The Ringmaster's Whip: The Role of Apple's MFN in the E-books Case

*By Adam Scott Kunz**

The Department of Justice (DOJ) recently was victorious in its battle with Apple, Inc., and five publishers over allegations of an industry-wide price-fixing scheme in the e-book market. After months of negotiation and litigation, Judge Denise Cote of the U.S. District Court for the Southern District of New York announced a final judgment on September 5, 2013, entering injunctive relief against Apple. The decision likely will have lasting effects for the future of the e-book industry and for other industries seeking to utilize an agency arrangement modeled after Apple's.

A review of the *Apple* case shows that the core of the litigation was Apple's use of a most favored nation clause (MFN) in its agreements with the publishers. The use of MFNs has long been recognized as a potential target of enforcement actions based on Section 2 of the Sherman Act. The DOJ and FTC have, in recent years, commenced enforcement actions and entered into consent agreements, particularly in the health care industry, in cases involving suspect MFNs.

While previous MFN cases largely involved unilateral conduct allegations, the *Apple* case challenges whether the use of an MFN in a vertical agreement can be a *per se* violation of Section 1 of the Sherman Act by facilitating or coordinating a horizontal conspiracy. Much of the MFN analysis in the *Apple* case turned on whether, under the Seventh Circuit's 2000 decision in *Toys "R" Us v. FTC (TRU)*, Apple was a "ringmaster" among conspirators. The answer to this question was entirely contingent upon what role the MFN played in Apple's underlying arrangements with each publisher – *i.e.*, whether the MFN was "the ringmaster's whip" Apple used to ensure that it could ultimately control and raise the price of e-books. The following examines the parties' and the court's characterizations of the MFN.

The DOJ's Complaint

On April 11, 2012, the DOJ filed a complaint against Apple and five major e-book publishers: Hachette Book Group, HarperCollins Publishers, Penguin Group, Macmillan, and Simon & Schuster. The DOJ's main allegation was that Apple had conspired with the five publishers to bring about an industry-wide price-fixing conspiracy in the e-book market. The DOJ further alleged that, with Apple as "ringleader," the defendants coordinated retail sales through the mutual adoption of an agency model that raised the price of e-books in an effort to curb the dominance of the biggest e-book supplier, Amazon. In the process, the DOJ argued that Apple was able to force a shift in the industry away from a wholesale system to an across-the-board adoption of an agency model. According to the complaint, one of the key ways that Apple and its codefendants were able to accomplish this was through the use of what DOJ called "an unusual most favored nation pricing provision."

Generally, an MFN is used as an inducement to contract in other agreements; the seller agrees to give the buyer the best terms it makes available to any other buyer, thereby assuring the buyer that it will not receive any worse terms the seller offers to another buyer. The DOJ alleged that Apple's MFN, however, did not ensure that Apple would receive the best available wholesale price of e-books from the defendant publishers, nor did it ensure that the publishers would not set a higher retail price in Apple's online iBookstore than they set on other websites (including Amazon's). Instead, DOJ alleged that the MFN required each of the publishers to guarantee that it would lower the retail price of each e-book in Apple's iBookstore to match the lowest price offered by any other retailer. This was true, DOJ alleged, even if the publisher did not control that other retailer's ultimate consumer price. In other words, according to DOJ, instead of an MFN designed to protect Apple's ability to compete, the MFN was designed to protect Apple from having to compete at all on retail prices. As such, the DOJ alleged this was a *per se* violation of Section 1 of the Sherman Act.

The DOJ sought a laundry list of injunctive relief, including nullification of the MFN in Apple's contracts and placing both internal and external custodians to monitor Apple's antirust compliance.

The *Toys "R" Us* Debate

Although DOJ was explicit in its allegations regarding the MFN, it was not clear what role the MFN would play at trial until the parties submitted their pretrial memoranda after having completed discovery. In their respective filings, both sides took very different views as to the role of the MFN in the underlying transactions. In both its pre-trial and post-trial briefs, DOJ characterized Apple's actions as a *per se* violation of Section 1 of the Sherman

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Act. Apple was, according to DOJ, acting "in the center as the ringmaster" of a horizontal agreement among the five publishers to fix prices.

For this point, DOJ relied upon *TRU* in which the Seventh Circuit held that Toys "R" Us had orchestrated horizontal agreements among toy manufacturers to curb sales of their toys to warehouse clubs, with which Toys "R" Us competed at the retail level. *See Toys "R" Us, Inc. v. FTC*, 221 F.3d 928, 939 (7th Cir. 2000). In that case, the FTC challenged a network of vertical agreements that Toys "R" Us had entered into with each of the toy manufacturers, under which the manufacturers agreed to restrict distribution to warehouse clubs on the condition that the other manufacturers would do the same. The Seventh Circuit ruled that, while the horizontal agreements between the manufacturers were themselves *per se* violative of Section 1 of the Sherman Act, the vertical orchestration of those agreements by Toys "R" Us also was itself a *per se* violation.

Relying on *TRU*, DOJ argued in its briefing that, like the toy manufacturers in *TRU*, the publishers made statements that each of them was entering into the arrangement with Apple (which included the MFN) on the expectation that the other publishers would do likewise. Additionally, DOJ argued, like Toys "R" Us, Apple had provided assurances to all of the publishers that each member of the network would equally participate, thus ensuring that one publisher's action would be supported by the other four. DOJ pointed to the MFN as proof-positive that Apple had created a scheme that would incentivize the publishers to forgo incremental benefits on e-book prices in exchange for a virtual guarantee of greater sales through Apple and a reduction of market dominance from the leading e-book retailer, Amazon.

By contrast, in its pre-trial and post-trial briefing, Apple stated that it did not view *TRU*, and the attendant role of the Apple MFN, to be so succinct. Apple sought to minimize *TRU*, arguing that the toy retailer had used its massive retail dominance in a narrow market to pressure toy manufacturers to enter into the horizontal agreements. The preexisting relationships between Toys "R" Us and the manufacturers, Apple maintained, meant that Toys "R" Us could leverage its ongoing business relationships into a more restricted network. In turn, according to Apple, Toys "R" Us not only had the ability to set the conspiracy machine in motion, but to then monitor and enforce the underlying agreements. In essence, Apple argued that Toys "R" Us had market power in toy retailing, while Apple lacked any market power in the retail sale of e-books.

Apple further argued that nothing in the express language of its MFN, nor in the communications surrounding its development, could lend credence to the idea that Apple used it as a way to "monitor and enforce" a conspiracy. Instead, Apple argued that the MFN arose out of a legitimate business interest and, indeed, a procompetitive motive. It asserted that the MFN was intended to lower prices on the most visible e-books in Apple's iBookstore and was not used as a method to force the publishers to adopt an agency model with other retailers. This fact alone meant that Apple was able to invigorate competition in an e-book market dominated by Amazon. In its briefing, Apple pointed to its relative absence from the e-book market and its nascent relationship with the publishers as clear examples that its MFN – the "first contact," so to speak, with the publishers – made it wholly different from the toy retailer in TRU.

The Court's Decision

On July 10, 2013, Judge Cote issued an opinion and order concluding that Apple engaged in and facilitated a conspiracy that constituted a *per se* violation of Section 1 of the Sherman Act.

Reading the court's opinion, it is evident how important the MFN was to the underlying controversy and the court's analysis. In nearly every section of the opinion, Judge Cote noted the important role the MFN played in all of Apple's negotiations with the publishers and subsequent pricing actions. The court found that the MFN 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 [publishers] 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.

In reaching its decision, the court acknowledged that the MFN alone was not enough for Apple to have coordinated the horizontal conspiracy among the publishers. The MFN would simply have required the publishers to treat Apple no differently than any other e-book carrier. But, when it was paired with other conditions in the agreement, the MFN had substantial weight. The court noted that "[b]y combining the MFN with the pricing tiers, the pricing discretion Apple gave to the Publishers with one hand, it took away with the other." Although the publishers "could theoretically raise e-book prices in the iBookstore above the $9.99 price point to the top of the Apple pricing tiers, unless the Publishers moved all of their e-tailers to an agency model and raised e-book prices in all of those e-bookstores, Apple would be selling its e-books at its competitors' lower prices."

Similarly, in theory, a publisher could simply have used the same prices it had given to Amazon: an e-book sold on

Apple's iBookstore could have been $9.99 just as it would have been on Amazon. In setting that price, the publisher would have obeyed the terms of the MFN, offering to Apple no better price than one offered to another carrier. However, the publisher would have suffered a financial setback on the individual e-book: under Apple's agency model, the publisher would have had to pay Apple – the publisher's "agent" – a 30% commission for Apple's sale in the iBookstore. The publisher would have incurred no such loss under the pre-existing wholesale arrangement with Amazon. Each publisher, then, had only two options. It could avoid the agency agreement with Apple altogether and continue under a wholesale model, which the court noted, none of the publishers liked. Or, the publisher could accept Apple's arrangement – an agency model, with the MFN and pricing tiers – and thereby force an agency model upon Amazon and other retailers, ensuring that the publisher both complied with Apple's MFN and did not sustain a loss through Apple's agency agreement.

Alone, no one publisher could demand a change of this sort from Amazon. However, because each of the publishers expressly agreed to Apple's arrangement – an agency model, with the MFN and pricing tiers – on the expectation that all of the other publishers would similarly agree, the MFN "eliminated any risk that Apple would ever have to compete on price when selling e-books." In the court's words, as a "practical matter," the MFN forced "the [p]ublishers to adopt the agency model across the board" and place further pressure on Amazon. The "MFN became such a critical term in Apple's contracts with the [publishers]. It literally stiffened the spines of the [publishers] to ensure that they would demand new terms from Amazon. Thus, the MFN protected Apple from retail price competition as it punished a [publisher] if it failed to impose agency terms" on other retailers.

Under the court's reading of *TRU*, Apple's MFN had only one purpose: to create an economic climate in which the publishers would have no other choice than to demand an agency model from Amazon *because of* their relationship with Apple. Since any single publisher would, in the court's words, "be in significantly worse terms financially" without acting in concert with the other publishers, the MFN was the fulcrum on which the publishers could demand an industry shift toward an agency model. Without the MFN, there would have been no horizontal conspiracy monitored and enforced by Apple.

Moreover, the court rejected Apple's argument that it did not have the same market dominance as Toys "R" Us and, thus, that its relationship with the publishers was not a *per se* violation of the Sherman Act under *TRU*. According to the court, "the fact that Apple was not a dominant player in the relevant market in no way diminishe[d] the instructive value" of cases like TRU. It said "[c]ourts have never found that the vertical actor must be a dominant purchaser or supplier in order to be considered" a ringmaster among conspirators. Instead, all that is required is proof that the vertical defendant "was aware of the purported scheme" and "the horizontal defendants agreed to it." The court found that both requirements were met in Apple's case. "[W]ith Apple's active encouragement and assistance, the [publishers] agreed to work together to eliminate retail price competition and raise e-book prices, and again with Apple's knowing and active participation, they brought their scheme to fruition." Consequently, the court concluded that DOJ had "shown not just by a preponderance of the evidence . . . but through compelling direct and circumstantial evidence" that Apple had engaged in "a *per se* violation of the Sherman Act."

After it ruled on liability, the court entered a final judgment which prohibited Apple from enforcing any retail price MFN in any agreement with the publishers relating to the sale of e-books. It further prohibited Apple from entering into any *other* agreements with any e-book publisher containing the MFN. In so doing, the court substantially adopted DOJ's definition of the MFN.

Even where the MFN is not explicitly mentioned, the other provisions of the judgment, including the requirement for internal and external antitrust compliance monitors and for a blanket prohibition on Apple's entering into agreements that impede a retailer to set prices, all hearken to the MFN. Each element of the final judgment is a direct result of the constraints Apple placed on the publishers through the MFN.

Conclusion

From the outset, the MFN was the core issue of the Apple e-books controversy; DOJ brought the MFN to the front and center in its initial complaint. But how it fit in the legal framework became more clear once the parties presented their evidence and submitted their briefs. Ultimately, the court accepted DOJ's argument, relying on the *TRU* decision, that Apple was at the center of a *per se* horizontal conspiracy among e-book publishers. In so doing, the court took the view that the MFN was not just a key facet of the Apple arrangement, but the "ringmaster's whip" that Apple used to ensure acceptance and compliance with its arrangement.