and innovative competition, for the benefit of consumers and the economy as a whole. *Amici* are well situated to discuss how firms compete, and how antitrust law affects firms' competitive behavior. A list that includes the titles and professional affiliations of *amici* is appended to this brief.[2]

INTRODUCTION AND SUMMARY OF ARGUMENT

Efficient markets depend on firms acting in their independent business interests. In this case, the District Court's failure to consider the economics of the vertical agreements between Apple and the Publisher Defendants led it to infer that Apple facilitated and participated in a horizontal price-fixing conspiracy. The District Court never considered evidence and economic reasoning that the vertical

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[1] Pursuant to Federal Rule of Appellate Procedure 29 and Local Rule Rule 29.1, *amici* state that no party or party's counsel authored this brief in whole or in part. *Amici* further state that no party, party's counsel, or any other person other than *amici* and *amici*'s counsel contributed money that was intended to fund preparing or submitting this brief.

[2] Pursuant to Federal Rule of Appellate Procedure Rule 29(a), *amici* state that all parties have consented to the filing of this brief.

agreements were in Apple's independent business interest in entering e-book retailing, wholly apart from any horizontal conspiracy.

The provisions of the agreements at issue—agency, "most-favored-nation" (MFN) clauses, and price caps—can be instrumental in facilitating new entry, particularly into markets with an entrenched, dominant firm. In this case, the District Court disregarded economic evidence and reasoning that these provisions served Apple's independent business interest in entering the e-book market, where Amazon was a near-monopolist. The District Court also ignored economic evidence and reasoning suggesting that Apple's entry into e-book retailing, and not the MFNs, allowed the Publisher Defendants to persuade Amazon to switch from a wholesale to an agency business model.

Again ignoring evidence and economic logic, the District Court also erred in equating price increases for some e-books with harm to competition. Apple's entry into the e-book retail market dramatically *increased* competition by diminishing Amazon's power as a retail monopolist (and its ability to pursue a "loss-leader" strategy that inefficiently priced e-books below their acquisition cost). That increased competition gave publishers more bargaining power, thereby bringing e-book pricing closer to competitive levels.

These errors threaten to chill competition by discouraging the use of common vertical contracting techniques that are often essential to facilitating the

expensive and risky investments needed for entry into highly concentrated markets. Our antitrust laws should encourage, not penalize, vertical contracting arrangements that facilitate entry and enhance competition.

ARGUMENT

I. THE DISTRICT COURT DISREGARDED THE ECONOMICS OF THE RELEVANT CONTRACTUAL ARRANGEMENTS IN RELYING ON THEM AS EVIDENCE THAT APPLE PARTICIPATED IN A HORIZONTAL CONSPIRACY

Firms' pursuit of their independent business self-interests is the engine that makes markets work efficiently, to the benefit of competition and consumers. *See, e.g.*, Pepall, Richards, & Norman, *Industrial Organization: Contemporary Theory and Empirical Applications* 22 (4th ed. 2008) ("Like all firms, the perfectly competitive ones will each choose that output level which maximizes their individual profit."); Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* 242 (Edinburgh ed. 1806) (1776) ("By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it."). It is therefore critically important that antitrust courts exercise great care before relying on conduct that is fully consistent with a firm's independent business interest to infer an illegal conspiracy in violation of Section 1 of the Sherman Act lest they chill the proper functioning of the competitive process. Here, the District Court erred by failing to exercise such care. Unless overturned, the decision below threatens to impede the use of common vertical

contracting practices that facilitate entry of new firms into concentrated markets and other objectives critical to a healthy economy.

To determine whether conduct evidences that a firm has participated in a horizontal price-fixing conspiracy, economics requires us to assess whether the conduct was consistent with the firm's business interests acting independently of any such conspiracy. *See, e.g.*, Blair & Kaserman, *Antitrust Economics* 236 (2d ed. 2009) (discussing importance of whether conduct is in firm's independent business interest to assessing antitrust conspiracy allegations). If the conduct made independent business sense, then (without more) it does not suggest that the firm participated in a conspiracy. *Id.* The law recognizes this economic principle by requiring that evidence of price-fixing must "show that the inference of a conspiracy is reasonable in light of competing inferences of independent action." *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 588 (1986); *see also Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 764 (1984) (evidence of price-fixing must "tend[] to exclude the possibility that the [defendants] were acting independently"). It is only if the conduct would *not* have made business sense but for a conspiracy that economics allows us to conclude that the conduct is evidence of a conspiracy. *See* Blair & Kaserman, *supra*, at 235-237.

In this case, the District Court relied on Apple's Agency Agreements with the Publisher Defendants—and particularly the price-parity or MFN clauses and

price caps—as critical evidence that "Apple participated in and facilitated a horizontal price-fixing conspiracy," *United States v. Apple, Inc.*, 952 F. Supp. 2d 638, 694 (S.D.N.Y. 2013). In doing so, the District Court disregarded basic economic principles and substantial economic evidence that these vertical arrangements were in Apple's business interests independent of any horizontal conspiracy among the Publisher Defendants.

The MFNs and price caps in Apple's Agency Agreements enabled Apple to enter e-book retailing with the launch of the iBookstore and challenge Amazon's near-monopoly position. Indeed, the District Court expressly acknowledged that Apple would launch the iBookstore only if it "had agreements in place with a core group of publishers …, could assure itself it would make a profit in the iBookstore, and could offer e-book titles simultaneously with their hardcover releases." *Apple*, 952 F. Supp. 2d at 647. Yet, having recognized that Apple's entry into e-book retailing depended on suitable bi-lateral arrangements with publishers, the court flatly dismissed—without reference to the evidence—any notion that the Agency Agreements in fact facilitated the launch of the iBookstore: "The pro-competitive effects to which Apple has pointed, including its launch of the iBookstore …, are phenomena that are independent of the Agreements and therefore do not demonstrate any pro-competitive effects flowing from the Agreements." *Id.* at 694. These statements are irreconcilable. Since Apple required appropriate

agreements with publishers in order to enter e-book retailing, it was irrational simply to disregard the possibility that the Agency Agreements it actually used served its independent business interest in entering e-book retailing.

As we explain in detail below, MFNs and price caps can play a crucial role in facilitating entry, particularly in markets with an entrenched, dominant firm. Only by disregarding fundamental economic principles and important economic evidence could the District Court have failed to recognize that the MFNs and price caps were in Apple's business interests independent of any horizontal conspiracy.

A. The Agency Agreements' MFN Clauses And Price Caps Formed The Linchpin Of The District Court's Condemnation of Apple For Facilitating And Participating In Horizontal Price-Fixing

The District Court saw the MFN and price cap provisions in Apple's Agency Agreements as crucial mechanisms by which Apple facilitated and participated in the Publisher Defendants' horizontal price-fixing conspiracy. The District Court repeatedly stated that the MFN clauses "forced" the Publisher Defendants to move the entire industry to an agency model. *See Apple*, 952 F. Supp. 2d at 664 ("[T]he MFN effectively forced the Publisher Defendants to change their entire e-book distribution business to an agency model if they wanted to take control of retail pricing."); *id*. at 692 ("The MFN was sufficient to force the change in model."). The District Court concluded that by forcing this change to an agency model, the MFNs, in conjunction with the price caps, resulted in the effective fixing of retail

prices for e-books, including those sold on Amazon. *Id*. at 691-692 (describing price caps as "setting the new retail prices at which e-books would be sold"), 699 (finding it "evident that the caps for the price tiers were the fiercely negotiated new retail prices for e-books and that the MFN was the term that effectively forced the Publisher Defendants to eliminate retail price competition and place all of their e-tailers on the agency model"). The District Court's view of the Agency Agreements was thus critical to its ultimate conclusion, but unsupported by economic reasoning or evidence.

B. The District Court Failed To Consider Evidence That The Agency Agreements' MFN Clauses And Price Caps Were In Apple's Independent Business Interests

The District Court failed to consider evidence that the vertical Agency Agreements and their MFN and price cap provisions were in Apple's independent business interests in entering e-book retailing, wholly apart from any horizontal conspiracy among the Publisher Defendants to raise e-book prices. MFNs, price cap provisions, and the agency model more broadly are examples of common vertical contracting arrangements that facilitate new entry, such as Apple's launch of the iBookstore. Indeed, these vertical contracting tools allowed Apple to address market conditions, and the divergent incentives of its trading partners, that might otherwise have made it uneconomical for Apple to enter the e-book retailing business and challenge Amazon's near-monopoly position. *See Leegin Creative*

Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877, 878, 891 (2007) (describing how vertical agreements can "facilitate[e] market entry for new firms and brands" and have a "procompetitive effect"). This rationale in no way depended on any horizontal conspiracy among the Publisher Defendants.

1. MFNs can facilitate entry

MFNs between a new entrant and a supplier have substantial potential to facilitate entry. In general, vertical restraints, such as MFNs, promote entry by protecting a potential entrant's investments in its new venture. *See Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 55 (1977) ("[N]ew manufacturers and manufacturers entering new markets can use [vertical contracting restrictions] in order to induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer."). MFNs can do this by ensuring that established competitors do not obtain superior terms from suppliers that allow them to price products at levels that make the new entrant uncompetitive.

Here, as the District Court recognized, before making the substantial investments necessary to enter e-book retailing, Apple needed reasonable prospects that the iBookstore would be received well by consumers, and would make a profit. *See Apple*, 952 F. Supp. 2d at 647 ("Apple strongly hoped to announce its new iBookstore when it launched the iPad … but would only do so if it … could assure

itself it would make a profit in the iBookstore…."); *see also id.* at 662 ("Apple reiterated that … it did not want to lose money…."), 698 ("Apple emphasizes the following: it wanted to enter and compete successfully in the e-books market; it did not want to begin a business in which it would sustain losses."). Apple's effort to ensure the iBookstore's profitability is hardly surprising. As the Horizontal Merger Guidelines put out by the Department of Justice and the Federal Trade Commission recognize, "[e]ntry is [only] likely if it would be profitable." U.S. Dep't of Justice & Fed. Trade Comm., Horizontal Merger Guidelines § 9.2 (Aug. 19, 2010) , *available at* http://www.justice.gov/atr/public/guidelines/hmg-2010.html.

To run a profitable e-book retail platform, Apple needed sufficient customer volume. And price is obviously a critical factor in consumers' decisions where to purchase an e-book. If consumers could find e-books cheaper elsewhere, many would not shop for e-books at the iBookstore. As the District Court acknowledged, "[i]n order for Apple to compete with Amazon it needed to be able price e-books as cheaply as Amazon did." *Apple*, 952 F. Supp. 2d at 656-657. Apple proposed that the Agreements with the publishers include an MFN clause that would guarantee that retail prices for certain e-books (*New York Times* bestsellers and new releases) would be no higher than those charged by other e-book retailers for the same e-books. *See id.* at 662.

Thus, the MFN clauses allowed Apple to address a dynamic in the e-book retailing sector that otherwise would have made successful entry virtually impossible. Amazon, the dominant e-book retailer, was using its leverage over publishers to pursue a "loss-leader" strategy. Amazon was pricing the most popular e-books below the wholesale prices it paid publishers, in pursuit of Amazon's broader business objectives. *Apple*, 952 F. Supp. 2d at 708; *see generally Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 231-232 (1st Cir. 1983) (Breyer, J.) ("competitive industries are typically characterized by prices that are roughly equal to, not below, 'incremental' costs" (citation omitted)). Although the publishers objected to Amazon's strategy, they had no ability to stop it because Amazon was the only major e-book retailer. *Apple*, 952 F. Supp. 2d at 649-650 (describing how "Amazon dominated the e-book retail market, selling nearly 90% of all e-books" and the Publisher Defendants' unsuccessful attempts to move Amazon off of the $9.99 price point).

Apple, by contrast, had no interest in losing money on e-book sales. To justify entering the e-book business, it needed prospects for making money on e-books—standing alone—and it needed to be able to conduct its iBookstore consistent with its broader reputation for offering desirable products at competitive prices. *Apple*, 952 F. Supp. 2d at 647, 670 (Apple would only roll out its e-books platform if it could "assure itself it would make a profit in the iBookstore," and

Apple wanted to avoid prices that would "alienate [its] customers or subject [it] to ridicule"). Apple therefore sought bi-lateral contract provisions with publishers that would avoid Apple's being placed in a position where the publishers set retail prices (under the agency model) that made Apple's iBookstore uncompetitive with Amazon. Otherwise, Apple would be unable to generate sufficient sales to make the iBookstore business viable. *See id.* at 656 ("Apple had decided that it would not open the iBookstore if it could not make money on the store and compete effectively with Amazon."). Thus, the MFN provisions were directed at Apple's business objective of launching a profitable and successful iBookstore, which was independent of any horizontal conspiracy among the Publisher Defendants. *See id.* at 659 (observing that, because publishers could set prices under the Agreements, "Apple would be at a competitive disadvantage so long as Amazon … could price New Releases and NYT Bestsellers at $9.99, or even lower to compete with Apple. … Why would a consumer buy an e-book in the iBookstore for $14.99 when it could download it from Amazon for $9.99?"), 662 ("The MFN guaranteed that the e-books in Apple's e-bookstore would be sold for the lowest retail price available in the marketplace.").

2. Price caps can facilitate entry

Price caps can ameliorate misaligned incentives between manufacturers and distributors that may undermine the competitive process and result in consumer

harm. *See, e.g.*, Fesmire, *Maximum Vertical Price Fixing from* Albrecht *Through* Brunswick *to* Khan*: An Antitrust Odyssey*, 24 Seattle U. L. Rev. 721, 721 & nn.2-3 (2001) ("[F]or many years, a majority of economists have viewed maximum vertical price fixing as a practice that is not only benign, but, indeed, one that results in an increase in consumer welfare, a primary goal of antitrust") (collecting authorities); *see also State Oil Co. v. Khan*, 522 U.S. 3, 15-16 (1997) (discussing procompetitive aspects of vertical maximum price restraints and abrogating rule that such restraints are *per se* violations of the Sherman Act). And those misaligned incentives can thwart new entry.

Here, the publishers and Apple had divergent business incentives that Apple sought to address through vertical price cap provisions. Because of their concern about the effect of e-book prices on the market for printed books, the publishers desired e-book retail prices significantly higher than those Apple wanted. *See e.g.*, *Apple*, 952 F. Supp. 2d at 657 ("HarperCollins advocated that e-book prices be set in the range of $18 to $20, which [Apple] viewed as utterly unrealistic."). Apple's interest in bookselling was to sell e-books *and e-books only*. It therefore favored e-book retail prices at a level that would allow sufficient net commission profits for selling *e-books*. The publishers, by contrast, also had hard-copy businesses and relationships with hard-copy book retailers that could be impaired by retail e-book prices that did not properly account for the cannibalizing effect on hard-copy book

sales and in this sense were "too low." Accordingly, unlike Apple, each publisher's interest was not to maximize profits on the sale of e-books, but instead to ensure that retail prices were set at levels that would maximize their profits for their e-book and print-book businesses in the aggregate.

The price caps, therefore, were a device to promote Apple's independent business interest in protecting itself against prices set by publishers that would reduce e-book sales below Apple's profit-maximizing level and "either alienate [its] customers or subject [it] to ridicule." *Apple*, 952 F. Supp. 2d at 670; *see id.* at 658 ("Apple realized … 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."). Absent price caps, the publishers would have been free to set e-book prices at a level that maximized publisher profits—including at prices that could have driven consumers towards printed books and away from e-books sold by Apple in the iBookstore. Rather than tolerate this significant risk, Apple made price caps a precondition to its entry into the e-book market.

By failing to consider the economic evidence regarding Apple's independent business reasons for insisting on price caps, the District Court concluded that they were mechanisms for horizontal fixing of prices at high levels. *E.g.*, *Apple*, 952 F. Supp. 2d at 699 ("the caps for the price tiers were the fiercely negotiated new retail

prices for e-books"). But as an economic matter, that many retail prices in the Apple iBookstore may have been at the price cap suggests only that the price caps kept the Publisher Defendants from setting prices at levels even higher than the price caps—which would have conflicted with Apple's independent business interests. Far from reflecting a desire to facilitate collusion, or even a desire to have prices reach the negotiated caps, the price caps served to ensure that publishers' prices under the agency model would not drive customers away from the iBookstore, reduce e-book sales below Apple's profit-maximizing levels, and harm Apple's broader businesses reputation.[3] The price caps thus facilitated Apple's successful entry into e-book retailing. This is consistent with Apple's independent business interests, apart from any conspiracy among the Publisher Defendants.

3. Agency agreements can facilitate entry

The agency structure—a structure similar to the one used for Apple's App Store—facilitated the launch of the iBookstore by giving both publishers and

[3] Of course, that e-book prices at the iBookstore were at or near the caps is not surprising given that the Publisher Defendants were aggressively negotiating for higher price caps. *See Apple*, 952 F. Supp. 2d at 667 (describing the negotiations as "intense"); *see also id.* at 670 ("[T]he Publisher Defendants largely moved the prices of their e-books to the caps, raising them consistently higher than they had been *albeit below the prices that they would have preferred*." (emphasis added)). If the Publisher Defendants had actually wanted to set prices below the caps, there would have been little negotiation regarding Apple's proposed caps, and little need for caps in the first place.

Apple attractive terms. Apple was able to give publishers greater control over pricing, while at the same time ensuring Apple a predictable margin over its wholesale price. *Apple*, 952 F. Supp. 2d at 667. Far from "forcing" the Publisher Defendants to impose an agency model on Amazon—let alone forcing them to collude to fix prices for e-books—the Agency Agreements (and their MFN provisions and price caps) facilitated a choice for publishers. Apple's entry into e-book retailing gave publishers an alternative to the "loss-leader" pricing of the dominant e-book retailer. That was, to be sure, an attractive opportunity for the publishers. But as an economic matter, the crucial point is that the vertical Agency Agreements (by themselves) cannot evidence that Apple participated in any horizontal price-fixing conspiracy with the Publisher Defendants because the Agreements were in furtherance of Apple's independent business interests—namely Apple's entry into e-book retailing.

C. The District Court Failed To Consider Whether Apple's Entry As An e-Book Distribution Alternative Explained The Subsequent Changes In Industry Contracting And Pricing Practices

The District Court's reliance on MFN clauses and price caps to show that Apple conspired with the Publisher Defendants to move Amazon to an agency model and fix prices for e-books ignored that such changes may be explained simply by Apple's entry as an alternative to Amazon's e-book retailing hegemony. As a matter of economics, if Apple's entry alone explains these changes, then it

would be incorrect to conclude that Apple's vertical contracting devices facilitated a horizontal conspiracy among the Publisher Defendants. From an economic perspective, it is critical that courts consider whether Apple's entry alone explains any changes in publishers' contracting and pricing arrangements with Amazon. This avoids drawing unwarranted inferences that vertical contract provisions in a party's independent business interests evidence participation in a horizontal conspiracy—and avoids chilling self-interested conduct like new entry. Basic economic principles would predict that the introduction of a meaningful distribution alternative for the publishers would fundamentally alter the dynamics of their business arrangements with the previously dominant retailer. Here, the District Court failed to recognize these principles or even to consider economic evidence that it was Apple's entry, rather than the MFN provisions or price caps, that explained subsequent industry changes.

MFN Clauses. The District Court found that the "[t]he MFN was sufficient to force the change in model." *Apple*, 952 F. Supp. 2d at 692. But the District Court never considered that the entry of Apple (and expansion of Barnes & Noble) to challenge Amazon's dominant position in e-book retailing and the resulting changes in bargaining power between the publishers and Amazon—not the MFN clauses—might explain why the publishers were able to convince Amazon to switch from a wholesale to an agency model. Indeed, the District Court ignored

econometric evidence regarding this issue.[4] Due to these changes in market structure, publishers for the first time had a meaningful alternative to Amazon for retail distribution of their e-books. Economics tells us that the introduction of new competition into a retailing market with an entrenched dominant firm can substantially change bargaining dynamics and allow manufacturers to obtain retail distribution terms that are much more favorable to the manufacturer. Accordingly, from an economic perspective, the entry of Apple and expansion of Barnes & Noble could well explain why the publishers were able to obtain the switch to an agency model that they desired. Furthermore, economics teaches that in evaluating the MFN clauses as an alternative explanation for this switch, the District Court would need to consider any marginal impact of the MFN clauses in the context of the substantial change in bargaining power from new entry and expansion. But the District Court failed to do that here.

Price Caps. The District Court concluded that the price caps were to facilitate a horizontal price-fixing agreement by "setting the new retail prices at which e-books would be sold," *Apple*, 952 F. Supp. 2d at 691-692, and disregarded the evidence and economic logic that they were in Apple's independent business interest. As explained above at pp. 12-13, the publishers were concerned about

[4] *See* Declaration of Professor Benjamin Klein ¶¶ 9-32 (April 26, 2013) (received into evidence as Def.'s Ex. 720, *see* June 17, 2013 Trial Tr. at 2058-2061, *United States v. Apple, Inc.*, Nos. 12-cv-2826 & 12-cv-3394, Docket No. 318 (S.D.N.Y. July 1, 2013)).

pricing effects on hard-copy books as well as e-books, and thus had an incentive to price e-books higher than Apple would prefer. Economics shows that price caps at the retail level are often used to address just these types of misaligned incentives between manufacturers and retailers. The District Court never considered the economic evidence that the price caps in this case served Apple's independent business interest in keeping publishers from pricing e-books *higher* than would have absent the caps, and therefore do not evidence that Apple participated in any horizontal conspiracy among the Publisher Defendants. [5]

II. THE DISTRICT COURT ALSO DISREGARDED FUNDAMENTAL ECONOMIC PRINCIPLES AND IMPORTANT ECONOMIC EVIDENCE IN EQUATING PRICE INCREASES WITH HARM TO COMPETITION

We emphasize that the alleged agreement the District Court found to violate Section 1 of the Sherman Act was a horizontal agreement among the Publisher Defendants supposedly facilitated and joined by Apple. Accordingly, the principal economic question is that addressed in Part I: whether the Agency Agreement provisions that the District Court found to evidence a horizontal conspiracy were in Apple's independent business interests. Nonetheless, because the District Court relied on a finding that some retail e-book prices increased after Apple launched its iBookstore to conclude that Apple's entry could not have enhanced competition,

[5] *See* Klein Decl. ¶¶ 48-51.

Apple, 952 F. Supp. at 694, it is important to address the true economic implications of any such increased prices.

Even assuming that some retail e-book prices did increase post-Apple entry (a question about which we express no view), the District Court's reasoning runs contrary to established economic principles. Retail price increases can reflect a more, rather than less, competitive market. *See* Overstreet, FTC, *Resale Price Maintenance: Economic Theories and Empirical Evidence* 140 (1983) (price increases can be consistent with procompetitive effects); *see also Leegin*, 551 U.S. at 889-890 (describing how minimum resale prices can enhance competition).

Any prices increases following Apple's entry may well be quite consistent with enhanced competition, namely the disruption of Amazon's monopoly retail position, which allowed Amazon to force publishers into tolerating its loss-leader pricing strategy. Economics demonstrates that competitive markets benefitting consumers over the long run do not necessarily exhibit the lowest prices possible, but rather are "characterized by prices that are roughly equal to, not below, 'incremental' costs." *Barry Wright*, 724 F.2d at 232 (citing Scherer, *Industrial Market Structure and Economic Performance* 13-14 (2d. ed. 1980)). Indeed, the Supreme Court has cautioned against assuming that "actions violate the Sherman Act because they lead to higher prices," *Leegin*, 551 U.S. at 896-897; *see also Brantley v. NBC Universal, Inc.*, 675 F.3d 1192, 1202 (9th Cir. 2012) ("that an

agreement has the effect of … increasing prices to consumers does not sufficiently allege an injury to competition" and is "fully consistent with a free, competitive market"). Apple's entry provided publishers with an alternative e-book distributor, and the ability to bargain with Amazon on more equal footing. This entry may have led to prices for some e-books increasing to more than the "below incremental cost" levels that Amazon established when it held a retailing monopolist's power over publishers. But one cannot conclude that those increased prices necessarily reflected reduced competition for e-books or reduced consumer welfare.

III. IF NOT OVERTURNED, THE DISTRICT COURT'S DECISION WILL STIFLE PROCOMPETITIVE BEHAVIOR

The District Court's decision, if not overturned, threatens substantial harm to broader competition policy and to consumers. By relying on MFN clauses and price caps as crucial evidence that Apple colluded with the Publisher Defendants—and by failing sufficiently to consider economic reasoning and evidence that these contract provisions were in Apple's independent business interest in entering e-book retailing—the District Court's opinion will chill the use of common vertical contracting terms that promote entry and innovative business models to the benefit of competition and consumers. Firms should be able to act with confidence that courts will not misconstrue decisions they make in their independent business interests (apart from any conspiracy) to evidence participation in illegal price-

fixing conspiracies. *See Broadcast Music, Inc. v. Columbia Broad. Sys., Inc.*, 441 US. 1, 19-20 (1979) (noting favorably practices "designed to increase economic efficiency and render markets more, rather than less, competitive" (quotation marks omitted)). Otherwise, antitrust enforcement risks becoming a mechanism for stifling, rather than promoting, vigorous competition. *See generally* Baumol & Ordover, *Use of Antitrust to Subvert Competition*, 28 J.L. & Econ. 247 (1985) (discussing efficiency-reducing effects of over-enforcement of antitrust laws).

The District Court's decision is especially troubling because it threatens to discourage the use of contracting tools that facilitate the large and risky investments necessary for disruptive challenges to entrenched, dominant firms. E-book retailing before Apple's entry provides a paradigmatic example. To enter this business, a firm had to invest in developing a technological platform (*i.e.*, an e-reader) and a software platform, promoting the platform to millions of consumers, and reaching licensing or wholesaling agreements with a critical mass of e-book suppliers (*i.e.*, publishers). Each of these components was necessary for success, and each required a costly commitment of resources.

Tools such as agency agreements, MFNs, and price caps can spur the challenger firms to make the required investments by helping the challenger address market conditions and divergent trading partner incentives that could otherwise inhibit investments in entry—especially in the face of an entrenched

competitor with monopoly power. These contracting techniques—particularly when coupled with an agency model—enable market entry that might otherwise be unprofitable or too risky. In those circumstances, agency agreements, MFNs, and price caps can drive competition and innovation.

The danger that restricting these vertical contracting devices will chill entry and competition is not just theoretical. Indeed, there appears already to be real-world evidence that condemning these mechanisms has lessened rivalry in U.S. e-book retailing. The Final Judgment on appeal in this case prohibits Apple from, among other things: (i) entering into or enforcing MFNs with e-book publishers and (ii) with certain exceptions, entering into or maintaining any agreement with the Publisher Defendants that restricts Apple's ability to set the retail price or offer price discounts or promotions on e-books (*i.e.*, prohibitions on the type of agency agreements Apple negotiated with publishers).[6]

In a recent submission to the Canadian Competition Bureau arguing that the Bureau should refrain from imposing similar prohibitions, Kobo Inc., a small e-book competitor in the United States, explained the effect analogous prohibitions in the Publisher Defendant's Settlement Agreements and Final Judgments have had

[6] *United States v. Apple, Inc.*, Nos. 12-cv-2826 & 12-cv-3394, 2013 WL 4774755, at *2 (S.D.N.Y. Sept. 5, 2013).

on its U.S. business.[7] Kobo, which also uses agency agreements and MFNs in some of its licensing arrangements with publishers,[8] explained that after the Final Judgments, it "saw its net revenues steadily decline," it "has since stopped investing in marketing in the US, closed its office in Chicago," and "[i]ts market share and revenues are now negligible [in the United States.]"[9] Kobo also observed that following the Publisher Defendants' Final Judgments, "Sony exited the E-book market in the US entirely … and Barnes & Noble's NOOK E-book division reported heavy losses for the 2013 fiscal year."[10] Thus, at least in the view of one e-book retailer, restrictions on vertical agency agreements have already discouraged rivalry in the United States.

Our antitrust laws should encourage new entry. Indeed, this Court has affirmed time and again the social value of challenges to entrenched dominant firms: "[P]ossession of unchallenged economic power deadens initiative, discourages thrift and depresses energy; … immunity from competition is a

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7 Notice of Application, *Kobo Inc. v. Commissioner of Competition*, File No. 2014-002 (Comp. Trib.), Pleading No. 2 (Feb. 21, 2014), *available at* http://www.ct-tc.gc.ca/CMFiles/CT-2014-002_Notice%20of%20Application_2_38_2-21-2014_6285.pdf.

8 *Id.* ¶¶ 6-24.

9 *Id.* ¶ 44.

10 *Id.* ¶ 45. Based on its observed impact of the *Apple* Final Judgment on the U.S. e-book industry, Kobo concluded that similar prohibitions in Canada would harm the Canadian e-book sector: "A ban on Agency, even in the short term, will have a lasting and irreversible negative impact on the market for E-books in Canada." *Id.* ¶¶ 45-46.

narcotic, and rivalry is a stimulant, to industrial progress; … the spur of constant stress is necessary to counteract an inevitable disposition to let well enough alone." *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 427 (2d Cir. 1945) (L. Hand, J.); *see Berkey Photo, Inc. v. Eastman Kodak Co.*, 603 F.2d 263, 272 (2d Cir. 1979); *see also United States v. Marine Bancorporation, Inc.*, 418 U.S. 602, 639 (1974) (rejecting challenge to merger where "the Government is in the anomalous position of opposing a geographic market extension merger that will introduce a third full-service banking organization to the Spokane market, where only two are now operating.").

The District Court's decision casts a specter of legal uncertainty over key vertical contracting tools that promote investment in market entry by challenger firms and thus frequently serve vital procompetitive ends. This Court should correct that error.

CONCLUSION

For the reasons stated, the Opinion and Order of the District Court should be REVERSED.

Respectfully submitted.

/s/ James C. Burling

LEON B. GREENFIELD
JONATHAN CEDARBAUM
DAVID SLUIS
WILMER CUTLER PICKERING
HALE AND DORR LLP
1875 Pennsylvania Avenue, NW
Washington, DC 20006
(202) 663-6000

MICHELLE D. MILLER
JAMES C. BURLING
WILMER CUTLER PICKERING
HALE AND DORR LLP
60 State Street
Boston, MA 02109

ARI SAVITZKY
WILMER CUTLER PICKERING
HALE AND DORR LLP
7 World Trade Center
250 Greenwich Street
New York, NY 10007

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CERTIFICATE OF COMPLIANCE

Pursuant to Fed. R. App. P. 32(a)(7)(C), the undersigned hereby certifies that this brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B).

1. Exclusive of the exempted portions of the brief, as provided in Fed. R. App. P. 32(a)(7)(B), the brief contains 5,556 words.

2. The brief has been prepared in proportionally spaced typeface using Microsoft Word 2010 in 14 point Times New Roman font. As permitted by Fed. R. App. P. 32(a)(7)(C), the undersigned has relied upon the word count feature of this word processing system in preparing this certificate.

/s/ James C. Burling
JAMES C. BURLING

March 4, 2014

LIST OF *AMICI*

(*affiliations are for identification only*)

Bradford Cornell, California Institute of Technology: *Amicus* Bradford Cornell is a visiting professor of economics at CalTech, and was for over 25 years the Bank of America Professor of Finance at the Andersen School of Management at UCLA. Professor Cornell is the author of several books and over 100 peer-reviewed journal articles on a wide variety of financial economics topics and has served as a reviewer for numerous finance and economics journals. He has testified in numerous cases involving the application of financial economics and has served as a project reviewer for the National Science Foundation for over 30 years.

Professor Janusz Ordover, New York University: *Amicus* Janusz Ordover has been a professor of economics at NYU since 1982, and the director of NYU's masters in economics program since 1996. He has published and lectured extensively on topics related to both law and economics, and antitrust issues specifically, authoring four books and monographs and over 100 other scholarly works. Professor Ordover has been a member of the board of editors for *Antitrust Report* for over 15 years, served as deputy assistant attorney general for economics in the Antitrust Division of the United States Department of Justice from 1991 to

1992, and has testified before the Federal Trade Commission, the United States Senate, and federal courts across the country.