IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

UNITED STATES OF AMERICA Plaintiff, v. APPLE, INC., HACHETTE BOOK GROUP, INC., HARPERCOLLINS PUBLISHERS, L.L.C. VERLAGSGRUPPE GEORG VON HOLTZBRINK PUBLISHERS, LLC d/b/a MACMILLAN, THE PENGUIN GROUP, A DIVISION OF PEARSON PLC, PENGUIN GROUP (USA), INC. and SIMON & SCHUSTER, INC., Defendants.	)	Civil Action No.12-CV-2826 (DLC)

COMMENTS OF *AMICUS CURIAE* BOB KOHN

REGARDING PROPOSED FINAL JUDGMENT AS TO DEFENDANTS
THE PENGUIN GROUP, A DIVISION OF PEARSON PLC
AND PENGUIN GROUP (USA), INC.

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INTRODUCTION

These comments are respectfully submitted in opposition to several provisions of the proposed Final Judgment (hereinafter, "Macmillan Settlement")[1] between the United States (the "Government") and defendants Verlagsgruppe Georg Von Holtzbrink GmbH and Holtzbrink Publishers, LLC d/b/a/ Macmillan (collectively, "Macmillan").

This public interest determination boils down to whether the Court should accept as reasonable the Government's *conclusion* that the higher prices that allegedly ensued after the adoption of the agency contracts harmed consumers and the lower prices likely to ensue after entry of the proposed Final Judgment will benefit consumers. If it can be shown, *as a matter law*, that the lower prices sought by the proposed settlement harm consumers, the relevant market and the public generally, then Government's conclusions about the proposed settlement are unreasonable and the settlement cannot be in the public interest.

If the Defendants' agency agreements, by definition, eliminated price competition at the retail level, and if those agreements were intrinsically legal—as the Government has admitted and as the District Court has now held—then the e-book price adjustments that followed the adoption of the agency agreements were the result of the correction of a pre-existing market failure brought about by the undisputed, systematic below marginal cost pricing of such e-books by Amazon, **which the Government has now admitted Amazon was doing.**[2] By imposing restrictions upon agency pricing, the settlements in this proceeding reverse the adjustment of such e-book prices back up to their efficient equilibrium (i.e., Amazon's marginal cost) and

[1] Macmillan Settlement (Dkt#174-1)

[2] See Section II below. Thus, the comments herein are focused upon new facts and the applicability of several key rulings of the District Court in its Opinion & Order dated September 5, 2012 (Dkt# 113), which was issued *after* the previous submissions of *amicus curiae* in this matter regarding the Final Judgment as to Hachette, HarperCollins, and Simon & Schuster (the "Initial Final Judgment")—including Comments of Bob Kohn (ATC-0143, April 30, 2012), Proposed A*micus Curiae* Brief of Bob Kohn dated August 13, 2012 (Dkt#97-1), and *Amicus Curiae* Brief of Bob Kohn dated September 4, 2012 (Dkt#110).

therefore, as a matter of law, such restrictions have a negative impact upon the relevant market and the public generally.

Accordingly, it would be in the public interest for the Court to approve a revised settlement in a way that eliminates the restrictions upon Defendants' use of the agency model while maintaining the decree's remaining provisions to deter exchanges of competitive information and monitor compliance during an appropriate timeframe.[3] The proposed settlement between the United States and defendants The Penguin Group, A Division Of Pearson Plc. and Penguin Group (USA), Inc. ("Penguin") [4] and the Final Judgment[5] entered with respect to Hachette, HarperCollins, and Simon & Schuster should similarly be revised.

I. STANDARD OF REVIEW FOR TUNNEY ACT CASES IN THIS CIRCUIT

In its response to amicus curiae's comments to the proposed Penguin Settlement, the Government did not deny that the standard of review it proposed has not been followed by the Court of Appeals for the Second Circuit. The proper standard to be followed by the District Court is set forth in the Second Circuit decisions cited in this section.

Prior to entry of a proposed final judgment, the Tunney Act requires a court to determine that such entry is "in the public interest." 15 U.S.C. § 16(e)(1). Though the statute does not define that phrase, the Second Circuit has held that such words "take meaning from the purposes of the regulatory legislation." *United States v. American Cyanamid Co.*, 719 F.2d 558, 565 (2d Cir. 1984). More specifically, "the Court should look to the elements of that species of antitrust violation." *United States v. Int'l Bus. Machines Corp*., 163 F.3d 737, 742 (2d Cir. 1988).

The Government touched upon the alleged species of antitrust violation when it stated in

[3] The District Court has the power to do so under Second Circuit precedent cited in Section IV below.
[4] Penguin Settlement (Dkt#162-1)
[5] Initial Final Judgment (Dkt#119).

this action that, "Low prices, of course, are one of the principal goals of the antitrust law." Dkt#81 (Gov't Response) at 22 (citing, *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328, 340 (1990) (opinion by Justice Brennan). But, in citing *Atlantic Richfield*, the Government omitted Justice Brennan's crucial caveat, which Justice O'Conner specifically included when she quoted Justice Brennan: "Low prices benefit consumers regardless of how those prices are set, *and so long as they are above predatory levels, they do not threaten competition*." *Brook Group v. Brown and Williamson Tobacco Corp.*, 509 U.S. 209, 223 (1993) (opinion by Justice O'Conner quoting, *Atlantic Richfield* at 340) (emphasis added).

As noted, this case is *not* about limiting e-book price competition at the retail level through the adoption of the agency model. It's about *the rise in e-book prices after the switch to the agency model*. The operative terms of each of the settlements restricts the agency model such that e-book prices will be lowered for a period of time, at not only cost to the Publisher Defendants, but to competitors of Amazon, independent booksellers, authors of copyrighted works, and the public at large who will suffer from the misallocation of resources. It is in that context the Penguin Settlement is to be considered, and the Tunney Act directs courts to consider several factors, including "the impact of entry of such judgment upon competition in the relevant market or markets" and its impact "upon the public generally." 15 U.S.C. § 16(e)(1).

Though normally a court makes only the minimal determination of whether a settlement agreement is to be accorded the status of a judicially enforceable decree, the court has a "larger role" where the consent judgment resolves "antitrust suits brought by the United States." *Int'l Bus. Machines*, 163 F.3d 737, 740 (quoting *Janus Films v. Miller*, 801 F.2d 578, 582 (2d Cir. 1986)).

Some courts, including the District Court, have held that "the relevant inquiry is whether

the Government has established an ample 'factual foundation for the Government's decisions such that its conclusions regarding the proposed settlement are reasonable'." Dkt#113 at 14 (quoting *United States v. Keyspan*, 783 F.Supp.2 633, 637-38 (S.D.N.Y. 2011). Research by this writer has been unable to uncover a single decision by the Second Circuit Court of Appeals which adopts the *Keyspan* standard of review. The standard in this Circuit appears to be that which was established in *American Cyanamid* and *IBM*, cited above.

In any event, the argument below remains unaffected should the District Court again embrace the *Keyspan* formulation. Even under the *Keyspan* standard, the courts may "give due respect to the government's perception of its case" (*Keyspan* at 638) and may be "deferential to the government's predictions as to the effect of the proposed remedies" (*Microsoft*, 56 F.3d at 1461), but such respect is *not due*, and such deference is *not earned*, where the Government's *conclusions* regarding the settlement are unreasonable. *Keyspan* at 637-38.

In inquiring whether the Final Judgment is in the public interest, or whether Government's conclusions are reasonable, the courts need not engage, as the Government has suggested, in a "full-blown, lengthy and expensive trial." Dkt#81 (Gov't Response to Comments) at 44. On the contrary, the courts may inquire into the reasonableness of the Government's conclusions assuming all of the factual allegations regarding defendants' conduct in the Complaint, stripped of their bare conclusions (i.e., the subject of this inquiry under *Keyspan*), are true. To defer to both the Government's alleged facts as well as their conclusions would indeed make "a mockery of judicial power."

Amicus curiae is not suggesting that the Court "construct [its] own hypothetical case and then evaluate the decree against the case," or "redraft the complaint to inquire into other matters that the United States did not pursue" or "engage in an unrestricted evaluation of what relief

would best serve the public." Dkt#5 (Initial CIS) §VII (quoting *United States v. Microsoft Corp*., 56 F.3d 1448, 1459-62 (D.C. Cir. 1995); *Keyspan* at 638; *United States v. BNS, Inc*., 858 F.2d 456, 462 (9th Cir. 1988)). Nor is the Court being asked to "reach beyond the complaint to evaluate claims the government did not make." *Microsoft*, 56 F.3d at 1459.

On the contrary, in evaluating the reasonableness of the Government's *conclusions*, the District Court need simply assume all of the Government's *factual allegations* as true, and add to those allegations the Court's own *factual findings*. It is respectfully submitted that, when Reason is applied to the factual foundation, the District Court's only conclusion can be that elements of the Penguin Settlement that restrict the operation of the agency model, for however short a period, are not in the public interest.

II. THE SETTLEMENT'S RESTRICTIONS ON AGENCY PRICING IS NOT IN THE PUBLIC INTEREST

The Macmillan Settlement is not in the public interest because the restrictions it imposes on agency pricing unwinds the pro-competitive impacts of Defendants' conduct upon the relevant market and the favorable impacts of such conduct upon the public generally.

A. The Settlement's Restrictions on Agency Contracts Reverse the Benefits to the Public of Defendants' Agency Contracts

The Government has *concluded* that the restrictions on the agency contracts in the proposed settlement will *benefit* consumers. This public interest determination boils down to whether the Court should accept as reasonable the Government's *conclusion* that the higher prices that ensued after the adoption of the agency contracts were harmful and the lower prices the Government says are "likely" to ensue after entry of the proposed Final Judgment are beneficial to the relevant market and the public generally. If it can be shown, *as a matter law*, that such lower prices are harmful, the relevant market and the public generally, then

Government's conclusions about the proposed settlement are unreasonable and the settlement cannot be in the public interest.

It is self-evident that the purpose and effect of the agency agreements, *by definition,* was *to eliminate e-book price competition among e-retailers*. This is because, under the agency model, price competition for e-books occurs among the publishers, not the retailers. Indeed, the Government's admission that the elimination of price competition at the retail level is not unlawful is virtually codified in each of the settlements.[6] It should be clear, then, that this action was never about eliminating e-book price competition at the retail level. It was merely about the increase in e-book prices that ensued after the adoption of the agency contracts. But if those increase in prices were beneficial, then any decease in prices caused by the proposed settlement is harmful. **Even if the publishers had not colluded as the Government has alleged, the adoption of agency pricing would still have resulted in higher e-book prices, because the agency model forced Amazon to cease selling e-books at below their marginal cost**.

Until recently, the Government carefully avoided ever admitting that Amazon was selling trade e-books at below marginal cost. Until the Court's Opinion & Order regarding entry of the

[6] See, for example, Macmillan Settlement (Dkt#174-1) at §V.D. ("After the expiration of prohibitions in Sections V.A. and V.B of this Final Judgment, this Section V.D. shall not prohibit Penguin from unilaterally entering into or enforcing any agreement with an E-book Retailer that restricts, limits, or impedes the E-book Retailer from setting, altering, or reducing the Retail Price of any of Penguin's E-books or from offering price discounts or any other form of promotions to encourage consumers to Purchase any of Penguin's E-books"). Oddly, in support of its ruling that the Government met the "minimal" standard of review for the initial Final Judgment, the District Court found that it was "undisputed that the Agency Agreements disallowed retail price discounting" and that after the adoption of such agreements "a consumer could not find Publisher Defendants' newly-released and bestselling books for $9.99 at any retailer." Dkt#113 (Order) at 32-33. If the District Court was suggesting here that the agency agreements, by disallowing discounting, were somehow unlawful, then the District Court will need to explain how the agency agreements, which intrinsically eliminate price competition at the retail level, can be considered unlawful and "not intrinsically unlawful" at the same time. *Cf.* Dkt#113 (Order) at 17. If all the District Court was suggesting was that e-book prices rose above the $9.99 price, it has not explained how such price rises could have harmed consumers or were otherwise unlawful. If the Court is suggesting here that all price increases harm consumers or are necessarily unlawful, then it clearly adopted the Government's mistaken view of pricing under the antitrust law as its own.

Initial Final Judgment, it was thought to be undisputed that, under the retail model, Amazon was selling e-books made available by the defendant publishers and by most, if not all, independent book publishers, at below its marginal cost, consistently, "[f]rom the time of its Kindle launch" until Amazon's acceptance of the agency model. See, Dkt#5 CIS §II.A. Even the Government directly alleged facts in its Complaint and Competitive Impact Statement that Amazon was selling e-books at below their marginal cost, something which the Government has *never* denied.[7] Amazon's marginal cost, under the retail model, was at least equal to the fixed wholesale price (e.g., $13.00, which is 50% of a typical list price of $26.00) it pays to the publishers for each *incremental* e-book it sells.[8] Dkt#5 (CIS) §II.A. These books were re-sold by Amazon for "$9.99-or-less." Id.; Dkt#1 (Complaint) at ¶30. Thus, for example, at a marginal cost per e-book of $13.00, Amazon was selling such e-books at $3.01 (more than 23%) below its marginal cost.

The Government stated it "reviewed data from Amazon and others" to investigate Amazon's e-book distribution business. Dkt#81 (Gov't Response) at 21. By the end of its investigation, the Government concluded that Amazon was not engaging in predatory pricing. Id. Dkt#1 (Complaint) ¶30. **It is noteworthy, however, that in reaching such *conclusion*, the Government *never* alleged or asserted that Amazon was *not* selling below marginal cost**. The Government merely asserted that no objector supplied evidence that "Amazon threatens to drive out competition and obtain monopoly power." Dkt#81 at 22. Needless to say, that is not the same as saying Amazon did not re-sell e-books below its marginal cost—a necessary element of

[7] It may well be that the District Court was mislead by certain carefully crafted statements about Amazon's pricing policies set forth in the Government's Complaint and Response to Public Comments dated August 3, 2012, discussed below.

[8] Amazon has additional marginal costs, such as the cost of wirelessly delivering each incremental e-book to a *Kindle* e-reader, which is estimated to cost nearly 15 cents per e-book delivery. See, *Kindle Direct Publishing Agreement, Pricing Page* (as of July 28, 2012).

predatory pricing.

Being unable to deny facts which it provided in its Complaint and CIS, and then without ever categorically denying that Amazon was selling e-books at below marginal cost, the Government jumped to its peculiar conclusion: based on its investigation and review of data from Amazon and others, "Amazon's e-book distribution business has been consistently profitable." Dkt#1 ¶30; repeated in Dkt#81 (Gov't Response) at 4, 21-22).

Implicit in that conclusion was the legal standard which the Government applied to its review of data. The Government provides no citation for the proposition that the standard for predatory pricing under Section 2 of the Sherman Act (15 U.S.C. §2) is whether the predator's business "has been consistently profitable."

In *Brook Group v. Brown and Williamson Tobacco Corp.*, 509 U.S. 209, 222-24 (1993), the Supreme Court set forth two elements for an action for predatory pricing. The first is to establish that prices were set at "below an appropriate measure of its rival's costs." Interpreting its prior holdings, the Court stated, "below-cost prices should suffice." Id at 223. This was consistent with the standard previously adopted by the Second Circuit. *Northeastern Telephone Co. v. American Tel. & Tel. Co.*, 651 F.2d 76, 86-89 (2d. Cir. 1981), cert. denied, 455 U.S. 943 (1982) ("The relationship between a firm's prices and its marginal costs provides the best single determinate of predatory pricing"). Marginal cost is traditionally defined as "the increment to total cost that results from producing an additional increment of output." *Northeastern* at 87 (quoting Areeda & Turner).

This prerequisite is clearly satisfied by the Government's own factual allegations. By selling e-books for "$9.99-or-less" that it purchased at higher amounts Amazon was selling such e-books at below their marginal cost. Unless the price cutter can show that its low price is purely

"'promotional,' *e.g.*, a 'free sample'," or "show that it expects costs to fall when sales increase," then "the firm cannot rationally plan to maintain the low price." *Barry Wright Corp. v. ITT Grinnell Corp.,* 724 F.2d 227, 230-34 (1st Cir. 1983) (opinion by Circuit Judge Breyer).

Amazon's practice of below marginal cost pricing was no Macy's "promotion." These were not "free samples" or "loss leaders." Amazon's below-cost pricing was consistently applied to newly-released and bestselling trade e-book made available by the Defendant Publishers and by most, if not all, independent book publishers, from the time of its Kindle launch until Amazon's acceptance of the agency model. Dkt#5 §II.A. "Without special circumstances there is little to be said in economic or competitive terms for such a price cut." *Barry Wright,* 724 F.2d 227, 231. The Government has supplied neither the public nor the District Court with any evidence of special circumstances to justify Amazon's below marginal cost pricing.[9]

Nor can Amazon expect its marginal cost for e-books to decrease with volume. Amazon's marginal cost for selling each *incremental* e-book having a list price of $26.00 will always remain $13.00, whether Amazon sells one copy or one million copies. "At a minimum, one would wonder why this firm would cut prices on 'incremental production' below its 'avoidable' costs unless it later expected to raise its prices and recoup its losses." *Barry Wright,* 724 F.2d 227, 232.

At first, the District Court seemed to embrace the Government's odd conclusion that "Amazon's e-book business was 'consistently profitable'." Dkt#113 (Order) at 39. But then, it went on to elucidate the law of predatory pricing correctly, only to *overlook* the Government's own factual allegations supporting Amazon's below cost pricing and the apparent care the Government took never to deny it.

[9] If the Government has materials or documents that would shed light on this key issue—containing a "smoking gun" or its "exculpatory opposite"—it is bound by the Tunney Act to share it with the public and the District Court. See discussion below in Section II.E.

For example, this is how the Government defended Amazon against the charges by hundreds of commentators of below cost pricing:

> No objector to the proposed Final Judgment has supplied *evidence* that, in the dynamic and evolving e-book industry, Amazon threatens *to drive out competition and obtain the monopoly pricing power* which is the ultimate concern of predatory pricing law. [Dkt#81 (Gov't Response) at 22 (emphasis added)].

While addressing the *ultimate* concern of predatory pricing law, the Government left out the law's *immediate* concern, the first prong of the test under *Brook Group* and *Northeastern*: whether Amazon was selling at below marginal cost. The Government *never denied* this, because the "evidence" of Amazon's selling below marginal cost was not only obvious and abundant, it was factually supported in the Government's own Complaint and CIS.

Yet, when the District Court addressed the issue of below marginal cost pricing, it stated,

> [W]hile comments complain that Amazon's $9.99 price for newly-re-leased and bestselling e-books was 'predatory,' none of them attempts to show that Amazon's e-book prices as a whole were below marginal cost. [Dkt#113 at 39].[10]

Of course, none of public commentators attempted to "show" it, because none of them had to. It was *undisputed*. As the Government observed, Amazon's below-cost pricing was the "overarching theme" of the public comments. Dkt#81 at 2. Facts supporting it were directly alleged in the Government's own Complaint and Competitive Impact Statement and the Government has never since denied that Amazon was selling e-books at below marginal cost.

[10] At a procedural level, what the District Court has done here is suggest that it was not the Government's, but the public's responsibility somehow "to show" that Amazon was selling below marginal cost. Where in the Tunney Act does the public have the right to conduct discovery on Amazon's marginal costs? (How else could they have learned this information?) Needless to say, nowhere. On the contrary, the Tunney Act specifically puts the burden of producing such facts upon the Government, requiring that "materials and documents that were considered determinative" in formulating the settlement shall "be made available to the public at the district court." 15 U.S.C. § 16(b). The District Court has simply turned the Government's statutory responsibility to the public on its head: instead of the Government, the public is now somehow responsible for filing with the District Court materials and documents that could be the "smoking gun" (or exculpatory opposite) of Amazon's below marginal cost pricing. See, discussion in Section III below regarding *United States v. Bleznak*, 153 F.3d 16 (2d Cir. 1998). The District Court should either require the Government to produce its documents relating to its investigation of Amazon's trade e-book pricing or appoint a special master under the Tunney Act, Section 16(f), to conduct discovery directly on Amazon to achieve that end.

Indeed, the express terms of each of the proposed settlements—which allow each Publisher Defendant to prevent Amazon from selling the publisher's "entire catalogue at a sustained loss"—is an express admission by the Government that Amazon was selling below marginal cost. See, for example, Competitive Impact Statement as to Macmillan (Dkt#175) at 8; Macmillan Settlement (Dkt#174-1) at Section VI.B.

Finally, to cap it off, **the Government has now finally conceded that Amazon's e-book prices as a whole were below marginal cost**. Specifically, in its Response to Public Comments on the Penguin Settlement, the Government asserted that the degree to which Amazon may discount under the settlement is limited to the "the level of [the e-retailer's] aggregate commission." Government Response to Penguin Settlement at 12. Thus, **according to the Government, the settlement permits Amazon to resume selling e-books at below marginal cost, albeit at prices "closer to their marginal cost" than before**. Id. at 12-13.[11]

In its criticism of the public's failure to come forth with sufficient facts regarding Amazon's below marginal cost pricing, the District Court seemed careful to use the phrase "as a whole," somehow suggesting that it has to be shown that Amazon was offering their e-books "as a whole" below marginal cost. Even if the District Court was meaning to suggest that such a showing is an essential element of an action against for predatory pricing, it is beside the point: to judge the reasonableness of the Government's *conclusions* regarding the proposed settlements, it need not be proven that that Amazon would actually be liable in an action for predatory pricing in order to show that the rise in e-book prices that occurred after the switch to the agency model could not have harmed to consumers. That is, **it cannot logically be denied that such increase in e-book prices constituted a correction of the market failure that Amazon created with respect to the huge number of e-books it systematically, and undisputedly, sold below its**

[11] How the Government could construe this as "a goal Mr. Kohn applauds" is baffling.

marginal cost. To the extent the Court believes it must be shown that Amazon's below-cost pricing of e-books had to be offered "as a whole" below marginal cost, the Court can now turn to the Government's admission of that fact—i.e., that Amazon is now selling e-books below, though "closer to" their marginal cost.

In a footnote in its Response to the Penguin Settlement (note 6 at 13), the Government notes *Northeastern* found only that prices below marginal costs will be "presumed predatory" (citing 651 F.2d 76, 78 (2d Cir. 1981). And added, "To succeed on a predatory pricing claim, an antitrust plaintiff must also establish that there is a 'dangerous probability' that the defendant will later 'recoup[] its investment in below-cost prices.' Brook Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 224 (1993)." The Government should have kept reading; Kohn's comments to the Penguin Settlement goes on to say:

The second prerequisite for predatory pricing is a demonstration that the predator has a "dangerous probability[] of recouping its investment in below-cost pricing." *Brook Group*, 509 U.S. 209, 224. In order to recoup their losses, the predator "must obtain enough market power to set higher than competitive prices." Id. at 225. **This prerequisite was satisfied by the District Court's *factual finding* that Amazon achieved a "90 percent monopoly" of the e-book market.** Dkt#113 34-35. The existence of the requisite market power ordinarily may be inferred from the predominant share of the market. See, *United States v. Grinnell Corp*., 384 U.S. 563, 571 (1966) (in which 87% of the market constituted "monopoly power").

Moreover, in the Second Circuit, once the first prerequisite is demonstrated, the second is *presumed*. With such a presumption in hand, the Government should not have been expecting members of the public to produce "evidence" of Amazon's threat to drive out competition (Dkt#81 at 22), but disclosing to the District Court exculpatory facts that would overcome that

presumption. **Without the presence of facts to overcome the presumption, conduct that resulted in raising illegally-low (consumer welfare-harming) prices back up to the consumer welfare-optimizing level of marginal cost could not have, as a matter of law, harmed consumers.**

The Government now having conceded that Amazon's e-book prices as a whole were below marginal cost, the settlements cannot be in the public interest, because any increase in e-book prices back up to the level of Amazon's marginal cost, could not have harmed consumers. On the contrary, the alleged increase in prices could only have benefited consumers, because selling below marginal cost, as recognized by the Second Circuit in *Northeastern* discussed below, causes a misallocation of resources. Thus, with lower prices not only being the stated intent of the proposed settlements, but the only logical result of them, the Government's conclusions about the settlements, even under the *Keyspan* standard, could not have been reasonable—in which case, the settlements cannot be held to be in the public interest. Moreover, to this point, it doesn't matter whether the alleged collusive conduct was unjustifiable. Higher prices resulting from the settlements, because they have a harmful impact upon the relevant market and the public generally, cannot be in the public interest.

B. Restrictions on Agency Pricing Have a Harmful Impact Upon the Relevant Market

The Macmillan Settlement reverses at least two undisputed pro-competitive impacts upon the relevant market: reducing Amazon's monopoly power and monopsony power. Meanwhile, the settlement's only alleged pro-competitive impact has been found by the District Court not to exist.

1. Impact Upon Amazon's Monopoly Power

As noted, the District Court found that it is "undisputed" that Amazon had achieved a "90

percent monopoly" in the e-book market and that, following the course of defendants' conduct as alleged in the Complaint, Amazon's market share in trade e-books dropped from an undisputed 90% to 60%. Dkt#113 at 34-34. The restrictions placed on the Defendants' use of agency pricing set forth in the settlements unwind the pro-competitive effects which the District Court found to be undisputed.

2. Impact Upon Amazon's Monopsony Power

The Complaint itself alleges ample facts to demonstrate that defendant publishers faced in Amazon a single buyer generating 90% of their e-book revenues who both wielded and exercised demonstrable monopsony power. Dkt#1 (Complaint) at ¶80.[12] It has been said that a monopsony is the "mirror image" of monopoly. *Todd v. Exxon Corp.*, 275 F.3d191, 202 (2d Cir. 2001). Under the textbook economic definition, the monopsonist, in depressing the price of the goods purchased, transfers wealth to itself from the supplier of the goods. According to the Government's own Merger Guidelines, the monopsonist will *not* pass along the lower price input to its downstream consumers. Horizontal Merger Guidelines of 2010 at §12.[13] And, as discussed infra, the use of monopsony power to reduce the price paid to publishers and authors for e-book distribution rights is antithetical to the exercise of the rights of copyright owners, whose pricing is already significantly constrained by the free-rider/piracy problem.[14]

When Amazon's 90% monopoly of the e-book market dropped to 60%, Amazon's

[12] Amazon's exercise of this power against Macmillan was not the first time. Doreen Carvajal, "Small Publishers Feel Power of Amazon's Buy Button," *New York Times* (June 16, 2008). See, Comments of Author's Guild (ATC-0214 at 3, 5-6. http://www.justice.gov/atr/cases/apple/comments/atc-0214.pdf.

[13] U.S. Dept. of Justice and Federal Trade Commission, *Horizontal Merger Guidelines* (August, 19, 2010) http://www.justice.gov/atr/public/guidelines/hmg-2010.pdf

[14] *Moor-Law* 527 F.Supp. 758, 763, discussed *infra*. See also, John Cirace, *CBS v. ASCAP: An Economic Analysis of a Political Problem*, 47 Fordham L. Rev. 277, 293-94 (1978-79) (the collusive conduct by music publishers in *Broadcast Music* was justified, not by reduced transaction costs, but by the need to balance the monopsony power of the three TV network buyers of musical performances), discussed in Proposed *Amicus Curiae* Brief of Bob Kohn (Dkt#97-1) at 12-14.

monopsony power dropped correspondingly. Neither the Government nor the District Court disputed the fact that this pro-competitive drop in Amazon's monopoly and monopsony power were directly attributed to Defendants' switch to the agency model.

3. Alleged Pro-Competitive Impact Upon the Relevant Market Never Existed

Initially, in its CIS, the Government concluded that the agency price restrictions in the Final Judgment would have pro-competitive impact upon the relevant market, because the termination of defendants' agency contracts would reverse the elimination of e-book price competition among e-retailers. Dkt#5 §III.A.1. But the District Court has since ruled that this alleged pro-competitive impact never existed. Since the District Court found (Dkt#113 at 33), as the Government recognized (Dkt#81 at vi), that Defendants' agency contracts were not "intrinsically unlawful," the effect of the agency contracts—the replacement of e-book price competition at the retail level with e-book price competition at the publisher level—was not "intrinsically" anticompetitive.

The worst that could be said about the shift to the agency model was that it had a neutral impact upon the e-book market. Thus, since the objective of the Penguin Settlement is to return e-book price competition to e-retailers (Dkt#5 III.A.1), such objective is not pro-competitive at all.[15]

[15] Subsequent to entry of the initial Final Judgment, two of the world largest trade book publishers announced their intention to merge. Eric Pfannner & Any Chozick, "Random House and Penguin Merger Creates Global Giant," *New York Times* (October 29, 2012) ("The deal, analysts said, would give the new company, to be called Penguin Random House, greater scale to deal with the challenges arising from the growth of electronic books and the power of Internet retailers…companies [who have] the size to let them negotiate better terms on prices." Given the impact of the Final Judgment upon the relevant market, the proposed merger would appear, not unlike the alleged collusive switch to the agency model, to be a pro-competitive response to Amazon's monopsony power. See, Cirace, *supra*. Apparently, the Justice Department would not disagree, as it has announced that it will not raise an anti-trust objection to the

C. Restrictions on Agency Pricing Have a Harmful Impact Upon the Public Generally

Defendants' conduct, as alleged, had undisputed positive impacts upon the public generally that would be unraveled by the Penguin Settlement.

1. Harms the Public Interest in Promoting the Creation of Works of Authorship

One of the essential the considerations in promoting the public interest underlying *copyright* and *antitrust* is the distinctive nature of the products at issue—copyrightable works of authorship delivered and consumed in *digital* form.

Recognizing the "tax"[16] that the copyright imposes upon consumers required to achieve its important public purpose, the Department of Justice and the Federal Trade Commission jointly devised a specific policy to be applied when enforcing the antitrust laws in cases involving copyrights and other forms of intellectual property. The antitrust enforcement policy of the United States with respect to copyrighted works, such as e-books, is stated in the *Antitrust Licensing Guidelines for the Licensing of Intellectual Property* (April 6, 1995) ("IP Guidelines").[17] The IP Guidelines recognize that intellectual property has important characteristics that distinguish it from other forms of property. IP Guidelines §2.1. Antitrust analysis must take these differences into account in evaluating specific market circumstances in which transactions regarding them occur. Id.

E-books, like music performances and downloads, have the classic characteristics of what

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merger. Leslie Kaufman, "Justice Department Approves Random House-Penguin Merger," *New York Times* (February 14, 2013).

[16] Though it results in "a tax on readers for the purpose of giving a bounty to writers" (*Golan v. Holder*, 132 S.Ct. 873, 899 (2012) (opinion by Justice Ginsburg, quoting T. Macaulay, *Speeches on Copyright* 25 (E. Miller ed. 1913), copyright remains an essential means by which "an important public purpose may be achieved." *Sony Corp. of America v. Universal Studios, Inc.*, 464 U.S. 417, 429 (1984).

[17] http://www.justice.gov/atr/public/guidelines/0558.pdf.

are known as, "public goods." See, *Broadcast Music, Inc. v. Moor-Law, Inc*., 527 F.Supp. 758 (D. Del. 1981), *aff'd without published opinion*, 691 F.2d 490 (3d Cir. 1982). First, unlike private goods (e.g., apples or printed books), which can be withheld from the market and released only in exchange for payment, an e-book can be consumed without leaving any less for others to consume. See, *Moor-Law* at 763. Second, the digital nature of e-books facilitates the reproduction of perfect copies at virtually no cost, making it difficult for the copyright owner to exclude persons who do not pay for consuming the e-book—a problem known as the free rider problem,[18] misappropriation,[19] infringement,[20] illegal file sharing,[21] or piracy.

For these reasons, courts have recognized that "the natural market forces of supply and demand do not operate normally on pricing in this market." *Moor-Law* at 763. This is because the cost of acquiring a copy of and consuming an additional *printed book* costs the consumer something. By contrast, because of the free rider or piracy problem, the marginal cost of acquiring and consuming an additional *e-book* can be as low as zero. *Moor-Law* at 763.

The public good characteristics of e-books make normal cost-based pricing infeasible. Id. For example, the price that a publisher can charge for an e-book is subject to a natural constraint: illegal competitors charging zero for the same e-book. In *Moor-Law,* the District Court found, as an observed fact, that "the free rider problem does provide a significant constraint on the price [the copyright owner] charges." Id. The free rider problem tends to make the copyright owner's enforcement costs high. Because higher enforcement costs can more than consume increased revenue from a higher price, the copyright owner considers this problem when setting a price. Id.

Thus, there is an inherent limit to how much "tax" may be exacted from consumers by

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[18] Id.
[19] IP Guidelines §1.0.
[20] *Copyright Act*, 17 U.S.C. §501(a).
[21] *A&M Records, Inc. v. Napster, Inc.*, 239 F.3d 1004, 1011 (9th Cir. 2001).

book publishers for e-books, because they must compete with free riders who can readily take advantage of the e-books' digital form to cheaply trade in pirated copies without payment.

Amazon has repeatedly used its monopsony power in attempts to lower its cost for books. In January, 2008, Amazon removed the buy buttons from more than 1,000 self-published printed books and threatened that these books would be permanently removed from the Amazon website unless the books were published via Amazon's own BookSurge print-on-demand service. See, Comments of Authors Guild (ATC-0214) at 4. That 2008 incident was a precursor to what Amazon did to Macmillan on Friday, January 29, 2010. Dkt#1 ¶80. Had Amazon succeeded in putting Macmillan out of business, there would have been one less major publisher competing to acquire publishing rights from authors—resulting in authors being paid less for publication rights to their e-book manuscripts.

The use of monopsony power to reduce the price paid to publishers and authors for e-books is antithetical to the exercise of the rights of copyright owners, whose pricing is already significantly constrained by the free-rider/piracy problem. *Moor-Law* at 763. At the same time, there is no corresponding benefit to consumers. According to the Government's own Merger Guidelines, the monopsonist will *not* pass along the lower price input to its downstream consumers. Horizontal Merger Guidelines of 2010 at §12.

These critical distinctions between e-books and printed books should have been part of the factual foundation underlying the Government's decisions in this case. Yet, no mention of these distinctions, nor mention of the IP Guidelines, can be found in any of the Government's filings in this action or the District Court's Entry Order. Dkt#113. By failing to take them into account, the Government's conclusions regarding the Penguin Settlement were not reasonable. By restricting the freedom of authors and publishers to control the price of their works to the

public, in way that actually harms competition in the relevant market and the public generally, the proposed settlement unjustifiably interferes with the essential means by which the U.S. Constitution provides them for the purpose of promoting the important public interest in the creation of Writings.[22]

2. Harms the Public Interest in Efficient Prices for E-Books

In its response to amicus curiae's comments to the proposed Penguin Settlement (at 12), the Government made a startling admission: the discounting the settlements require publishers to allow is limited to "the level of [the e-retailer's] aggregate commission" and thus, an e-retailer "will be selling e-books closer to their marginal cost."

Hence, the agency model, which is intrinsically lawful, which put an end to *below* marginal cost pricing, returned e-book prices to their economically efficient level for consumers; the settlement, in allowing e-retailers to resume selling e-books at prices that are *below* (though "closer to") their marginal cost, partially *reverses* the market-correcting adjustment in prices following the agency contracts. Reversing such price adjustments, even partially (by virtue of the aggregate limitation), causes an economically inefficient result that harms consumers and the public generally.

While the public has a Constitutionally-recognized interest in the promotion of works of authorship, it does not have any interest in low prices. See, Dkt#81 at 21-22 (where the Government expresses its mistaken belief that "low prices" are a "core ambition" of free markets). *Low prices* are <u>not</u> the core ambition of either the law or the markets. *Efficient prices* are. As the Second Circuit has held, consumer welfare is not maximized by "low" pricing, but by

[22] *U.S. Constitution*, Article I, §8; *Copyright Act*, 17 U.S.C. §101 *et.seq.; Sony Corp.,* 464 U.S. 417, 429 (1984).

"marginal cost" pricing. *Northeastern* 651 F.2d at 87-88.

By seemingly borrowing the Government's mistaken primacy of "low prices," the District Court was lead, for example, to reject the legitimate concerns expressed by "bricks & mortar" retailers. Retailers of printed books are not seeking protection from "the working of the market" or the "vicissitudes" of competition. Dkt#113 at 23-24. The digital disintermediation of printed book retailers may well be inevitable, but Amazon's below marginal cost pricing does not constitute a "working of the market" or "competition on the merits." As Areeda & Turner (at 712) explain, selling below marginal cost leads to an improper allocation of resources and "greatly increases the probability that rivalry will be extinguished or prevented for reasons unrelated to the efficiency of the monopolist." See, *Northeastern,* 651 F.2d at 87-88.

By allowing a predatory-induced market failure to resume for another two years, the Penguin Settlement will cause the natural disintermediation of physical bookstores to occur *faster* than they would in a competitive market, putting at risk the businesses of physical retailers, large and small, perhaps years before the digital evolution of the book industry would otherwise disintermediate them. The immediate beneficiary of this *accelerated* digital disintermediation is the predator itself, Amazon. This is precisely the kind of misallocation of resources that predatory pricing causes and why the Second Circuit makes it *presumptively* illegal. It invokes the very essence of the Second Circuit's declaration that the purpose of antitrust law is "not to protect businesses from the working of the market," but "to protect the public from the *failure of the market*." *United States v. Int'l Bus. Machines*, 163 F.3d 737, 741-42 (2d Cir. 1998) (emphasis added).

III. THE GOVERNMENT HAS FAILED TO COMPLY WITH THE TUNNEY ACT BY NOT DISCLOSING DOCUMENTS THAT WERE DETERMINATIVE

In its response to amicus curiae's comments to the proposed Penguin Settlement (at 13), the Government responded that the Court has already determined the materials supplied by the Government provided an "ample factual foundation for [its] decisions regarding the proposed Final Judgment." Opinion & Order, Dkt# 113 at 12-13. The question of whether determinative materials and documents must be disclosed does not turn on whether the Government has provided an "ample factual foundation," but whether under 9th Circuit law the Government made available "documents that are either 'smoking guns' or the exculpatory opposite." *United States v. Bleznak*, 153 F.3d 16, 20 (2d Cir. 1998). Particularly in light of the Government's admission that the settlement permits Amazon to sell e-books as a whole below their marginal costs, **the Court should require the Government to disclose to the public by filing with this Court its materials and documents that were determinative on the issue of whether Amazon's e-book business was "consistently profitable."**

As noted above, this amicus believes that either the Court has been mislead about the Government's investigation regarding Amazon's pricing practices or the Court was simply wrong to have put the burden on the public to "show that Amazon's e-book prices as a whole were below its marginal costs." Id at 40. Otherwise, members of the public deserve an explanation from the Court as to how they were expected to accomplish such a task (1) without the Court exercising the powers it has at its disposal under 15 U.S.C.16(f)(1-3) or (2) without being able to review the Government's documents and materials that could constitute a "smoking gun" or its "exculpatory opposite" on the issue of whether "Amazon's e-book prices as a whole were below its marginal costs."

Compliance with the procedural requirements of the Tunney Act ensures the district court

has before it the information it needs in order to make an informed determination whether the decree is in the public interest. *Massachusetts v. Microsoft*, 373 F.3d 1199, 1246 (D.C. Cir. 2004). Accordingly, the Act requires that the Government make available *to the public at the district court* "any other materials and documents which the United States considered *determinative* in formulating" the proposed decree. 15 U.S.C. §16(b) [emphasis added]. Such requirement is confined "to documents that are either 'smoking guns' or the exculpatory opposite." *United States v. Bleznak*, 153 F.3d 16, 20 (2d Cir. 1998).

In its CIS, the Government asserted that it considered "no determinative materials or documents" in formulating the settlement. Dkt#163§VIII. Given, however, that selling below marginal cost is *presumed* illegal in this Circuit, it is not up to objectors to supply "evidence" to the Government of Amazon's threat "to drive out competition." That threat was presumed when the Government alleged facts that Amazon was pricing below marginal cost. Dkt# ¶¶2, 30; Dkt#5 §II.A; Dkt#163 §II.A. Thus, the burden was not on the public, but rather on the Government to overcome that presumption with facts supporting their conclusion that Amazon's below marginal cost pricing was *not* exclusionary.

Accordingly, materials or documents supporting the Government's conclusion that Amazon's e-book business was "consistently profitable" would clearly constitute "either 'smoking guns' or the exculpatory opposite." *Bleznak*, 153 F.3d 16, 20. This is because, to the extent Amazon was pricing e-books at below its marginal cost, any conduct by defendants to raise prices back to the marginal level could not have harmed consumers. Since the alleged *harm to consumers* constituted a "substantial inducement to the government to enter into the consent decree" (*Bleznak* at 21) such materials and documents were not merely relevant, but *determinative*. By failing to disclose them to the public, it is not in compliance with the Tunney

Act and, because they go "to the essence of" the Government's conclusions regarding the Penguin Settlement, entry of such settlement must be denied unless and until such determinative documents are disclosed. See, *United States v. Bechtel Corp*., 648 F.2 660, 664 (9th Cir. 1981).

IV. THE COURT SHOULD APPROVE A REVISED PENGUIN SETTLEMENT

By entering the Initial Final Judgment in this case, the District Court has made a regrettable error that—by virtue of the restrictions on the agency pricing—has saddled consumers with an unnecessary misallocation of resources in the trade e-book market—lasting the next two years, perhaps longer. The Court should not compound its mistake by entering either the proposed Macmillan Settlement or proposed Penguin Settlement—at least not without modification.[23] Only by modifying all of the settlements in this case to remove their respective restrictions on the Defendant's agency agreements will the settlements align with the public interest.

Accordingly, it is submitted that a settlement that contains only the following provisions is in the public interest: Sections I, II, III, V (E and F only), VI (A only), VII, VIII, IX, X, XI, and XII. The intention is to eliminate all of the restrictions on agency pricing, which would otherwise have the effect of unwinding the pro-competitive and impacts upon the relevant market and favorable impacts upon the public generally of Defendants' conduct. At the same time, the balance of the settlement would ensure that any future competitive information exchanges between or among the Defendants will be enjoined and monitored for compliance over an appropriate timeframe.

The Government cites no Second Circuit authority for the proposition that the District

[23] The public interest does not require that the proposed Penguin Settlement be rejected in its entirety. The District Court is urged to enter a revised Penguin Settlement comprised only of provisions that do not unravel the pro-competitive effects that Defendants' conduct had upon the relevant market and the public generally.

Court's authority under the Tunney Act is limited to merely approving or disapproving a consent decree. Indeed, the Second Circuit, in *de novo* review of a District Court's decision, has held that itself may vacate a consent decree in part and "remand the case to the District Court for entry of a revised decree consistent with [its] opinion." *Guardians Assoc. New York Police Dept., Inc. v. Civil Service Comm'n of the City of New York*, 630 F.2d 79, 113 (2d Cir. 1980). **In its Response to Comments on the Penguin Settlement, the Government did not deny that this Court, under *Guardians*, has the authority to revise a consent decree.**

CONCLUSION

In the Second Circuit, the courts have a "larger role" where a consent judgment resolves "antitrust suits by the United States." *United States v. Int'l Bus. Machines Corp.*, 163 F.3d 737, 742 (2d Cir. 1988). The disinfectant of the Court's public interest determination under the Tunney Act need not be a placebo. *Cf.*, *Broadcast Music, Inc. v.DMX, Inc.*, 683 F.3d 32, 49 (2d Cir. 2012). The Court is urged to set aside the "rubber stamp" which the Government submitted in the form of its proposed standard of review and approve the proposed Penguin Settlement to the extent it is revised to eliminate all restrictions upon the use of agency pricing.

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