

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

THE STATE OF TEXAS, <i>et al.</i>,)	
)	No. 12-cv-3394(DLC)
)	
Plaintiffs,)	
)	
v.)	
)	
PENGUIN GROUP (USA), INC., <i>et al.</i>,)	
)	
Defendants.)	
)	
)	

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PRELIMINARY STATEMENT

Plaintiff States (“The States”) and the United States have filed a joint memorandum of law which sets forth in detail the law applicable to the States’ claims against Apple and Penguin and many of the facts bearing on the alleged conspiracy’s existence and Defendants’ liability (“Joint Brief”). Plaintiff States respectfully submit this Supplemental Memorandum of Law addressing certain aspects of their claims against Penguin, as well as issues relevant to their state law claims against both Defendants.¹

The case against Penguin is straightforward: Penguin agreed with four of its five principal competitors – Hachette, HarperCollins, Macmillan, and Simon & Schuster (collectively with Penguin, the “Conspiring Publishers”) – to raise the price consumers paid for trade e-books. No later than the summer of 2009, the Conspiring Publishers agreed that they needed to act collectively to achieve this shared goal. During December 2009 and January 2010, Apple facilitated an agreement among the Conspiring Publishers to raise trade e-book prices by adopting the Agency Model across all of their distribution outlets.² The conspiracy eliminated trade e-book retail price competition and the Conspiring Publishers and Apple shared the conspiracy’s spoils: the Publishers received the higher retail prices they had been trying unsuccessfully to introduce to the market before Apple’s arrival and Apple was able to enter the market without having to compete with Amazon on e-book prices. Apple would also earn its desired 30 percent gross margin on trade e-book sales. The conspiracy succeeded and, beginning the week of April 1, 2010, consumers began paying more for e-books sold by the Conspiring

¹ To the extent possible, the States have avoided duplication of material in the Joint Brief.

² The States view the conduct underlying Counts I and III of their Complaint as a single conspiracy and the States do not allege a separate anticompetitive effect from Counts I and III. The distinction between the counts serves to emphasize Penguin and the Publishers’ agreement on the need for collective action to raise e-book prices and search for a means to do so prior to Apple’s involvement. Accordingly, the States do not object if the Court construes them as a single count (as alleged in the DOJ Complaint). If the Court proceeds in this manner, the States respectfully request that the Court find Penguin joined the conspiracy alleged no later than July 29, 2009.

Publishers.³

Defendants' conduct violated Section 1 of the Sherman Act, 15 U.S.C. § 1, and various state laws. As such, the Court should hold Defendants liable for these violations, and enter an injunction to remedy the effects of the violation and ensure that Defendants do not similarly violate the law going forward.⁴

ARGUMENT

I. Penguin's Agreement with its Competitors to Raise Prices Constitutes a *Per Se* Violation of Section 1.

Plaintiff States must establish three elements to prevail in their *per se* case against Penguin. First, the States must demonstrate Penguin and the other Conspiring Publishers are horizontal competitors. *See, e.g., Catalano, Inc. v. Target Sales, Inc.*, 446 U.S. 643, 646-47 (1980) (a horizontal agreement to fix prices is an archetypal example of practices that are conclusively presumed illegal without further examination under the rule of reason); *Starr v. Sony BMG Music Entm't*, 592 F.3d 314, 326 n.4 (2d Cir. 2010) (citations omitted). Second, the States must establish that Penguin and the other Conspiring Publishers entered into an agreement. *See id.*; *see also Standard Oil Co. v. United States*, 221 U.S. 1, 58 (1911). Finally, the States must prove that the purpose or predictable effect of the agreement was to set, raise, or stabilize prices. *See Arizona v. Maricopa County Medical Society*, 457 U.S. 332, 349 (1982).

A. Penguin Competes With The Other Conspiring Publishers.

Penguin cannot seriously dispute that the other Conspiring Publishers are its competitors.⁵

³ The conspiracy resulted in the Conspiring Publishers' backlist prices rising as well. Ashenfelter Direct ¶ 47 (considered together, frontlist and backlist prices rose); Burtis Report ¶53 and Table 9 (PX-0831).

⁴ Should the Court find Apple and Penguin liable, issues related to civil penalties and damages on behalf of the States' respective consumers will be tried separately.

⁵ *See* Penguin's Objections and Responses to the Plaintiff States' First Set of Interrogatories, Response 7, at p. 12 (PX-806); *see also* John Makinson Dep. (Mar. 15, 2013) at 101:22-102:19 ("Penguin competes [with other

B. Penguin Entered Into An Agreement To Raise E-book Retail Prices With The Other Conspiring Publishers and Apple.⁶

To establish that Penguin and the other Conspiring Publishers entered into a horizontal agreement, facilitated by Apple, the States must show that these companies shared “a conscious commitment to a common scheme designed to achieve an unlawful objective.” *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 764 (1984). Because the purpose or predictable effect of the agreement was to allow Penguin and the other Conspiring Publishers to set, raise, or stabilize prices, the conspiracy deserves condemnation as *per se* illegal. *See, e.g., Maricopa County*, 457 U.S. at 349; *Catalano*, 446 U.S. at 647.⁷ In evaluating whether the Plaintiff States’ evidence meets this standard, the Court “must look to the evidence as a whole and consider any single piece of evidence in the context of other evidence.” *In re Flat Glass Antitrust Litig.*, 385 F.3d 350, 369 (3d Cir. 2004).⁸

A horizontal price-fixing agreement may be proven by direct evidence, or may be “inferred on the basis of conscious parallelism, when such interdependent conduct is accompanied by circumstantial evidence and plus factors . . .” *Todd v. Exxon Corp.*, 275 F.3d 191, 198 (2d Cir. 2001). A common vertical firm’s facilitation of the conspiracy does not remove the conduct from the scope of the *per se* rule. *See Interstate Circuit v. United States*, 306 U.S. 208, 231-232 (1939); *Toys “R” Us v. FTC*, 221 F.3d 928, 936 (7th Cir. 2000). The use of

publishers] in the acquisition of rights and it competes in the sale and marketing of books, principally. . . . [I]n a nutshell, that’s how we compete.”); David Shanks Dep. (Mar. 20, 2013) at 60:23-61:17 (Penguin competes for sales with other Big Six publishers on at least some of its titles).

⁶ Because of the overlap in evidence, the States address the second and third required elements together. The Joint Brief addresses the legal treatment of these elements at length. This brief contains a summary discussion that does not differ in substance.

⁷ *See also* Joint Brief at 33-35.

⁸ Contrary to the argument Penguin has made in this case, the States need not “disprove all nonconspiratorial explanations for [Penguin’s] conduct.” *In re Publication Paper Antitrust Litig.*, 690 F.3d 51, 63 (2d Cir. 2012) (*quoting* Phillip E. Areeda & Herbert Hovenkamp, *Fundamentals of Antitrust Law* § 14.03(b)). Rather, the States’ evidence only must “cast[] doubt on inferences of independent (not combined) action or proper conduct by” Penguin. *Capital Imaging Assocs. v. Mohawk Valley Medical Assocs.*, 996 F.2d 537, 545 (2d Cir. 1993) (*citing Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 575, 588 (1986)).

vertical restraints to support the conspiracy likewise does not render the horizontal price-fixing agreement itself subject to the rule of reason. *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 893 (2007). Contrary to Penguin’s assertions, the tail does not wag the dog.

Ample evidence, both direct and circumstantial, demonstrates that, with Apple’s facilitation, Penguin agreed with the other Conspiring Publishers to raise e-book prices by adopting the agency model across all distribution outlets. Penguin and its co-conspirators worked together to convert Amazon and other e-book distributors to the Agency Model in order to do so.⁹

1. By the End of Summer 2009, the Publishers Agreed to Act Collectively to Raise Trade E-book Retail Prices.

Penguin, like the other Conspiring Publishers,¹⁰ saw Amazon’s \$9.99 pricing of bestselling e-books as “bad for the book industry.”¹¹ According to Penguin, the \$9.99 price point negatively affected consumer perception of the appropriate pricing for print books, reduced the continuing viability of brick-and-mortar retailers, and created significant barriers to entry for other e-bookstores.¹² According to John Makinson, CEO of the Penguin Group, Penguin also had concerns that Amazon’s power in the trade e-book market might lead to disintermediation.¹³

Beginning in September 2008, John Makinson attended dinners with the Conspiring Publishers’ CEOs held in private rooms at exclusive New York restaurants such as Picholine. The CEOs discussed these concerns, as well as possible solutions, and other sensitive business

⁹ While the Joint Brief discusses evidence relating to each of the Conspiring Publishers, this brief focuses on evidence related to Penguin.

¹⁰ See Joint Brief at pp. 6-7.

¹¹ John Makinson Dep. (Mar. 15, 2013) at 217:22-218:9; see also *id.* at 240:24-241:4 (pricing NY Times bestsellers at \$9.99 sent consumers the “wrong message”).

¹² See, e.g., Richard Heffernan Dep. (Mar. 1, 2013) at 80:5-82:2, 90:12-91:22; see also PEN 013663 (Oct. 20, 2009 email from John Makinson to “Penguin Movers and Shakers”) (PX-0129) (“We’ve been concerned for a while now about the impact on consumer perceptions of the \$9.99 e-book and it wasn’t encouraging to see that issue spill over into the physical book market last week . . .”).

¹³ See John Makinson Dep. (Mar. 15, 2013) at 260:11-261:13; PEN013125 (Email from David Shanks to Tim McCall and Susan Kennedy re Amazon’s offering 70 percent royalties to authors: “This is war.”) (PX-0706); Joint Brief at 7.

information.¹⁴ Penguin’s counsel did not attend and, in some cases, may not even have been aware of these dinners.¹⁵ By the week of July 27, 2009, Penguin and the Conspiring Publishers began discussing a joint venture aimed primarily at compelling Amazon to raise e-book prices.¹⁶

Just one week later, in a draft Penguin “Three Year Plan” prepared for the Board of Directors of Pearson (Penguin Group’s parent company), John Makinson wrote:

Competition for the attention of readers will be most intense from digital companies whose objective may be to disintermediate traditional publishers altogether. This is not a new threat but we do appear to be on a collision course with Amazon, and possibly with Google as well. *It will not be possible for any individual publisher to mount an effective response, because of both the resources necessary and the risk of retribution, so the industry needs to develop a common strategy.* This is the context for the development of the Project Z initiatives [joint ventures] in London and New York.¹⁷

Despite recognizing the need for collective action to increase trade e-book retail prices, Penguin and its competitors did not find a successful strategy until January 2010.

2. The Publishers’ and Apple’s Common Plan: Agency Model and the Path to Higher Retail Prices.

In December 2009, anticipating the release of the iPad tablet computer, Apple approached the Publishers about distributing e-books in what would become the iBookstore.¹⁸

¹⁴ See, e.g., HBG00091601 (Jan. 19, 2009 email from David Young to Arnaud Nourry proposing dinner among CEOs to “discuss options” concerning Amazon and Google) (PX-219); Penguin Response to DOJ CID Interrogatory No. 3 (PX-0810).

¹⁵ See Alexander Gigante Dep. (Apr. 17, 2013) at 106:2-107:23; 108:20-109:6; 110:4-110:8; 110:24-112:24; 113:4-114:19; 115:7-13.

¹⁶ HBG-NOUA00001618 (e-mail from Arnaud Nourry to Arnaud Lagardere re “Digital”). (English translation of PX-0391) (PX-0392).

¹⁷ PEN-LIT-00008099 at 8100 (Aug. 5, 2009 “Penguin Three Year Plan 2009”) (PX-0133) (emphasis added). This statement appeared verbatim in a later draft of the Plan dated September 3, 2009. See PEN077890 at 077891 (Sept. 3, 2009 “Penguin Three Year Plan 2009”) (PX-0330); see also David Shanks Dep. (Mar. 20, 2013) at 88:12-89:4 (agreeing with “most of” the statement that publishers would need a “common strategy” to respond to Amazon because of the necessary resources and risk of retribution). Mr. Makinson reiterated his view in an email to a colleague later in September: “The point about competition is that the whole publishing industry is facing a common threat ... The publishing industry will need to collaborate in order to meet these common issues – no one company has the resources to address the problem or could sustain on its own the retribution that would result from a challenge to Amazon. . .” PEN-LIT-00163100 (Sept. 10, 2009 email from John Makinson to Luke Swanson) (PX-0136).

¹⁸ See Joint Brief at pp. 11-12.

After Apple learned that competitive conditions in the trade e-books market would not permit it to earn its desired 30 percent gross margin on digital content, Apple and the Publishers entered into an illegal quid pro quo: the Publishers would agree with Apple and one another to raise e-book prices by shifting to an Agency Model across their distribution outlets, giving the Publishers higher retail prices and Apple would earn a 30 percent margin with no need to compete on price with the industry leader, Amazon.¹⁹ For newly released e-books, the plan was to raise prices to the levels specified in the “price caps” contained in Apple’s agency agreements.²⁰

In early 2011, Penguin CEO David Shanks described quite candidly how Apple and the Publishers accomplished their shared goals. Mike Bryan, then President of Penguin’s Canadian business, suggested that Penguin and other publishers might participate in a meeting with Indigo, a major Canadian bookseller, to discuss a perceived threat to their sales. Mr. Bryan asked Mr. Shanks: “Is this the sort of meeting that might happen with [Barnes & Noble]?” Mr. Shanks’s reply revealed Apple’s role in the conspiracy, and the publishers’ view as to its utility:

We would never meet with Barnes and all our competitors. The Government would be all over that. We would meet separately with Indigo being the facilitator and go between. That is how we worked with Apple and the government is still looking into that.²¹

From the beginning, Penguin and Apple shared a focus on using Apple’s entry as a means to raise prices of trade e-books. On December 15, 2009, in its first meeting with Apple, Penguin expressed its displeasure with Amazon’s pricing of *New York Times* Bestsellers at \$9.99.²² As Eddy Cue, Apple’s Senior Vice President of Internet Services and Software, and its lead

¹⁹ See, e.g., Penguin (Tim McCall) Dep. (Nov. 30, 2012) 125:2-126:24 (Penguin had to move Amazon to agency or Apple MFN would allow it to match price, meaning Penguin “wouldn’t have been able to afford the loss of margin”); see Joint Brief at pp 21-22.

²⁰ *Infra*, pp 10-11.

²¹ PEN-LIT-00199145 (Feb. 23, 2011 e-mail from David Shanks to Mike Bryan) (PX-0542).

²² APLEBOOK00434143 at 434144 (Dec. 15, 2009 email from Eddy Cue to Steve Jobs) (Penguin “not happy about \$9.99 price point . . . they don’t view a \$9[.]99 eBook as sustainable model”) (PX-0050).

negotiator in dealing with the publishers, testified, “[F]rom the first discussion I ever had with them [Penguin]. . . they want[ed] to keep prices as high as possible.”²³ Hachette Livre CEO Arnaud Nourry and Penguin Group CEO John Makinson met the next day,²⁴ ostensibly to discuss a proposed joint venture.²⁵ The meeting’s timing and the secrecy of Mr. Nourry’s reporting of it make it reasonable to infer that Mr. Nourry and Mr. Makinson almost certainly discussed how their companies should engage with Apple.²⁶

On January 5, 2010, Eddy Cue sent an e-mail to Penguin containing Apple’s initial term sheet, which he began by writing, “After talking to all the other publishers and seeing the overall book environment, here is what I think is the best approach for ebooks.”²⁷ Apple’s Agency Model term sheet set forth the basic parameters of the proposed plan: (1) Publishers would convert all outlets to the Agency Model; (2) Publishers could then set retail prices; (3) the contract would include pricing tiers; and (4) Publishers would sell new release e-books at the maximum price in each tier.²⁸ Accordingly, Apple proposed pricing many new release e-books at \$12.99, including *New York Times* Bestsellers that, at the time, typically retailed at \$9.99. Apple’s e-mail referred to its prices as “realistic,” which, given the nature of Apple’s e-mail, meant two things: higher than current prices and lower than physical book prices.

²³ Eddy Cue Dep. (Mar. 12, 2013) at 238:3-19.

²⁴ Hachette had also met with Apple on December 15, 2009. HBG0090952 (E-mail from Arnaud Nourry to Eddy Cue re Apple discussions) (PX-0298); APLEBOOK004341 (E-mail from Keith Moerer to Eddy Cue, forwarded to Kevin Saul, re “publisher meeting notes”) (PX-0693).

²⁵ See HBG-NOUA000053050 (E-mail exchange between Catherine Rault and Arnaud Nourry re “Breakfast J. Makinson confirmé”) (PX-0138); HBG-YOUNG000103570 (E-mail exchange between David Young and Arnaud Nourry re “Mackinson”) (PX-0468); PEN-LIT-00439575 (E-mail from John Makinson to other Penguin executives re “REDgroup retail announcement”) (PX-0541); PEN 083912 (E-mail from Genevieve Shore to Steven Dowling and Steven Hammersly re “apple”) (PX-0332); John Makinson Dep. (Mar. 15, 2013), 310:18-313:13, 314:2-314:18, 315:4-316:5, 325:4-327:10.

²⁶ In a follow-up e-mail internal to Hachette, Mr. Nourry described certain topics that had been discussed, but also stated that other portions of the Makinson meeting would be “shared with you on the phone.” HBG-YOUNG000103570 (PX-0468).

²⁷ APLEBOOK00434155 (Jan. 5, 2010 e-mail from Eddy Cue to David Shanks) (PX-0040). Substantially identical emails were sent to each of the other publishers as well. See Joint Brief at 12.

²⁸ APLEBOOK00434155 (Jan. 5, 2010 e-mail from Eddy Cue to David Shanks) (PX-0040).

Penguin, the other Conspiring Publishers and Apple agreed on a desire for higher prices, and negotiated over the precise contours of those prices. Mr. Cue expressly assured Penguin that consumers would be willing to pay higher prices for e-books.²⁹ Moreover, Apple communicated to Penguin that the price bands would be substantially the same in all of their agreements, reassuring Penguin – as Apple assured the other Conspiring Publishers – that these higher prices would take hold in the market.³⁰

On January 6, 2010 David Shanks responded to the Apple proposal, e-mailing Eddy Cue that Penguin needed prices “in the \$15 or higher level on new hardcovers.”³¹ On January 11, 2010, in an e-mail meant to follow Apple’s initial contract draft, Keith Moerer sent David Shanks a pricing analysis to explain “the price tiers we’ve proposed for hardcover new releases.”³² The analysis depicted all of Penguin’s current *New York Times* bestsellers priced at the maximums permitted by the price tiers.³³

The January 11, 2010 contract draft did not include an express term requiring Penguin to convert its outlets to the agency model.³⁴ However, it contained an MFN which Penguin viewed as functionally requiring it to convert Amazon (and other distribution outlets) to the agency model.³⁵ On January 12, Apple met with executives from Penguin, Hachette and HarperCollins. The next day, Mr. Cue reported to Mr. Jobs: “The response from both Penguin and Hachette was very similar – willing to do an agency model[,] go agency model for new releases with everyone

²⁹ Penguin (David Shanks) CID Dep. (Dec. 17, 2010), 69:7-71:24; Tim McCall Dep. (Jan. 30, 2013) 68:11-68:23, 186:7-186:23.

³⁰ David Shanks Dep. (Mar. 20, 2013) 286:25-287:4, 288:17-23; Kevin Saul Dep. (Feb. 22, 2013) 171:24-172:23.

³¹ APLEBOOK00434347 (Jan. 6, 2010 email from David Shanks to Eddy Cue) (PX-0049).

³² APLEBOOK-17125 (Jan. 11, 2010 email from Keith Moerer to David Shanks) (PX-0068).

³³ Later that day, Moerer sent Shanks another e-mail to “clarify” that the column entitled “iTunes eBook Retail Price” was meant to denote the “top price tier” for hardcover new releases. APLEBOOK-00003007 (Jan. 11, 2010 email from Keith Moerer to David Shanks) (PX-0066). The e-mail left blank the “iTunes eBook Retail Price” column for other Publishers’ titles, but, of course, Eddy Cue was to repeatedly reassure Penguin that its competitors would be getting the same deal.

³⁴ APLEBOOK00012793 (E-mail from Kevin Saul to David Young re “Apple,” attaching draft agency agreement) (PX-0322).

³⁵ Timothy McCall Dep. (Jan. 30, 2013) 126:24-127:20.

else[,] agree that digital books should be cheaper than physical but need a higher tier(s).”³⁶

Though the “tiers” in the Apple Agency Agreements purported to be “maximum” prices, Penguin admitted that it intended to price at the maximums.³⁷

On January 16, 2010, Apple sent a pricing proposal to Penguin and every other Conspiring Publisher that included higher prices for e-book versions of certain higher priced hardcovers.³⁸ Cue noted in the e-mail, “This gives you significantly more tiers and higher prices.” Making clear that Apple was negotiating one deal with all of the Conspiring Publishers, Cue wrote, “one question we have been asked is whether we would take less than a 30% commission.”³⁹ The answer to that question was no, and with a few minor tweaks, these price tiers became part of Apple’s agency agreements with the Conspiring Publishers, including Penguin.⁴⁰

The record demonstrates that Penguin did not act in its unilateral self interest in entering into the Apple Agency Agreement. Penguin expressly conditioned its agreement to Apple’s terms, including the proposed pricing, on the participation of its fellow Conspiring Publishers. Fearing Amazon retaliation, Penguin would not enter into the agreement with Apple unless a

³⁶ APLEBOOK-00012481 (Jan. 13, 2010 email from Eddy Cue to Steve Jobs) (PX-0026).

³⁷ See Penguin (David Shanks) Dep. (Mar. 21, 2013) at 123:17-124:14 (“Q: What do you mean, ‘that’s the price that it was’? A: That’s the digital list price that we put on it. You know, if that was the most we could put on it, then that’s what we put on it.”); see also Baker Direct ¶104 (price caps likely became “focal (natural and obvious)”).

³⁸ APLEBOOK-00012492 (Jan. 16, 2010 email from Eddy Cue to David Shanks) (PX-0120); APLEBOOK-00012487 (Jan. 16, 2010 email from Eddy Cue to David Young) (PX-0059); APLEBOOK-00003704 (Jan. 16, 2010 email from Eddy Cue to Carolyn Reidy) (PX-0511); APLEBOOK-00003706 (Jan. 16, 2010 email from Eddy Cue to John Sargent) (PX-0512); APLEBOOK-00003710 (Jan. 16, 2010 email from Eddy Cue to Brian Murray) (PX-0513).

³⁹ APLEBOOK-00012492 (Jan. 16, 2010 email from Eddy Cue to David Shanks) (PX-0120).

⁴⁰ On the day Penguin signed the contract with Apple, David Shanks emailed Eddy Cue to say that Penguin had “a problem” with Apple’s proposed price tier on certain paperback books. PEN013112 (Jan. 25, 2010 email from David Shanks to Eddy Cue) (PX-0019). In short order, Apple and Penguin were able to agree on language establishing that the \$9.99 price cap for paperbacks would apply only to paperbacks only for one year after publication. APLEBOOK384792, at 384804 (Apple-Penguin Agency Agreement) (PX-0002). Presumably, this was Apple’s intent all along, as the other Publishers’ Agreements contained similar language. See APLEBOOK00384732, at 384745 (Hachette-Apple Agency Agreement) (PX-0001); APLEBOOK00384807, at 384822-23 (Macmillan-Apple Agency Agreement) (PX-0003); APLEBOOK00384755, at 384770 (Simon & Schuster-Apple Agency Agreement) (PX-0004); APLEBOOK00384833, at 384845-46 (HarperCollins-Apple Agency Agreement) (PX-0005).

critical mass of the other Big Six publishers first signed agreements with Apple.⁴¹ Eddy Cue believed that, “Penguin, and David [Shanks] in particular of all of the publishers, was the most concerned about sort of not being alone or being one of two.”⁴²

In response to Penguin’s concerns, as the iPad launch announcement was rapidly approaching, Cue provided Shanks with the necessary assurances that a sufficient number of Penguin’s competitors had joined the scheme.⁴³ On January 21, 2010, Cue informed Shanks by e-mail that “We completed our first deal and are very close with two other publishers.”⁴⁴ On January 22, 2010, Mr. Shanks asked Mr. Cue if he had “any more of the big six confirmed yet.”⁴⁵ Six minutes later Mr. Cue called Mr. Shanks.⁴⁶ Later that day, Shanks let Cue know that he had “orders from London. You must have the fourth major or we can’t be in the announcement.”⁴⁷ Mr. Cue responded, “[h]opefully this is not an issue but if it is I will call you at 4 pm. It would be a huge mistake to miss this if we have 3.”⁴⁸ Later that evening, Mr. Cue wrote to Mr. Jobs that Mr. Shanks “wants an assurance that he is 1 of 4 before signing.”⁴⁹

On Sunday, January 24, 2010, Mr. Shanks and Mr. Cue had a two-minute call.⁵⁰ On January 25, 2010, Penguin became the fourth Big Six publisher to sign an agreement with Apple.

⁴¹ At the time Penguin entered into the agreement, Penguin did not believe that it had sufficient bargaining power to dictate e-book pricing terms to Amazon. *See* David Shanks Dep. (Mar. 20, 2013) at 16:18-18:14.

⁴² Eddy Cue Dep. (Mar. 13, 2013) at 344:14-17; *see also* David Shanks Dep. (Mar. 20, 2013) at 148:23-150:10 (confirming fear that Amazon would retaliate against Penguin unless other Big Six publishers also signed agreements with Apple).

⁴³ *See* Joint Brief at 17-18. Cue noted that none of the Conspiring Publishers were willing to move alone – each conditioned its participation on Apple securing at least one other Publisher. Apple likewise told the Publishers it would not launch without a critical mass of their participation in the iBookstore.

⁴⁴ PEN013117 (Jan. 21, 2010 email from Eddy Cue to David Shanks) (PX-0018).

⁴⁵ PEN013117 (Jan. 22, 2010 email from David Shanks to Eddy Cue) (PX-0018).

⁴⁶ *See* PX-0788 at 5 (Phone Call Summary reflecting phone calls among Publisher CEOs and Apple).

⁴⁷ APLEBOOK-01274664 (Jan. 22, 2010 email from David Shanks to Eddy Cue) (PX-29); *see also* Penguin (David Shanks) CID Dep. (Dec. 17, 2010) 86:15-24. “London,” in this case, meant not only Penguin’s direct parent, Penguin Group, but the ultimate parent company, Pearson. *See* Alexander Gigante Dep. (Apr. 17, 2013) 187:9-188:15.

⁴⁸ APLEBOOK-01274664 (Jan. 22, 2010 email from David Shanks to Eddy Cue) (PX-0029).

⁴⁹ APLEBOOK00434218 (Jan. 22, 2010 email from Eddy Cue to Steve Jobs) (PX-0028).

⁵⁰ *See* PX-0788 at 6.

That very morning, at approximately 9:46 am, Mr. Shanks telephoned Simon & Schuster CEO Carolyn Reidy for a call that lasted approximately four minutes.⁵¹ On this same day, Mr. Shanks engaged in repeated calls with Mr. Cue of approximately 20, six, and two minutes.⁵² Apparently during this flurry of communication, Mr. Shanks received sufficient assurances that three other Conspiring Publishers would participate in the plan.

Despite Shanks's knowledge that direct communications with Penguin's competitors about e-book distribution terms might violate the law,⁵³ he engaged in a series of meetings and phone calls with Carolyn Reidy and David Young during January 2010. While these contacts ostensibly pertained to the Muse/Bookish joint venture, Shanks cannot exclude the possibility that they discussed e-book distribution terms, including pricing.⁵⁴

Once the iBookstore opened and Penguin was able to set the prices consumers paid for new release trade e-books, Penguin, like the Other Conspiring Publishers, set over 90 percent of those prices at the caps.⁵⁵ Penguin also raised backlist prices.⁵⁶

3. After Entering into the Agreements with Apple, the Publishers Worked Together to Impose Agency on Amazon.

After Penguin signed its agreement with Apple, Penguin worked collectively with the other Conspiring Publishers to force Amazon to accept the Agency model.⁵⁷ On January 27, 2010, the day that Apple launched the iPad, Mr. Makinson of Penguin called Russ Grandinetti of Amazon to tell him that Penguin had moved to agency with its "first customer."⁵⁸ On January 28,

⁵¹ *Id.*

⁵² *Id.*

⁵³ See David Shanks Dep. (Mar. 20, 2013) 219:7-220:12 (calling competitors to inquire about their negotiations with Apple would constitute "conspiring").

⁵⁴ *Id.* at 220:23-221:20, 223:12-22, 225:21-226:19, 228:10-231:2, 237:3-238:8, 241:13-242:3.

⁵⁵ See Baker Direct ¶ 107

⁵⁶ See, e.g., Grandinetti Direct at ¶51; Burtis Report ¶ 53 and Table 9 (PX-0831).

⁵⁷ See Joint Brief at 20-22 (addressing in detail how the Apple Agency Agreements supported the Publishers' agreement, facilitated by Apple, to convert distribution outlets other than Apple to Agency).

⁵⁸ Grandinetti Direct ¶ 43. See also PEN832017 (Jan. 27, 2010 email from Marjorie Scardino to Glen Moreno) (PX-

2010, Macmillan became the first publisher to insist that Amazon adopt the Agency Model. Amazon responded by removing the buy buttons from all of Macmillan's books (physical and e-books) and Macmillan CEO John Sargent publicly aired the dispute in an open letter on Macmillan's website.⁵⁹ John Makinson e-mailed Sargent directly, offering words of support.⁶⁰

Implicitly acknowledging that each of the Conspiring Publishers would move quickly against Amazon, thereby rendering Amazon's response ineffective, David Shanks had already advised his colleagues in Penguin's publicity department not to worry about responding to press inquiries on the subject. He knew that the issue would blow over quickly, because "Amazon cannot sustain their model with just Random House and a bunch of small publishers and by selling used books."⁶¹ Shanks's prediction was proven correct. After the other Conspiring Publishers, including Penguin, "simultaneously" informed Amazon that they would hold back new e-book releases unless Amazon adopted the Agency model, Amazon succumbed to the collective pressure.⁶² As their negotiations with Amazon unfolded, the Publishers continued to communicate with one another.⁶³ In one instance, Penguin executive Tim McCall left a voicemail with David Naggar of Amazon, stating that he was "hearing through the grapevine"

0727) (describing the plan as "imposing [agency] on Amazon."); *See also* PEN831799 (Jan. 26, 2010 email from Marjorie Scardino to Penguin Board) (PX-0530). Ms. Scardino, in her email, recognized that the Apple deal gave Penguin "a chance to change models for the future," and that Amazon "may not like it," but Penguin had nevertheless determined that it "ha[d] to have this showdown." *Id.*

⁵⁹ APLEBOOK-03345533 (Jan. 31, 2010 email from John Sargent to Eddy Cue) (PX-0046).

⁶⁰ MAC 0044175 (Feb. 1, 2010 email from John Makinson to John Sargent: "Just to say that I'm full of admiration for your articulation of Macmillan's position on this. Bravo.") (PX-0075).

⁶¹ PEN013071 (Jan. 31, 2010 email from David Shanks to Marilyn Ducksworth) (PX-0115).

⁶² *See* Grandinetti Direct ¶¶ 46-47. Beginning in April 2010, for a period of approximately seven weeks, as part of a successful effort to force Amazon to switch to an Agency model contract, Penguin chose not to allow Amazon to sell Penguin's new release e-books. *Id.* ¶50; David Shanks Dep. (Mar. 20, 2013) at 279:19-280:6; *see also* PEN012756 (Mar. 9, 2010 email from David Shanks to John Makinson) ("Looks like we have to expect that April 1 will come and we will not have our new ebooks up on Amazon.") (PX-0228). Penguin admitted that "if we were the only publisher that had [asked for agency from] Amazon, I assume they would have said, 'Forget it, we're not selling your books,' which is exactly what happened to Macmillan." Penguin (Tim McCall) Dep. (Nov. 30, 2012), 233:2-16.

⁶³ *See, e.g.,* PEN-LIT-00163067 (Mar. 20, 2010 email from John Makinson to David Shanks) ("I'm trying to get a hold of Arnaud Nourry.") (PX-0131); John Makinson Dep. (Mar. 15, 2013), 402:24-407:17 (agreeing that it was a "fair reading" of PX-0131 that Mr. Makinson was reaching out to Hachette to discuss Amazon); Naggar Direct ¶ 34.

that Amazon was giving some publishers a certain term that Penguin also hoped to obtain.⁶⁴

In the two months prior to the iBookstore's April 3, 2010 launch, four of the five Publisher Defendants moved Amazon to agency.⁶⁵ Penguin moved Amazon to agency pricing in May of 2010 because certain terms in its existing agreement with Amazon caused delay.⁶⁶ Even then, Penguin was able to force Amazon to move to agency earlier than planned by withholding new e-books from the Kindle store starting April 1, 2010, but providing these titles to Amazon's rivals.⁶⁷

4. Penguin Pressured Random House to Adopt Agency for the "Welfare of the Industry."

After the announcement of the iBookstore, Penguin recruited Barnes & Noble to punish Random House, the only Big Six publisher not to join the conspiracy, in an effort to get Random House to join the rest of the "industry" in converting to an agency model.⁶⁸ In a March 4, 2010 e-mail David Shanks sent to Steve Riggio, then-CEO of Barnes & Noble, Shanks implored Barnes & Noble to refuse to promote Random House books on its website. His words were unambiguous, and his intent clear:

Since Penguin is looking out for B&N's welfare at what appears to be great cost to us, I would hope that B&N would be equally brutal to Publishers who have thrown in with your competition with obvious disdain for your welfare I hope you make Random House hurt like Amazon is doing to people who are looking out for the overall welfare of the publishing industry. I hope you can see how strongly I feel about this. They should not be allowed to be selfish and win.⁶⁹

Penguin's campaign to make Random House suffer for being "selfish," rather than pursuing the conspirators' shared goals, continued for months. On June 22, 2010, Dick

⁶⁴ See Naggar Direct ¶ 34.

⁶⁵ See Naggar Direct ¶ 32.

⁶⁶ Penguin (David Shanks) CID Dep. (Dec. 17, 2010) 114:11-117:21; Naggar Direct ¶ 33

⁶⁷ Grandinetti Direct ¶ 50.

⁶⁸ Apple, too, applied pressure to Random House. See Joint Brief at 22-23.

⁶⁹ PEN012999 (Mar. 4, 2010 email from David Shanks to Steve Riggio) (PX-0116).

Heffernan, President of Sales for Penguin's adult and children's hardcover business, complained to Theresa Horner at Barnes & Noble that B&N had featured three Random House titles in a full-page *New York Times* advertisement for the Nook:

Penguin went to an agency model to help support booksellers like B&N where the retailer can raise the price and perceived value of a book and make the retailer a profit. To have B&N support the one publisher who didn't do that in this ad makes us feel like our efforts to make our industry stronger are not appreciated by the biggest book account in the country.⁷⁰

After David Shanks brought this advertisement to the attention of Barnes & Noble President William Lynch, Lynch responded, "slipped by me – you won't see another one. Thanks for bringing this to my attention David."⁷¹ Barnes & Noble heeded Penguin's request to pressure Random House and Random House eventually recognized that the Conspiring Publishers were behind the pressure.⁷²

David Shanks, meanwhile, engaged directly with Random House executives to urge them to adopt the Agency Model. First, at some time after Penguin had converted Amazon to agency, he had lunch with Random House's then-President of Sales, Operations, and Digital, Madeleine McIntosh, to determine if there was "any chance [Random House] were going to change" to Agency.⁷³ Shanks didn't mention the Agency Model explicitly, but told McIntosh that "[s]he had an obligation to the industry to do something to help the industry."⁷⁴ Shanks stated that McIntosh "knew what [he] was talking about."⁷⁵ Likewise, only two weeks before his CID Deposition in December 2010 – with knowledge that Penguin's conduct was being investigated by federal and state enforcement authorities – Shanks had lunch with Random House CEO

⁷⁰ PEN067552 (June 22, 2010 email from Dick Heffernan to Theresa Horner) (PX-0643).

⁷¹ BN00530143 (June 22, 2010 email from William Lynch to David Shanks) (PX-0118).

⁷² See RH-USDOJ-00018644 (Sept. 24, 2010 email from Madeline McIntosh to Markus Dohle and Anne Davis: "[P]art of the timing of BN's pressure with us re: agency has been due to pressure they're receiving from other publishers.") (PX-0520).

⁷³ Penguin (David Shanks) CID Dep. (Dec. 17, 2010) at 132:2-133:11.

⁷⁴ *Id.* at 134:8-10.

⁷⁵ *Id.* at 133:14-17.

Markus Dohle and had substantively the same conversation with Dohle regarding the Agency Model.⁷⁶ Penguin cannot argue that it adopted Agency as a unilateral and competitive act against Random House (or any Conspiring Publisher).⁷⁷ If Penguin viewed Agency as providing it a competitive advantage over Random House, it would never seek to coerce and persuade its largest rival into adopting the same strategy. Ultimately, Random House succumbed to the pressure from Penguin, Barnes & Noble, Apple, and others, and entered into agency agreements with Apple and its other retailers.⁷⁸

The totality of the evidence as described above and in the Joint Brief demonstrates that Penguin and its fellow Conspiring Publishers, with Apple's facilitation, entered into an agreement to raise e-book prices by adopting the agency model across all distribution outlets. This agreement constitutes a *per se* violation of the antitrust laws.

II. Because the Anticompetitive Effects of Defendants' Conduct Outweigh any Alleged Procompetitive Benefits, Penguin Should Be Held Liable Even Under the Rule of Reason.

If the Court chooses to conduct a more exhaustive rule of reason analysis to review the conspiracy, the Court still should find Penguin liable. The legal standard for establishing a violation of the antitrust laws under the rule of reason provides for a three-step test.⁷⁹ First, Plaintiff States must show that Penguin and the Other Conspiring Publishers' conduct had "substantial adverse effects" on competition as a whole in a relevant geographic and product

⁷⁶ *Id.* at 134:21-135:9.

⁷⁷ *See* Shanks Dep. (Mar. 20, 2013) 61:18-62:21 (Penguin did not gain a competitive advantage over other conspiring publishers by signing Apple Agency agreement).

⁷⁸ RH-USDOJ-00025408 (Jan. 18, 2011 executed copy of Random House-Apple Agency Agreement) (PX-0006).

⁷⁹ The analysis set forth below is not required if the Court concludes that a more limited "quick look" rule of reason test is appropriate. The states submit that the anticompetitive effects caused by the Defendants' conspiracy are so plain that the quick look rule of reason would be appropriate. *See* Joint Brief at 35. And of course, even under a full blown rule of reason analysis, Defendants should be held liable.

market.⁸⁰ No “detailed market analysis” or “further showing of market power” is necessary if the plaintiff offers “proof of actual detrimental effects” such as an increase in price or a reduction in output.⁸¹ If Plaintiff States meet their burden, Penguin must show that the agreement had sufficient procompetitive benefits to outweigh the harm it presents to competition.⁸² If Penguin is able to meet this burden, Plaintiff States still prevail if they can demonstrate that the restraint was not the least restrictive means for Penguin to achieve the pro-competitive benefits.⁸³

A. Penguin, the Conspiring Publishers and Apple’s Conduct Caused Substantial Anticompetitive Effects in the market for trade e-books sold in the United States.

The evidence demonstrates, and Professor Baker, the States’ economic expert, concludes, that the alleged conspiracy caused retail prices in the market for trade e-books sold in the U.S. to rise, with retail prices of the Conspiring Publishers’ e-books increasing almost 17 percent.⁸⁴ Likewise, output of trade e-books sold by Conspiring Publishers in the U.S. fell by at least 4.4 percent (and likely more) with consumers suffering additional harm from purchasing less-preferred e-books.⁸⁵ This section addresses the appropriate antitrust market definition and each of these effects, in turn.

1. Trade E-books Sold in the United States Forms A Relevant Market.

Trade e-books sold in the United States are the relevant product and geographic markets (together, relevant market) for analysis of the Defendants’ conduct. Where, as here, the States can demonstrate substantial anticompetitive effects, the Court need not define the precise contours of the relevant market.

⁸⁰ See *United States v. Visa U.S.A, Inc.*, 344 F.3d 229, 238 (2d Cir. 2003); *K.M.B. Warehouse Distributors, Inc. v. Walker Manufacturing Co.*, 61 F.3d 123, 127 (2d Cir. 1995).

⁸¹ See *Capital Imaging Associates, P.C. v. Mohawk Valley Medical Associates, Inc.*, 996 F.2d 537, 546 (2d Cir. 1993) (citing *F.T.C. v. Indiana Federation of Dentists*, 476 U.S. 447, 460-61 (1986)).

⁸² See, e.g., *Geneva Pharms. Tech Corp. v. Barr Labs, Inc.*, 386 F. 3d 485, 506-07 (2d Cir. 2004).

⁸³ *Id.*

⁸⁴ Baker Direct ¶ 115; Ashenfelter Direct ¶ 47.

⁸⁵ Baker Direct ¶115-117.

i. The United States is the Proper Geographic Market.

The United States is the appropriate geographic market for evaluating Penguin's agreement. The relevant geographic market covers the geographic area where competition occurs. *See, e.g., Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320, 327 (1961). It "encompasses the geographic area to which consumers can practically turn for alternative sources of the product and in which the antitrust defendants face competition." *Heerwagen v. Clear Channel Com'ns*, 435 F.3d 219, 228 (2d Cir. 2007) (*quoting Morgenstern v. Wilson*, 29 F.3d 1291, 1296 (8th Cir. 1994)). As the Second Circuit has stated, the "relevant geographic market for goods sold nationwide is often the entire United States...." *Id.* Penguin, unlike its codefendant Apple, apparently maintains that the relevant geographic market is broader than the United States.⁸⁶

Penguin admits that the relevant geographic market is not narrower than the United States.⁸⁷ But Penguin appears to argue that the relevant geographic market should include all primarily English-speaking countries, including Australia, Canada and the United Kingdom.⁸⁸ This assertion is unrealistic. As Professor Baker notes, Amazon, among other outlets, has introduced technological barriers to U.S. consumers attempting to buy e-books abroad.⁸⁹ U.S. customers find themselves redirected to Amazon's U.S. e-bookstore. Similarly, Apple consumers in the U.S. cannot purchase e-books at an Apple iBookstore in a country where their account is not registered.⁹⁰ When building its iBooks app, including the iBookstore, Apple did not look to

⁸⁶ Apple does not dispute that the United States is the appropriate geographic market. *See* Apple's Objections and Responses to Class Plaintiff's First Set of Contention Interrogatories (PX-0803), Response 2, at p. 6.

⁸⁷ *See* Penguin Group (USA), Inc.'s Objections and Amended Responses to the Plaintiff States' Interrogatories No. 1, 6, 8 and 10, Response 1, at p. 2 (PX-0799).

⁸⁸ *Id.* at p. 2-3.

⁸⁹ Baker Direct ¶ 41, n 25.

⁹⁰ Jeffrey Robbin Dep. (Dec. 17, 2010) at 92:16-19.

foreign retailers as competitors.⁹¹ Likewise, Penguin’s January 25, 2010 agency agreement with Apple was limited to e-book distribution in the U.S.⁹²

Supported by Professor Ashenfelter’s empirical work, Professor Baker’s conclusion that demand for trade e-books sold in the United States is likely inelastic bolsters the conclusion that the U.S. is the relevant geographic market.⁹³ If substitution to foreign suppliers were sufficient to defeat price increases in the U.S., these results would not hold. Penguin’s argument that a possible world market for free trade e-books is relevant to the determination of the geographic market lacks merit because free e-books are not in the relevant product market.⁹⁴

ii. Trade E-books Sold Form a Relevant Product Market.

The market for trade e-books sold is a relevant product. A relevant product market comprises all products “reasonably interchangeable by consumers for the same purposes, because the ability of consumers to switch to a substitute restrains a firm’s ability to raise prices above the competitive level.” *Geneva Pharms. Tech. Corp. v. Barr Labs, Inc.*, 386 F. 3d 485, 496 (2d Cir. 2004) (internal quotation marks and citation omitted). Professor Baker concluded that trade e-books sold form a relevant product market. Based on the results of various empirical analyses by Professor Ashenfelter, in the context of economic theory and market factors, Professor Baker concluded that the retail demand for trade e-books sold in the United States is likely inelastic.⁹⁵

Because demand for trade e-books sold in the U.S. is likely inelastic, a coordinated price rise among all sellers of trade e-books would almost surely be profitable.⁹⁶ If the relevant

⁹¹ *Id.* at 81:15-20.

⁹² APLEBOOK00384792, at 384793 (Penguin-Apple Agency Agreement) (PX-0002).

⁹³ Baker Direct ¶ 43, n. 29.

⁹⁴ Professor Baker excludes free trade e-books from his market definition. Baker Direct ¶ 141, n. 216.

⁹⁵ Baker Direct ¶ 43; Ashenfelter Direct ¶ 50 and Table 1.

⁹⁶ Baker Direct ¶ 43.

market contained substitutes such as other e-books, print books or other forms of entertainment, substitution to these other products would render the coordinated attempt to raise prices ineffective. Professor Baker, therefore, rightfully excludes these products from his definition of the relevant market. Additional support for this product market definition includes the scope of the price tier provisions of Penguin's Apple Agency Agreement, which apply only to trade e-books.⁹⁷ Moreover, the concerns that motivated Penguin's participation in the conspiracy were focused on trade e-book pricing, and, in particular, newly released trade e-books.⁹⁸

iii. The Defendants' Agreement Substantially Harmed Competition in the Relevant Market Leading to Increased Prices and Reduced Output.

The agreement among Penguin, its fellow Conspiring Publishers and Apple eliminated retail price competition for e-book sales. First, by implementing the agreement to impose the Agency Model on Amazon, Penguin and the Conspiring Publishers ended Amazon's ability to set retail prices and discount e-books sold to consumers.⁹⁹ Additionally, from the moment they could set the retail price, Penguin and the Conspiring Publishers overwhelmingly set the prices for their new release e-books at commonly understood, pre-agreed prices.¹⁰⁰ These prices were generally significantly higher than the prices that would have prevailed absent the conspiracy.¹⁰¹ In short, Penguin's and its co-conspirators' actions caused substantially higher prices and lower output, archetypal anticompetitive effects cognizable in antitrust analysis. *See In re DDAVP Direct Purchaser Antitrust Litig.*, 585 F.3d 677 (2d Cir. 2009) (quoting *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 489 (1977)).

Professor Baker explains that average prices rose across the market for trade e-books sold

⁹⁷ APLEBOOK00384792, at 384804 (Penguin-Apple Agency Agreement) (PX-0002).

⁹⁸ *See supra*, Section I.B.

⁹⁹ Grandinetti Direct ¶¶ 51-56.

¹⁰⁰ *See Baker Direct* at ¶ 107. Prices for backlist books rose, as well. *See Burtis Report* at ¶ 53 and Table 9 (PX-0831).

¹⁰¹ Ashenfelter Direct ¶ 47 (Finding approximately 17% price increase including frontlist and backlist titles.)

because Defendant Publishers' prices increased markedly and prices of non-Conspiring publishers did not decrease.¹⁰² His results rely on the work of Professor Ashenfelter, the States' econometrics expert, who determined that the conspiracy caused average consumer prices for trade e-books published by Penguin and the other Conspiring Publishers to increase 16.8 percent.¹⁰³ Even Penguin's experts have conceded that consumer prices for Penguin and its co-conspirators' trade e-books increased following the conduct at issue.¹⁰⁴ Nonetheless, Dr. Burtis and Professor Rubinfeld¹⁰⁵ argue that overall e-book prices fell following the Defendant Publishers' adoption of the Agency Model,¹⁰⁶ driven by the prices of e-books sold from Publishers that did not participate in the conspiracy.¹⁰⁷ The analysis in Dr. Burtis's expert report does not control for the influence of any confounding factors on e-book pricing.¹⁰⁸ Accordingly, unlike Professor Ashenfelter, who uses two techniques (a control group and fixed effects) to control for a variety of confounding influences on e-book prices,¹⁰⁹ Penguin's experts cannot credibly argue that lower e-book prices *resulted* from Penguin's and its co-conspirators' conduct. Professor Ashenfelter demonstrates that merely controlling for the changing mix of publishers leads to the opposite conclusion reached by Dr. Burtis: post-conspiracy e-book retail prices rose

¹⁰² Baker Direct ¶ 115.

¹⁰³ Ashenfelter Direct ¶ 47. In their effects, analysis, the States address the price increase caused by the conspiracy on all covered titles, not merely on Penguin's titles.

¹⁰⁴ "[A]verage prices for Publisher Defendants' eBooks increased—in varying amounts—in the period after the Apple agency agreements." (Burtis Report at ¶ 25 (PX-0831)). See also Rubinfeld Report (PX-0833) at ¶ 16 ("[T]he initial effect of the move to an agency model was an initial increase in prices of best-selling ebooks....").

¹⁰⁵ Professor Rubinfeld relies on Dr. Burtis's flawed analysis for additional support in his expert rebuttal report. Rubinfeld Rebuttal Report ¶¶ 14, 50 (PX-0834).

¹⁰⁶ Burtis obtains this result by comparing average trade e-book retail prices from February 2008 through March 2010, with the average trade retail prices of trade e-books from April 2010-through March 2012. Burtis Report ¶ 26 (PX-0831).

¹⁰⁷ Burtis Report ¶ 25 and Graph 1 (The non-Conspiring Publishers line, while not depicted, must be lower than Conspiring Publishers lines and accordingly responsible for the results.) (PX-0831); see also Baker Direct ¶ 121.

¹⁰⁸ See Ashenfelter Direct ¶ 17 and Baker Direct ¶ 120 (discussion of Burtis' lack of control and inappropriate "but for" world).

¹⁰⁹ These confounding influences include, but are not limited to: changes in title mix, aging of titles, monthly changes in demand and differences in consumer composition at different e-bookstores. See Ashenfelter Direct ¶ 8.

on average.¹¹⁰

Professor Baker explains why Professor Ashenfelter's empirical results regarding Defendant Publishers' reduced e-book output translate into harm across the trade e-books market.¹¹¹ Professor Ashenfelter demonstrates that the quantity of trade e-books sold by Penguin and the other conspiring publishers decreased by 14.5 percent relative to titles sold by non-agency publisher Random House.¹¹² Professor Baker, using relative market shares, and allowing for the possibility of consumer substitution toward generally lower-priced Random House titles, concludes that this implies a quantity reduction of no less than 4.4 percent for Conspiring Publishers.¹¹³ Penguin has contended that its conduct resulted in an increase in the number of e-books sold,¹¹⁴ but that contention depends on Dr. Burtis's and Professor Rubinfeld's analyses,¹¹⁵ which again fail to control for the influence of confounding factors. As Professor Ashenfelter notes, the trade e-books market was expanding rapidly prior to the Defendants' conduct.¹¹⁶ Accordingly, an uncontrolled comparison of e-books sales pre- and post- the alleged conspiracy would be expected to show substantial growth of sales in the post-period.¹¹⁷ However, this analysis is nearly meaningless for determining the effects resulting from the conspiracy. Professor Ashenfelter shows that the quantity of e-books sold post-Agency falls below what would be predicted by the pre-Agency trend.¹¹⁸

¹¹⁰ See Ashenfelter Direct ¶ 63 and Figure 11.

¹¹¹ Baker Direct ¶ 117-18.

¹¹² Ashenfelter Direct ¶ 47; *see also* Joint Brief at 37.

¹¹³ Baker Direct ¶ 117-18.

¹¹⁴ Penguin Group (USA), Inc.'s Objections and Responses to Plaintiff States' First Set of Interrogatories (PX-0806), Response 3, at p. 8.

¹¹⁵ See Burtis Report at ¶¶ 27-28 and Graph 3 (PX-0831), and Rubinfeld Report at ¶¶ 34-35, 187 and Exhibit 3 (PX-0833).

¹¹⁶ Ashenfelter Direct ¶ 69.

¹¹⁷ Ashenfelter Direct ¶ 67.

¹¹⁸ Ashenfelter Direct ¶ 68.

B. Penguin Cannot Demonstrate Procompetitive Benefits that Outweigh the Anticompetitive Effects of its Conduct in the Market for Trade E-books Sold in the U.S.

Penguin has asserted a number of procompetitive justifications for its conduct. The asserted procompetitive justifications are not legally cognizable, not attributable to the conduct at issue, or not quantifiable.

Penguin has asserted that the agreement led to an increase in competition in the market for e-reading devices.¹¹⁹ This assertion fails as a matter of both law and fact. As a matter of law, to be cognizable, the procompetitive benefits must be accrued in the same market damaged by the anticompetitive effects, rather than in a different market. *See, e.g., United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 370 (1963). Here, the anticompetitive effects occurred in the e-books market; any alleged procompetitive effects, to the extent they occurred at all, are tied to the device market.¹²⁰

To the extent there were consumer benefits in devices that were coincident with the conspiracy, these are more plausibly attributable to the introduction of the iPad, rather than the opening of the iBookstore or the conspiracy alleged. Again, Professor Rubinfeld's and Dr. Burtis's analyses fail to control for any confounding factors that would affect device prices – including Apple's introduction of the iPad. Penguin, like Apple, acknowledges that the iPad would have been introduced whether or not the Defendants reached an agreement.¹²¹ Accordingly, any benefits from the iPad did not result from the conduct at issue in this case.

Penguin also contends that consumers benefitted from the conduct's effects on physical books. Again, physical books lie outside the relevant market, and to the extent Penguin

¹¹⁹ See Burtis Report ¶¶32-34 (PX-0831); Rubinfeld Report ¶¶ 49, 194 (PX-0833).

¹²⁰ As Professor Baker has explained, e-books and e-readers are complementary products. They are not products that compete in the same market. Baker Direct ¶ 45.

¹²¹ *See* Penguin (David Shanks) CID Dep. (Dec. 17, 2010) at 72:15-73:24, 74:21-75:7 (explaining that negotiations were tied to the iPad launch and if negotiations failed, the iPad would be launched without an iBookstore but with other e-reading applications); *see also* Joint Brief at 38.

establishes these benefits, they are not cognizable in this matter. *Philadelphia Nat'l Bank*, 374 U.S. at 370. Penguin presents meager empirical evidence related to physical books generally and none of their experts' analyses have controls sufficient to attribute any causation to the conduct at issue.

In sum, the only potential procompetitive benefit to which Penguin can point is the establishment of the iBookstore. However, Penguin's experts have failed to quantify any benefits resulting from the opening of the iBookstore. Moreover, to the extent Penguin has successfully alleged any procompetitive benefits from the iBookstore, Professor Rubinfeld did not balance these against possible anticompetitive effects resulting from Penguin's conduct.

III. Penguin's and Its Fellow Conspiring Publishers' Agreement to Fix Prices, Facilitated by Apple, Renders Them Liable under Plaintiff States' Antitrust and Consumer Protection Laws.

In Count IV of the Second Amended Complaint, Plaintiff States alleged that Penguin's and Apple's conduct violated various State laws.¹²² The Attorneys General may bring actions for injunctive relief and civil penalties in the name of the State for violations of their state law counterparts to Section 1 of the Sherman Act and other related statutes. This Court has the

¹²² See Ala. Code § 8-10-1; Alaska Restraint of Trade Act, Alaska Stat. § 45.50.562, and the common law of Alaska; Uniform State Antitrust Act, Ariz. Rev. Stat. Ann. § 44-1402; Arkansas Unfair Practices Act, Ark. Code Ann. § 4-75-309, and the common law of Arkansas; Colorado Antitrust Act of 1992, Col. Rev. Stat. § 6-4-104, and the common law of Colorado; Connecticut Antitrust Act, Conn. Gen. Stat. Ann. §§ 35-26, 35-28, 35-29 and Connecticut Unfair Trade Practices Act, Conn. Gen. Stat. Ann. § 42-110b; Delaware Antitrust Act, Del. Code Ann. tit. 6, § 2103; District of Columbia Antitrust Act, D.C. Code § 28-4502; Idaho Competition Act, Idaho Code Ann. § 48-104; Illinois Antitrust Act, 740 Ill. Comp. Stat. Ann. 10/3; Ind. Code Ann. §§ 24-1-1-1, 24-1-2-1; Iowa Competition Law, Iowa Code Ann. § 553.4; Kansas Restraint of Trade Act, Kan. Stat. Ann. § 50-101; La. Rev. Stat. Ann. §§ 51:122, 51:1405; Maryland Antitrust Act, Md. Code Ann., Com. Law § 11-204; Massachusetts Consumer Protection Act, Mass. Gen. Laws c. 93A, § 2; Michigan Antitrust Reform Act, Mich. Comp. Laws Ann. §§ 445.772, 445.772; Mo. Rev. Stat. § 416.031, Mo. Rev. Stat. § 407.020, et seq., as further interpreted by 15C.S.R. 60 8.010 et seq. and 60 9.010 et seq.; Neb. Rev. Stat. §§ 59-801, 59 1603-59-1609, §§84-211 and 84-212, Uniform Deceptive Trade Practices Act, Neb. Rev. Stat. § 87 302, and the common law of Nebraska; N.M. Stat. Ann. §§ 57-1-1, 57-12-1-3; N.Y. Gen. Bus. Law §§ 340, 369-a; Uniform State Antitrust Act, N.D. Cent. Code Ann. § 51-08.1-02; Ohio Rev. Code Ann. §§ 1331.01, 1331.02, 1331.04, and the common law of Ohio; the common law of Pennsylvania; 10 L.P.R.A. §§ 257, 258 and 32 L.P.R.A. § 3341; S.D. Codified Laws § 37-1-3.1; Tennessee Trade Practices Act, Tenn. Code Ann. § 47-25-101, Tennessee Consumer Protection Act, Tenn. Code Ann. § 47-18-104, and the common law of Tennessee; Tex. Bus. & Com. Code Ann. §§ 15.05(a), 15.21, 15.40; Utah Antitrust Act, Utah Code Ann. § 76-10-914(1), and the common law of Utah; Vt. Stat. Ann. tit. 9, § 2453; Virginia Antitrust Act, Va. Code Ann. § 59.1-9.5; West Virginia Antitrust Act, W. Va. Code Ann. §§ 47-18-3; Wis. Stat. Ann. § 133.03.

authority to assume pendent jurisdiction over the Plaintiff States' state law claims as they arise out of the same facts as the federal law claims set forth in their Second Amended Complaint. *See* 28 U.S.C. § 1367.

Penguin and Apple stipulate that as of April 3, 2010, or shortly thereafter, Penguin sold trade e-books, through its agents, to consumers in each of the Plaintiff States.¹²³ Penguin's and Apple's anticompetitive conduct affected commerce in each of the Plaintiff States. Penguin's and Apple's anticompetitive conduct has had and continues to have a substantial effect upon the trade and commerce within each of the Plaintiff States.¹²⁴

Plaintiff States' state law claims, as alleged in Count IV of the Plaintiff States' Second Amended Complaint, arise out of the same facts that establish Penguin's and Apple's liability under Section 1 of the Sherman Act: Penguin's and its fellow Conspiring Publishers' agreement to raise consumer e-books prices, facilitated by Apple. Those facts mandate a finding of liability for Penguin's and Apple's violations of state law.

CONCLUSION

For the foregoing reasons, the Court should declare that Penguin and Apple have violated the Sherman Act, 15 U.S.C. § 1, as well as the state law claims enumerated in footnote 122, *supra*, and order all equitable relief necessary to undo the effects of Defendants' agreement and prevent Defendants from similarly violating antitrust laws in the future.

¹²³ This stipulation is attached as Exhibit A to the Parties' Proposed Joint Pretrial Order dated April 26, 2013.

¹²⁴ Penguin and Apple do not dispute that sales of trade e-books took place in interstate commerce. Penguin's Answer to States' Second Amended Complaint ¶ 115 (PX-0793); Apple's Answer to States' Second Amended Complaint ¶ 115 (PX-0792).

Dated: April 26, 2013

Respectfully Submitted,

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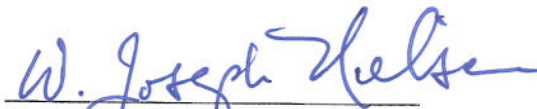
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A handwritten signature in blue ink that reads "W. Joseph Nielsen". The signature is written in a cursive style with a horizontal line underneath the name.

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