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

THE STATE OF TEXAS, *et al.*, Plaintiffs, v. PENGUIN GROUP (USA), INC., *et al.*, Defendants.	Civil Action No. 12-cv-3394 (DLC) ECF Case
IN RE ELECTRONIC BOOKS ANTITRUST LITIGATION	Civil Action No. 11-md-2293 (DLC) ECF Case

PRETRIAL MEMORANDUM OF LAW IN SUPPORT OF PENGUIN GROUP (USA), INC.

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PRELIMINARY STATEMENT

Stripped of its thin conspiracy allegations and flawed legal theories, at its core this action is about punishing Penguin and Apple for entering a vertical distribution agreement that undeniably helped foster actual competition in the eBook marketplace. Before, Amazon's Kindle Store threatened to be the only player on the eBook scene. By becoming Amazon's legitimate competitor, Apple challenged Amazon's top position and opened the door to a competitive eBook retail market—not only for Apple but for other new entrants as well. This type of lawsuit, in which the States (and the federal government) bring antitrust claims for actions that indisputably encouraged new competitive entry and toppled an existing monopoly, has never, to Penguin's knowledge, been brought before. It is unprecedented.

This lawsuit is also misguided. The States do not dispute the lack of competition before Penguin adopted its Apple agency agreement or the competitive spurt that followed. Indeed, the States highlight in their own complaint that "Amazon accounted for the vast majority" of eBook sales, "conservatively estimated at upwards of 80%." (Second Am. Compl. ¶ 26.) Yet that breathtakingly dominant market share, in which Amazon was concededly "willing to sell [bestselling] titles at a loss," threatening to cement its market hegemony, is not what the States protest; rather, it is Penguin's willingness to agree to sell books to Amazon's competitors on different terms. Why do the States blame Penguin? Because for a fleeting time after the iBookstore's launch, the price of some new-release eBooks went up by a few dollars. And on what theory do the States contend that Penguin's prices went up? Because Penguin agreed with Apple to incorporate a price *ceiling* in its contract and promised to *lower* its price on the iBookstore if another eBookseller offered it for less.

Never mind that sales of eBooks have skyrocketed after the launch of Apple's store or average retail prices for eBooks have plummeted. Never mind that more free eBooks are being offered online than ever before. And never mind that there is now a "big three" of legitimate eBook retail competitors – Amazon, Apple, and Barnes & Noble, not to mention scores of small and independent booksellers. If Penguin had not agreed with Apple to participate in Apple's innovative iBookstore on the terms that Apple proposed in January 2010, that Store might never have launched.

Worse still, the States' claims are not just misguided for denying the concrete procompetitive effects of the challenged behavior, but are foreclosed as a matter of law. Before this Court can evaluate whether the acknowledged procompetitive effects of the emergence of Apple's iBookstore (and Penguin's role in helping that happen) outweigh the resulting short-lived eBook price increases, it first has to determine that there was "concerted" rather than independent action. The States cannot point to any such agreement.

For one thing, the States' concession that Penguin's agency agreement with Apple is genuine dooms any finding of an unlawful vertical combination, since pricing terms in genuine principal-agent relationships are insulated from antitrust scrutiny. And the States' allegations of a horizontal conspiracy in which Penguin agreed or conspired to fix prices with its competing publishers is equally flawed. The States cannot show that Penguin's decision to negotiate and ultimately agree with Apple's agency terms and join Apple's iBookstore was anything other than a self-interested business decision. The timing of that decision is, moreover, naturally explained by nothing more nefarious than the corresponding launch of the iPad, the innovative, full-color platform that would showcase the new store's products.

In the end, the States' efforts to punish concededly pro-competitive behavior in the guise of protecting consumers from temporarily higher (though now reduced) prices should be recognized for what it is – a perhaps well-intentioned, through nevertheless shortsighted, focus on prices instead of what is truly meant to be the focus of the antitrust laws: competition. The States' claims must be squarely rejected and its action dismissed.

BACKGROUND[1]

By 2009, it was apparent that eBooks were becoming a transformative element in the book industry. (PSOF ¶¶ 22-27.) Penguin, however, welcomed the introduction and growth of eBooks, as Penguin never wanted to stand in the way of a consumer's preferred method of reading. (PSOF ¶¶ 25, 29.) Company executives were excited about the growth and power of digital sales--eBooks had already achieved strong and profitable sales performance. The format promised to continue growing. Selling more books, in whatever fashion, format, or channel, is critical to Penguin's mission. (PSOF ¶¶ 34.)

The emergence of online sales and eBooks did give rise to strategic and business challenges, however. Online sales and eBooks were disrupting Penguin's traditional business models and distribution channels. (PSOF ¶¶ 37-39.) One important concern for Penguin was the impact on traditional "brick and mortar" bookstores. These bookstores played a crucial role in the marketing and sale of books. They served as the venue for the introduction and promotion of new titles and new authors, by holding book-signing events, lectures and store-sponsored promotions. The community of traditional bookstores, both independents and chain stores, historically provided the best and most effective vehicle for book promotion. Over the past

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[1] Although the following background provides an overview of the essential facts underlying the allegations in this complaint, those facts and accompanying record citations are set forth in far greater detail in the accompanying Penguin's Proposed Statement of Facts ("PSOF").

several decades, such outlets had increasingly disappeared from the landscape. The looming Border's bankruptcy cast a pale on the industry. (PSOF ¶¶ 40-39.)

At the same time, the number of actual sellers of eBooks was also constricting. Amazon had quickly gained a share of the sales of eBooks that approached or even exceeded 80% and Penguin executives began to consider the possibility of a world in which consumers had few or just one choice of significant venues to purchase books. Penguin would also face the problem of having but one dominant account. (PSOF ¶¶ 32, 60-61.)

Penguin executives believed, further, that Amazon's marketing strategy of loss-leading certain, new-release, best selling eBooks was raising barriers to entry and threatening the competitive health of the Penguin's business. (PSOF ¶¶ 56-59.) Amazon's practice of charging $9.99 per title for nearly all eBook versions of newly released titles, Penguin officials believed was contrary to the Company's long-term interests and diminished the value of the written word. The online environment simply had not replicated the brick & mortar channel's ability to reach consumers, help discover new authors, or market a broad and diverse array of titles. (PSOF ¶ 41.) And Penguin was facing the possible loss of the promotion and marketing function performed by the brick-and-mortar stores. Penguin, moreover, was concerned that Amazon's "one size fits all" policy, pricing virtually all new-release eBooks at the uniform below-cost price of $9.99, would undermine the importance of content in readers' purchase of books and transform books into commodities. (PSOF ¶¶ 52-55.)

As 2009 progressed, Penguin received complaints from retailers about Amazon's below-cost sales. (PSOF ¶¶ 66-70.) These retailers said that they were losing sales to Amazon's eBooks or else suffering losses if they cut their prices to meet Amazon's. Some publishers

"windowed" their eBooks – delay release of eBooks to some point in time after the printed books were released. (PSOF ¶¶ 75-76.)

Penguin, however, never adopted a policy of windowing eBooks—such an act was contrary the Company's philosophy of broad access. (PSOF ¶¶ 77-78.) Instead, Penguin offered incentive-based terms to its eBooks accounts in an attempt to solve what it viewed as the real problem: the differing incentives online sellers and Penguin. Penguin's proposed deal terms were unique. (PSOF ¶¶ 71-73.)

Penguin also formed with other publishers (and one retailer) two official joint-ventures—one in the United States and one in the United Kingdom—to develop and launch direct-to-consumer, online book marketing and possibly sales websites. If others would not build successful online book marketing presence, the concept was that publishers, who best understand their titles, could. These efforts were aimed at increasing distribution and ultimately competition. (PSOF ¶¶ 79-90.)

In the midst of this uncertainty, in December of 2009, Penguin received an unsolicited request to meet with Apple. Apple informed Penguin that it was about to release a new revolutionary, multi-function tablet device (later named the iPad), and Apple was interested in opening a digital bookstore which would sell books through the new device. (PSOF ¶ 91.)

When Apple approached Penguin about selling eBooks in December of 2009, it was perceived by Penguin as a promising opportunity. Apple was hugely successful, with millions of customers and a string of successes in digital content marketing. Apple offered the prospect of providing meaningful competition for the giant Amazon. It was common knowledge that Apple was, in fact, about to bring out another blockbuster product. Apple, quite simply, was just "cool." (PSOF ¶ 92.)

In these circumstances, Penguin wanted to find a replacement for the business it was losing because of the decline of the brick-and-mortar stores, create competition for Amazon, and increase consumer options and access. In the first Apple-Penguin meeting, Apple outlined several essential conditions which it indicated it would insist on if it were to go into the eBook business: (1) Apple would not be willing to operate its eBook business at a loss; (2) all publishers would be treated equally; (3) the time for negotiation would be very short because the launch of the iPad and the iBookstore would take place in late January and a decision would have to be reached by then. Notably, Penguin did not propose or offer to do business based upon the agency model. Instead, Penguin was prepared to go forward based upon wholesale terms and, indeed, sent a proposed contract to Apple. It was ignored. (PSOF ¶¶ 93-95.)

It was not secret at this time that Apple was approaching publishers about a bookstore. It had been reported by CNN and was discussed in the press. (PSOF ¶ 97.) And it was no secret that Apple would have to convince multiple publishers to agree to provide their titles to the store. A bookstore with only one publisher's titles would be like a shoe store with only left-footed shoes. (PSOF ¶ 96.)

On January 5, 2010, Apple sent Penguin (and, as it turned out, to five other eBook publishers) the terms under which it would agree to go forward in opening its online bookstore. It called for an agency arrangement. This was the first time Penguin began to consider a principal/agent relationship with Apple for eBooks. (PSOF ¶ 102.)

Penguin and Apple then engaged in intense negotiations with respect to this agency proposal. Penguin analyzed the deal and negotiated the best terms it believed it could get. Most critically, Penguin analyzed the model and determined that while it would lower Penguin's effective wholesale price (*i.e,* the amount it would receive per title), Penguin plausibly believed it

would increase sales sufficiently to make the deal profitable. Penguin made this determination and its decision by itself. (PSOF ¶¶ 108-21.)

On January 25, 2010, Penguin and Apple executed a formal agency arrangement, a form of vertical distribution agreement. The central elements of the deal were as follows:

1. Apple would function as Penguin's agent and be compensated by a 30% commission.

2. Penguin would sell the eBooks directly to the consumers and would set the price to be paid by the consumers.

3. A formula ("price grid") was adopted which established a ceiling price for eBooks, limiting the amount Penguin could charge consumers.

4. Penguin agreed that if Apple's competitive retailers offered eBook titles at a lower price than Penguin was pricing the same titles, Penguin would reduce its price for those same titles in order to keep Apple competitive.

At or about the same time that Penguin and Apple entered into this agency agreement, four other publishers—Simon & Schuster, MacMillan, Hachette and Harper Collins—entered into agency agreements with Apple. Apple had been able to collect its critical mass of book publishers necessary to give it the reasonable possibility of success.

Apple then became a new entrant and Penguin considered whether to move its other accounts to the agency model. Based upon what it viewed as its reasonable business interests, ultimately independently determined to do so. Penguin and Amazon, however, could not come to terms. For a period of approximately four months, the two businesses negotiated and Penguin operated both under agency terms and wholesale. Amazon and Penguin then came to terms. (PSOF ¶¶ 140-47.)

The entry of Apple and Penguin (and other publishers) adoption of the agency model has benefited consumers. eBooks prices are down. (PSOF ¶¶ 156-66.) Output is up. (PSOF ¶¶ 161-62.) New entrants now sell books, including hundreds of independent bookstores. (PSOF

¶¶ 172-76.) Other market participants, like Barnes & Noble, are stronger competitors and have taken significant share from Amazon. (PSOF ¶ 169.) Enhanced eBooks are now possible. (PSOF ¶ 190.) Device competition is fierce and their prices have dropped. (PSOF ¶ 191.)

Amazon, admittedly, can no longer loss lead the in selling Penguin's book—Penguin sets those prices. But Amazon still has the same incentive to draw eyeballs to its website and capture consumers into its platform—it simply does it through loss leading other publisher's titles and its devices. And Penguin, as a bookseller direct to consumers, competes with Amazon. (PSOF ¶¶ 183-90.)

This is the background for this competition lawsuit.

ARGUMENT

I. LEGAL STANDARD

Section 1 of the Sherman Act prohibits "only unreasonable restraints of trade." *Bus. Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 723 (1988). To prove Penguin liable for an antitrust conspiracy, the States must show, by a preponderance of the evidence, *see In re Publ'n Paper Antitrust Litig.*, 690 F.3d 51, 61 (2d Cir. 2012), (i) "a combination or some form of concerted action between at least two legally distinct economic entities" that (ii) "constituted an unreasonable restraint of trade either *per se* or under the rule of reason." *PepsiCo., Inc. v. Coca-Cola Co.*, 315 F.3d 101, 109 (2d Cir. 2002).

With regard to the first prong, there is a "basic distinction between concerted and independent action," since "[i]ndependent action is not proscribed" under Section 1. *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 760-761 (1984). If the action is deemed concerted, the second prong tests whether the action was nonetheless reasonable under the so-called "rule of reason," which "is the accepted standard for testing whether a practice restrains trade in violation of § 1." *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 885 (2007). Only an

extremely narrow category of practices that "have 'manifestly anticompetitive' effects, and lack . . . any redeeming virtue," are deemed *per se* illegal restraints. *Id.* at 886.

At all times, the burden is on the States to show an agreement that "reveal[s] a unity of purpose or a common design and understanding, or a meeting of minds in an unlawful arrangement"—put another way, "a conscious commitment to a common scheme designed to achieve an unlawful objective." *Monsanto Co.*, 465 U.S. at 764 (internal citation omitted). For the reasons that follow, the States cannot meet their burden.

II. THE STATES CANNOT PROVE THAT PENGUIN PARTICIPATED IN A CONSPIRACY IN VIOLATION OF SECTION 1 OF THE SHERMAN ACT

Although the States assert three independent conspiracies in their Complaint, they allege that Penguin joined only two of them: a horizontal agreement among the publishers to raise eBook prices by the end of summer 2009 (Second Am. Compl. ¶ 120) (Count I); and a horizontal agreement among the publishers, facilitated by Apple, to raise eBook prices by January 2010 (*id.* ¶¶ 126–28) (Count III). The States do not allege that Penguin participated in the conspiracy described in Count II, the "windowing" of eBooks in the fall of 2009. (*Id.* ¶¶ 123–25). In addition, in Count IV, the States assert a host of state-law antitrust claims that parallel, and are contingent upon, Counts I & III. *See* Joint Pretrial Order at 8.

Section 1 of the Sherman Act applies only to "contract[s], combination[s] . . . or conspirac[ies]" that are in restraint of trade. 15 U.S.C. § 1. In evaluating claims under the Act, courts typically distinguish "horizontal" restraints, involving concerted action between competitors, from "vertical" restraints, involving agreements "at different levels of the market structure," such as between manufacturers and distributors. *United States v. Topco Assocs., Inc.*, 405 U.S. 596, 608 (1972); *see Anderson News, LLC v. Am. Media, Inc.*, 680 F.3d 162, 182 (2d Cir. 2012). The States cannot show a conspiracy here because they have not alleged that

Penguin's vertical agreement with Apple, standing alone, violates the Sherman Act. Nor can they prove that Penguin entered into any horizontal agreement with fellow publishers, let alone a horizontal conspiracy with the purpose and effect of raising eBook prices.

A. The States Do Not Allege A Vertical Agreement In Restraint Of Trade

As a preliminary matter, the only restraints alleged by the States are "horizontal" agreements between Penguin and the other publishers (Count I), or between Penguin and the other publishers, as "facilitated" by Apple (Count III). (*See* Second Am. Compl. ¶¶ 121, 127; States' Objections and Responses to Penguin Group (USA), Inc.,'s Contention Interrogatories, No. 11 ("Counts I and III of the Second Amended Complaint both allege horizontal conspiracies.")).

As such, although it is undisputed that Penguin entered into a vertical agency agreement with Apple, the States nowhere allege that this agreement, standing alone, was unlawful. That makes sense. After all, the States do not "challenge whether Penguin['s] . . . e-book distribution contracts at issue in this case establish [a] genuine agency relationship[] with" Apple (Ltr. from Pl. States to Judge Cote, Oct. 15, 2012 (Dkt. No. 127, 12-cv-3394)), and courts have held that such close relationships between suppliers and distributors cannot be considered concerted action under Section 1 where the agent is simply a "salaried conduit" for the supplier. *Hardwick v. Nu-Way Oil Co.*, Inc., 589 F.2d 806, 811(5th Cir. 1979); *see Call Carl, Inc. v. BP Oil Corp.*, 554 F.2d 623, 627–28 (4th Cir. 1977) (holding, in the context of an agency relationship, that "there can be no underlying price fixing conspiracy upon which to hinge a *per se* Section 1 violation" as a supplier "is entitled to select the price at which it sells its own products"); *see also Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 769 (1984).

Even if the States had separately challenged Penguin's agency agreement with Apple, their challenge would fail. Vertical agreements are "widely used in our free market economy"

and "there is substantial scholarly and judicial authority supporting their economic utility." *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 57–58 (1977). This includes vertical agreements where a manufacture sets a minimum price for the sale of its product; such agreements have various procompetitive effects like "stimulat[ing] interbrand competition," which is "the primary purpose of the antitrust laws." *Leegin*, 551 U.S. at 890 (internal quotation marks omitted). And as explained below, *see infra* Part III.A, the vertical agreement between Penguin and Apple in this case had numerous procompetitive effects, such as lowering eBook prices, increasing sales, and encouraging a new eBook retail market entrant, the iBookstore.

B. The States Cannot Prove A Horizontal Agreement In Restraint Of Trade

Because they assert no unlawful vertical restraint of trade involving Penguin, the States can only prevail if they prove their horizontal price fixing allegations, *i.e.*, if they demonstrate that Penguin entered into a conspiracy with its competitors that was "formed for the purpose and with the effect of raising . . . price[s]." *In re Publ'n Paper Antitrust Litig.*, 690 F.3d at 61–62. (*See* Second Am. Compl. ¶¶ 120-121 (alleging agreement "to raise e-book prices"); 127 (alleging that the "Agency Model [i]s a mechanism to raise the retail prices for frontlist e-books")). Whether the States could prove a conspiracy among some or all of the publishers is irrelevant; instead, the question for trial is whether *Penguin* conspired with the other publishers with respect to any of the conspiracies alleged in the States' complaint.

Because "an arrangement must embody concerted action in order to be a 'contract, combination . . . or conspiracy' under § 1," *Am. Needle, Inc. v. Nat'l Football League*, 130 S. Ct. 2201, 2209 (2010), "[t]he crucial question" in such cases is "whether the challenged conduct 'stems from independent decision or from an agreement, tacit or express,'" *Starr v. Sony BMG Music Entm't*, 592 F.3d 314, 321 (2d Cir. 2010) (quoting *Theatre Enters., Inc. v. Paramount Film Distrib. Corp.*, 346 U.S. 537, 540 (1954)). "[P]roof of joint or concerted action is required;

proof of unilateral action does not suffice." *Anderson News, LLC*, 680 F.3d at 183; *see Volvo N. Am. Corp. v. Men's Int'l Prof'l Tennis Council*, 857 F.2d 55, 70-71 (2d Cir. 1988) (noting that Section 1 "does not prohibit independent business actions and decisions" (internal quotation marks omitted)). Therefore, the burden is on the "plaintiff seeking damages for a violation of § 1 of the Sherman Act [to] present evidence that "tends to exclude the possibility" that the alleged conspirators acted independently." *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 588 (1986).

The States do not purport to offer any direct evidence that tends to exclude the possibility that Penguin acted independently, such as a defendant admission, a corroborating witness, or a written agreement. In the absence of direct evidence, the only way for the States to prove a conspiracy to raise prices is through "circumstantial facts supporting the inference that a conspiracy existed." *Mayor & City Council of Baltimore, Md. v. Citigroup, Inc.*, 709 F.3d 129, 136 (2d Cir. 2013). The States' main evidence is parallel conduct in that Penguin entered an agency agreement shortly before the launch of the iBookstore and around the same time as some of the other publishers. But parallel conduct alone is insufficient to support an inference of conspiracy. *Apex Oil Co. v. DiMauro*, 822 F.2d 246, 253 (2d Cir. 1987); *see Theater Enters., Inc.*, 346 U.S. at 541. "[M]erely observing parallel conduct among competitors does not necessarily explain its cause," *Mayor*, 709 F.3d at 136, as parallel conduct that is "consistent with conspiracy" may be "just as much in line with a wide swath of rational and competitive business strategy unilaterally prompted by common perceptions of the market." *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 554 (2007). For this reason, parallel conduct must be accompanied by other factors that tend to exclude the possibility that the party acted independently. *See Todd v. Exxon Corp.*, 275 F.3d 191, 198 (2d Cir. 2001) (noting that an agreement "may be inferred on the basis

of conscious parallelism, when such interdependent conduct is accompanied by circumstantial evidence and plus factors").

1. The States fail to allege that Penguin joined a Count I horizontal conspiracy.

The States assert two independent conspiracies that Penguin purportedly joined. Regarding the first, the States allege that "[b]y no later than the end of summer 2009, Macmillan, Penguin, and the other three . . . publishers entered into an agreement to work together to raise . . . e-book retail prices from the $9.99 price point." (Second Am. Compl. ¶ 120). Their principal evidence for this claim is that, "[o]n or around June 16, 2009, John Makinson attended a dinner at Picholine in New York City where he discussed Amazon's role in e-books," along with other vague references to "discussions" and "communications" in July 2009. (*See* States' Responses and Objections to Penguin Group (USA), Inc's Interrogatories, Am. Response to Contention Interrogatory No. 2; *see also* Second Am. Compl. ¶¶ 30–31 (alleging generally that the publishers shared common fears and concerns about the future of the eBooks market); *id.* ¶ 33 (the publishers attended various "exclusive" dinners in New York); *id.* ¶¶ 34–36 (some publishers—although not Penguin—took independent actions during the relevant time period)). The States also vaguely allege (but have not yet pointed to corroborating evidence) that Penguin had agreed with the other publishers "that something had to be done" about Amazon's pricing and "were collectively searching for the means" to effectuate a price increase that summer. (Second Am. Compl. ¶ 40).

Whatever evidence the States may have about other publishers, such allegations are plainly inadequate to prove a conspiracy against Penguin. That is because plaintiffs have failed to even allege, never mind prove, "circumstantial facts supporting the inference that a conspiracy existed" by July 2009. *Mayor*, 709 F.3d at 136; *see Twombly*, 550 U.S. at 565 (rejecting a

Section 1 claim based on pleadings that "mentioned no specific time, place, or person involved in the alleged conspiracies"). Penguin cannot be swept into a conspiracy claim because it "shared common fears" with other publishers, and because its CEO ate "dinner at Picholine" with business colleagues. *See PepsiCo., Inc.*, 315 F.3d at 109 (To prove a Section 1 violation, a plaintiff must show "a combination or some form of concerted *action* . . . that constituted an unreasonable restraint of trade" (emphasis added)); *see also Proof of Conspiracy Under Federal Antitrust Laws* 63 (2010) ("As a threshold matter, in cases relying on conscious parallelism, plaintiffs must establish that defendants in fact took similar actions.").

Indeed, the extreme inadequacy of the States' proof with regard to Penguin's ostensible 'agreement to agree' in the summer of 2009 "that something had to be done" is brought home by examining Count II, which involves four of the publishers—but not Penguin. Count II concerns the "windowing" of eBooks to Amazon, *i.e.*, delaying the release of an eBook until well after the printed version is released. As the States themselves freely admit, this action, which did not occur until the "fall of 2009," was actually the "*first* collective attempt to raise prices." (Second Am. Compl. ¶ 41 & 12 (emphasis added)); *see also In re Elec. Books Antitrust Litig.*, 859 F. Supp. 2d 671, 675 (S.D.N.Y. 2012) (hereinafter "Class Action Order") (noting that the related Class Action Complaint alleges that the conspiracy began in fall 2009 with the "windowing" of eBooks). In other words, despite alleging in Count I that Penguin tacitly agreed with the other publishers to raise prices, the undisputed fact is that Penguin explicitly rejected the first collective attempt to do so. Needless to say, such "evidence" is worthless in showing an illegal agreement and indeed points in exactly the opposite direction. Count I fails as a matter of law.

2. The States cannot prove that Penguin joined a Count III horizontal conspiracy.

In the absence of any evidence showing "concerted action" by Penguin in either the summer or fall of 2009, the States' only argument is that Penguin joined the conspiracy "by no later than January 25, 2010," when it adopted the agency agreement with Apple. (States' Responses and Objections to Penguin Group (USA), Inc.'s Contention Interrogatories, Am. Response to Contention Interrogatory No. 1). There is, of course, no dispute that Penguin executed a distribution agreement with Apple on that date to sell eBooks under an agency model whereby Penguin would set the price (subject to certain maximum price caps) and Apple would take a 30% commission. But Penguin did so as part of unilateral negotiations regarding "Apple's proposal" of the agency model (Second Am. Compl. ¶ 63) in anticipation of the launch of the iPad and the iBookstore—not based on any agreement, tacit or explicit, with another publisher.

In particular, the record will show that:

- Penguin received an unsolicited phone call from Apple on December 11, 2009, requesting a meeting with CEO David Shanks to discuss eBooks. (PSOF ¶ 91).

- In an initial meeting on December 15, 2009, Apple proposed the possible eBook store to Penguin. (*Id.* ¶ 93)

- Penguin was prepared to proceed under a wholesale model with Apple and, indeed, Penguin's general counsel and director of digital sales worked during their respective Christmas vacations to draft a proposed wholesale contract, which was sent to Apple on January 4, 2010. (*Id.* ¶ 100).

- Penguin had no further substantive communications with Apple until a January 6, 2010 email, in which Apple proposed the agency model in concrete terms. (*Id.* ¶ 100). That email stated Apple's conclusion that agency terms were "the best approach for eBooks" and insisted that "all resellers of new titles need to be in the agency model." (*Id.* ¶ 100; PEN Ex. 61).

- Penguin's initial response to the agency model was negative, since the proposed detail terms would reduce Penguin's revenues on a per title basis. (PSOF ¶¶ 104, 111). Penguin's management ultimately agreed to the agency model only when convinced that the deal made business sense for the company. (*Id.* ¶¶ 125–28). Although the

agency terms would yield less money and margin per title, Penguin estimated that the broader distribution through Apple would increase sales volume and make the deal profitable (*Id.*).

- On January 25, 2010, the day scheduled for execution of the agreement, Apple proposed new deal terms that fundamentally changed the value of the agreement for Penguin. (Id. ¶ 129). Penguin rejected these last-minute changes and told Apple that it "would not play" under the new terms. (*Id.* ¶ 130). Only after the terms were renegotiated did Penguin enter the agency agreement with Apple. (*Id.*)

The States offer no evidence that "tends to exclude the possibility" that bilateral negotiations with Apple were the motivating force in Penguin's adoption of the agency model. *Matsushita*, 475 U.S. at 588. In fact, the States assert no direct evidence of an express or tacit agreement among the publishers, instead relying wholly on circumstantial evidence in the form of parallel conduct, plus a handful of isolated interfirm communications and emails with Apple. But none of this evidence shows that Penguin entered into a conspiracy.

First, the States focus on parallel conduct—namely, the similarity in the terms of the various agency agreements and the near-simultaneity in the execution of the various vertical agreements—as suggesting concerted action. But as the record makes clear, and as the States themselves concede, these parallel features are explained by two simple facts: from the outset, Apple insisted (1) that the material terms of the agreements be essentially the same; and (2) that the timing of the agreements' execution be controlled by the impending launch of the iPad and the iBookstore on January 27, 2010. (PSOF ¶¶ 94, 106). Because Apple approached each of the publishers in the same time frame, demanded the same initial contract terms, and offered the same hard-and-fast deadline, no inference of horizontal conspiracy can be drawn from the fact that Apple ultimately entered into similar agreements with different publishers. "An antitrust plaintiff may not . . . rest on conclusory assertions of conspiracy when the defendants have

proffered substantial evidence supporting a plausible and legitimate explanation of their conduct." *Burlington Coat Factory Warehouse Corp. v. Esprit De Corp.*, 769 F.2d 919, 923 (2d Cir. 1985).

In other words, the parallel conduct alleged here resulted from "independent responses to common stimuli" or "interdependence unaided by an advance understanding among the parties," *Twombly*, 550 U.S. at 556 n.4, and accordingly does not constitute a horizontal conspiracy in violation of the Sherman Act. *See In re Ins. Brokerage Antitrust Litig.*, 618 F.3d 300, 328 (3d Cir. 2010) ("[P]laintiffs' logic would divine a horizontal agreement from virtually any parallel expenditures for marketing services, on the mistaken ground that a firm would not pay for advertising . . . in the absence of an agreement with its competitors to enter into similar contracts with the advertising company."). To the extent Penguin's contract is similar to the contracts entered by the other publishers, those "[s]imilar contract terms . . . reflect similar bargaining power and commercial goals" on the part of all the publishers. *In re Elevator Antitrust Litig.*, 502 F.3d 47, 51 (2d Cir. 2007). In these circumstances, similarity and simultaneity are fully explained without any suggestion of conspiracy.

Second, and relatedly, in this Circuit vertical deal terms unilaterally and uniformly imposed by a vertical distribution partner do not evidence a horizontal conspiracy. *See PepsiCo, Inc.*, 315 F.3d at 110 (rejecting Section 1 claim "that because Coca-Cola assured each of the [distributors] that it would uniformly enforce similar loyalty agreements with other [distributors], Coca-Cola's loyalty policy is, in reality, a *per se* illegal horizontal conspiracy among the [distributors] and Coca-Cola"). Because the agency agreements with Apple were vertical deals unilaterally insisted upon by Apple, they cannot be re-characterized as a horizontal conspiracy. *See* Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 1402c, n.35 (3d ed. 2010) ("[I]f a vendor sells to a vendee with the promise 'all other vendees are paying the same price' that does

not serve to turn a set of identical . . . purchasing agreements into a horizontal price-fixing conspiracy."); *id.* ¶ 1427 n.47 ("[I]f the buyer of any product wishes to condition its purchase on several sellers' agreeing with him, characterizing sellers who do so as conspirators with each other serves no purpose of the antitrust laws.").

Although the States may point to certain vertical assurances made by Apple to Penguin regarding its distribution terms with other publishers, such assurances by their nature are *vertical* terms. *See PepsiCo, Inc.*, 315 F.3d at 110 (rejecting horizontal conspiracy theory where plaintiff's only "'offer of proof' of an agreement was simply that Coca-Cola assured the [distributors] that the loyalty policy would be uniformly enforced [across distributors] and encouraged them to report violations"); *see also In re Ins. Brokerage Antitrust Litig.*, 618 F.3d at 329–30 ("[A] manufacturer's practice of informing each of its distributors of the identities of its other distributors—as well as the prices they paid and the volume they received—would not plausibly imply a horizontal agreement among the distributors[.]"); *Howard Hess Dental Labs. Inc. v. Dentsply Int'l, Inc.*, 602 F.3d 237, 254 (3d Cir. 2010) (finding no horizontal conspiracy, even though "*every Dealer knew that every other Dealer agreed, or would agree, to this same plan*" (emphasis supplied)). Thus, the vertical assurances made by Apple cannot support an inference that Penguin entered into an unlawful horizontal agreement with its competitors.

Third, the States proffer evidence of a handful of isolated phone calls (but no emails) between Penguin and two of its competitors between January 5, 2010 and the execution of the Agency Agreement on January 25, 2010. Yet there is virtually no evidence that any of those communications with executives at Hachette or Simon & Schuster concerned Apple; CEO David Shanks (at the time of the investigation) recalled a grand total of two passing references to Apple

during phone calls in late 2009 and early 2010. (David Shanks Aff. ¶ 96).[2] There is certainly no evidence at all of communications concerning an agreement to raise eBook prices. *See* Phillip E. Areeda & Herbert Hovenkamp, *Fundamentals of Antitrust Law* § 14.04a (3d ed. Supp. 2010) ("[T]he existence of meetings or phone conversations among the defendants does not warrant the inference that they agreed about prices, terms of dealing with the plaintiff, or any other subject matter even if such subjects were discussed."). In truth, the most notable thing about Penguin's interfirm communications in January 2010 is how few there were compared to the dozens of phone calls that executives at MacMillan and Simon & Schuster made with other publishers. (*See* Second Am. Compl. 20-21 (charts of phone calls); *see also id.* ¶ 74 (noting that Penguin was "not included in the previous charts")).

In any event, courts have consistently recognized that mere chatter between competitors is itself insufficient to prove an agreement as a matter of law. *Apex Oil Co.*, 822 F.2d at 254 ("interfirm communications . . . may not necessarily lead to an inference of conspiracy"); *see Proof of Conspiracy Under Federal Antitrust Laws* 76–78 ("Plaintiffs often cite the opportunity to conspire—such as meetings or conversations among alleged conspirators—as a plus factor. This plus factor, however, is given relatively little weight."). This is particularly true where, as here, the competitors were engaged in ongoing legitimate joint venture activity. (*See* PSOF ¶¶ 79–90, 135).[3]

Fourth, the States argue that "the conspiracy alleged in Count III of the Second Amended Complaint could reasonably be referred to as a 'hub and spoke' conspiracy," in that the States are

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[2] There is no record of any Penguin communications at all with Harper Collins or MacMillan during this time period.

[3] In this case, Penguin's high-level communications with other publishers must be understood and evaluated in light of the fact that Penguin was contemporaneously involved in the creation of Bookish, a legitimate collaboration among Penguin, Hachette, and Simon & Schuster. Plaintiff States have not alleged—nor could they—anything improper about this joint venture activity.

alleging a "conspiracy among horizontal competitors facilitated by a common vertical firm[.]" (States' Responses and Objections to Penguin Group (USA), Inc.'s Contention Interrogatories, Response to Contention Interrogatory No. 9). Such a conspiracy typically "involves a hub, generally the dominant purchaser or supplier in the relevant market, and the spokes, made up of the distributors involved in the conspiracy. The rim of the wheel is the connecting agreements among the horizontal competitors (distributors) that form the spokes." *Dentsply Int'l*, 602 F.3d at 255 (internal quotation marks omitted).

The States' theory begs the question of whether a publisher conspiracy exists. Although the States can point to the existence of a hub (Apple) and spokes (the publishers), as already explained they fail to identify a separate "rim" involving Penguin—*i.e.*, the "connecting agreements among the horizontal competitors." *Id.* at 255. And without the publisher agreement, the States cannot show that Penguin was part of anything other than a "rimless" hub-and-spoke conspiracy, *i.e.*, a series of vertical price restraints between Apple and the publishers. *See Dickson v. Microsoft Corp.*, 309 F.3d 193, 203 (4th Cir. 2002) ("A rimless wheel conspiracy is one in which various defendants enter into separate agreements with a common defendant, but where the defendants have no connection with one another, other than the common defendant's involvement in each transaction."). Penguin's vertical agreement with Apple simply cannot be transformed into a horizontal conspiracy with other publishers by virtue of their common customer alone. *See PepsiCo, Inc.*, 315 F.3d at 109.

Finally, the States suggest that Penguin would not offer its books for sale on Apple's iBookstore unless it knew that a critical mass of other publishers would do the same. True enough. But nothing about Penguin's desire to have other publishers participate in the iBookstore launch aids the States' theory that Penguin entered into an agreement to *raise eBook*

prices. Cf. Monsanto Co., 465 U.S. at 764 (a plaintiff must show "a conscious commitment to a common scheme designed to achieve an unlawful objective"). The actual reason Penguin wanted a critical mass of other publishers to participate is that, like Apple, Penguin only wanted to participate in the iBookstore if it was going to be a successful venture with content from a variety of publishers. (PSOF ¶¶ 106–07). Especially considering Amazon's dominant market share at the time, Penguin had a legitimate and procompetitive interest in the success of a new potential distribution partner. *See State of New York by Abrams v. Anheuser-Busch, Inc.*, 811 F. Supp. 848, 876–78 (E.D.N.Y. 1993) ("Producers have a legitimate interest in ensuring that their distributors have the financial ability to implement the policies aimed at making them more effective competitors in the interbrand market.").

Thus, the key point is that, while Penguin was indisputably interested in a critical mass of publishers joining Apple's new eBook retail store, Penguin did not therefore agree with them to join, and it was certainly never interested in the *distribution model* its competitors negotiated with Apple. Based on Penguin's desire to have other publishers in the iBookstore, the States allege the upside-down theory that Penguin "entered into a horizontal agreement" with the other publishers "to use the Agency Model" as a way to raise prices. (Second Am. Compl. ¶ 127). In reality, the important thing for Penguin was broad-based participation in the iBookstore, not whether Macmillan or any other publisher sold its books to Apple on a wholesale or agency arrangement.

3. The States cannot show that Penguin joined a Count III conspiracy with the purpose and effect of raising eBook prices.

Although the States repeatedly accuse Penguin of conspiring with Apple and others to *raise the price of eBooks*, their evidence at best shows Penguin's agreement with Apple to change the *distribution method* for eBooks from the wholesale model to the agency model with

awareness that other publishers were being offered similar terms. But Penguin's adoption of the Agency Agreement a mere two days prior to the launch of the iBookstore "lead[s] to an equally plausible inference of mere interdependent behavior" as a result of a common stimulus, *Apex Oil Co.*, 822 F.2d at 254, as opposed to any inference of an "advance understanding" of a plot to raise eBook prices, *Twombly*, 550 U.S. at 556 n.4. This is particularly true because the States do not dispute that the model is itself genuine and valid. *See* Ltr. from Pl. States to Judge Cote, Oct. 15, 2012 (Dkt. No. 127, 12-cv-3394) (declining to "challenge whether Penguin['s] . . . e-book distribution contracts at issue in this case establish [a] genuine agency relationship[] with" Apple).

In fact, the States cannot prove an agreement at all, never mind an agreement to raise prices, based on the circumstantial evidence that Penguin later transitioned its other partners, including Amazon, to an agency arrangement as well. After considering a range of options, including a mix of both agency and wholesale models, Penguin ultimately settled on having a single agency model across all of its accounts. (PSOF ¶¶ 140, 147.) It had a perfectly legitimate business case for doing so – in particular, it made the most sense given tax and other legal requirements. (*Id.* ¶ 140.) Several of Penguin's customers, including Barnes & Noble and Kobo, were already anxious to move to the agency model themselves and negotiations moved quickly. (*Id.* ¶ 141.) Penguin also negotiated with Amazon and, while those negotiations were contentious, they hung up on Amazon's demand for a more-"onerous" most-favored nation clause of its own – *not* on a dispute over an agency as opposed to a wholesale model. (*Id.* ¶¶ 143-146.) Because Penguin decided to move to the agency model across all its accounts for its own reasons, and not because of Apple or the most-favored nation clause in the agency agreement, the States' evidence cannot show a "conscious commitment to a common scheme

designed to achieve an unlawful objective." *Monsanto Co.*, 465 U.S. at 764 (internal citation omitted).

III. PENGUIN'S ADOPTION OF THE AGENCY MODEL IS REASONABLE BECAUSE OF ITS MANIFESTLY PROCOMPETITIVE EFFECTS

Even if the States could prove a combination or some other form of concerted action among the publishers, that does not rise to a showing that the action was "an *unreasonable* restraint of trade[.]" *PepsiCo., Inc.*, 315 F.3d at 109 (emphasis added). The background principle in antitrust law is that "[t]he rule of reason is the accepted standard for testing whether a practice restrains trade in violation of § 1." *Leegin*, 551 U.S. at 885. As such, the Supreme Court "presumptively applies rule of reason analysis, under which antitrust plaintiffs must demonstrate that a particular contract or combination is in fact unreasonable and anticompetitive before it will be found unlawful." *Dagher*, 547 U.S. at 5; *see GTE Sylvania, Inc.*, 433 U.S. at 49 (under the rule of reason, "the factfinder weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition"). The States cannot carry their burden to demonstrate that the adoption of the agency agreement was on balance anticompetitive and therefore unreasonable.

A. The Adoption Of The Agency Model Was Procompetitive And Reasonably Expected To Promote Enterprise and Productivity

Penguin's conduct in adopting the agency model and joining the iBookstore launch was on balance procompetitive and reasonable. First and foremost, the agency agreement facilitated the entry of Apple into the eBook retail market. In the course of negotiations with Penguin, Apple made clear that it would enter the eBook market only if a "critical mass" of publishers agreed to participate (PSOF ¶ 106) and that agency terms were, in Apple's judgment, "the best approach for eBooks." (Id. ¶ 102; PEN Ex. 61). Thus, there can be no serious dispute that Penguin, by choosing to sign the agency agreement, facilitated Apple's entry into the eBook

market—a clear procompetitive benefit. *See Leegin*, 551 U.S. at 891 (identifying facilitation of market entry as a procompetitive benefit).

Moreover, sales of eBooks have increased dramatically under the Agency Model. In a period of approximately two years after Apple entered the market, the quantity of eBooks purchased each quarter rose from approximately 18 million to approximately 100 million, an increase of more than 447%. (PSOF ¶ 161). The iBookstore alone sold nearly 30 million eBooks and provided another 92 million "free" eBooks during the same period. (*Id.* ¶ 161). The greater output of eBooks under the Agency Model also constitutes a clear procompetitive benefit. *See* Areeda & Hovenkamp, *Fundamentals of Antitrust Law* § 15.02c (3d ed. Supp. 2010) ("A combination of competitors that makes possible production that would not otherwise occur at all clearly brings a legitimate benefit.")

As the volume of eBook sales has increased, average retail eBook prices have declined over time. Immediately following the shift to the Agency Model in April 2010, there was a short-lived increase in average eBook retail prices. (Burtis Aff. ¶ 28). But only one year after the alleged Count III conspiracy began, in January 2011, average eBook prices were lower than they had been prior to the Agency Model. (Id. ¶ 20). In the post-agency period, the weighted-average retail price of an eBook was $7.34, compared with $7.97 during the corresponding pre-agency period. (*Id.* ¶ 156).

In addition, eBook retailers have introduced a wide array of new and innovative e-reader devices and tablets after the implementation of the Agency Model. For example, between April 2010 and November 2012, Amazon introduced the Kindle Fire, the Kindle Touch, and the Kindle Paperwhite; Barnes & Noble introduced the Nook Color, the Nook Simple Touch, and the Nook Tablet; Apple introduced three iPad Wi-Fi devices and the iPad Mini; Sony introduced the Pocket

Edition PRS-350 and the Touch Edition PRS-650; Kobo introduced the Kobo eReader and the Kobo Touch; and Google introduced the iRiver Story HD and two Nexus devices. (Burtis Aff., Ex. 3). These new and improved e-readers were introduced at relatively lower prices compared with the pre-Agency period. Devices introduced by Amazon and Sony in the period prior to the Agency Model ranged from $199 to $489 each. (*Id.*). After April 2010, numerous devices with enhanced functionality were introduced at substantially lower price points, including the fourth-generation Kindle at $79 (September 2011), the Kindle Touch Wi-Fi version at $99 (November 2011), the fifth-generation Kindle at $69 (September 2012), and the Kobo Mini at $80 (October 2012). (*Id.*) These technological advances are further evidence of the procompetitive effects of the Agency Model. *See Leegin*, 551 U.S. at 891 ("New products and new brands are essential to a dynamic economy"); Areeda & Hovenkamp, *Fundamentals of Antitrust Law* § 15.02c (3d ed. Supp. 2010) ("The achievement of lower costs of production or better research and development are consistent with the purposes of the antitrust laws.").

In sum, the empirical evidence adduced at trial will clearly establish the procompetitive benefits of the Agency Model.

B. Penguin's Actions Were Not *Per Se* Unlawful

Although the rule of reason is "presumptively applie[d]" in evaluating restraints under the antitrust laws, *Dagher*, 547 U.S. at 5, there is a narrow category of agreements that have been shown, through judicial experience, to "always or almost always tend to restrict competition and decrease output," and thus are assumed unlawful *per se*, *Bus. Elecs. Corp.*, 485 U.S. at 723. However, "[t]o justify a *per se* prohibition a restraint must have 'manifestly anticompetitive' effects, and lack any redeeming virtue." *Leegin*, 551 U.S. at 886 (internal citations and quotation marks omitted); *Nat'l Soc'y of Professional Engineers v. United States*, 435 U.S. 679 (1978) (reserving *per se* liability for agreements that are "so plainly anticompetitive that no elaborate

study of the industry is needed to establish their illegality"). This court has previously recognized that "in most cases, 'antitrust plaintiffs must demonstrate that a particular contract or combination is in fact unreasonable and anticompetitive before it will be found unlawful.'" Class Action Order at 682 (quoting *Dagher*, 547 U.S. at 5).

The States allege that the publishers agreed "to fix e-book prices" in the iBookstore (*see, e.g.*, Second Am. Compl. ¶ 89), and normally "agreements among competitors to fix prices on their individual goods and services are among those concerted activities" that are considered *per se* illegal under Section 1, *Broadcast Music, Inc. v. Columbia Broadcasting System*, 441 U.S. 1, 8 (1979) ("*BMI*"). Nevertheless, this Court must analyze Penguin's actions under the rule of reason, for three reasons: (1) this is not a *per se* illegal naked price-fixing case; (2) this is not a *per se* illegal hub-and-spoke conspiracy; and (3) in any event, no agreement is considered illegal *per se* when the concerted action could "reasonably have been believed to promote enterprise and productivity." *In re Sulfuric Acid Antitrust Litig.*, 703 F.3d 1004, 1110–11 (7th Cir. 2012).

1. Penguin did not engage in naked price fixing.

Determining whether a particular business practice is *per se* unlawful as "price fixing" in violation of the Sherman Act involves more than "a question simply of determining whether two or more potential competitors have literally 'fixed' a 'price.'" *BMI*, 441 U.S. at 9. That is because "'price fixing' is a shorthand way of describing certain categories of business behavior to which the *per se* rule has been held applicable." *Id.* In reality, "there is often no bright line separating *per se* from Rule of Reason analysis" as "[*p*]*er se* rules may require considerable inquiry into market conditions before the evidence justifies a presumption of anticompetitive conduct." *Nat'l Collegiate Athletic Ass'n v. Bd. of Regents of Univ. of Oklahoma*, 468 U.S. 85, 104 (1984); *see Volvo N. Am. Corp.,*, 857 F.2d at 71-72 ("'Once a court has properly characterized a practice as price fixing, it is *per se* illegal. However, determining when a

practice should be so characterized can be very difficult, and may involve a fair amount of *sophisticated* economic inquiry.'") (quoting H. Hovenkamp, *Economics and Federal Antitrust Law* § 4.4, at 128). The Supreme Court has also "expressed reluctance to adopt *per se* rules . . . 'where the economic impact of certain practices is not immediately obvious.'" *Dagher*, 547 U.S. at 5 (2006).

That is why the *per se* treatment of a horizontal price agreement is generally limited to a "naked" price-fixing restraint, *i.e.*, an "agreement not to compete in terms of price or output," *Nat'l Collegiate Athletic Ass'n*, 468 U.S. at 109, "with no purpose except stifling of competition," *Arizona v. Maricopa Cnty. Med. Soc'y*, 457 U.S. 332, 362 (1982) (internal quotations omitted). In fact, a plaintiff is "mistaken in relying on pricing effects absent a further showing of anticompetitive conduct," given that "the antitrust laws are designed primarily to protect interbrand competition, from which lower prices can later result." *Leegin*, 551 U.S. at 895. Moreover, the mere fact that "prices can be increased in the course of promoting procompetitive effects" will not render conduct price-fixing that therefore mandates *per se* treatment. *See id.*

Under the circumstances here, the alleged agreement among competitors to adopt a similar agency model distribution scheme cannot be considered naked price-fixing that is illegal *per se*. Most obviously, the agency agreements on their faces reveal no agreement *among the publishers* to fix or raise prices, but instead are only separate vertical distribution contracts between each publisher and Apple. Without a "naked" horizontal output restriction or price-fixing among the competitors, the practice is not *per se* illegal because "the economic impact of [the] practice[] is not immediately obvious." *Dagher*, 547 U.S. at 5 (internal citations and quotation marks omitted); *see State Oil Co. v. Khan*, 522 U.S. 3, 10 (1997) ("*Per se* treatment is appropriate once experience with a particular kind of restraint enables the Court to predict with

confidence that the rule of reason will condemn it." (internal citation and quotation marks omitted)).

To be sure, the agency agreement that Penguin entered into contained provisions that involved eBook *pricing*, including (1) provisions that imposed price ceilings (not price floors) on the sales of particular eBooks; and (2) "most favored nation" clauses that obligated Penguin to offer its eBooks to Apple at the lowest price Penguin offered in the market. But neither of these provisions "fixed" or "raised" eBook prices, and accordingly the existence of these vertical pricing terms cannot condemn the alleged horizontal conspiracy as illegal *per se*.

For one thing, the price ceilings provided a *cap* for prices but no corresponding sales *floor*. Needless to say, it is not "immediately obvious" that setting a *ceiling* on the price for eBooks constitutes price fixing. *Dagher*, 547 U.S. at 5. Nor does the existence of a "most favored nation" clause convert the application of the *per se* rule. (*See* Second Am. Compl. ¶¶ 91–92). Contrary to the States' contentions, many courts have recognized that such clauses are fundamentally *pro*competitive. *See Blue Cross & Blue Shield United of Wis. v. Marshfield Clinic*, 65 F.3d 1406, 1415 (7th Cir. 1995) ("'Most favored nations' clauses are standard devices by which buyers try to bargain for low prices, by getting the seller to agree to treat them as favorably as any of their other customers."); *Ocean State Physicians Health Plan, Inc. v. Blue Cross & Blue Shield of R.I.*, 883 F.2d 1101, 1110 (1st Cir. 1989) ("We agree with the district court that such a policy of insisting on a supplier's lowest price—assuming that the price is not 'predatory' or below the supplier's incremental cost—tends to further competition on the merits and, as a matter of law, is not exclusionary."). And even courts that do not admit such clauses' procompetitive benefits nevertheless evaluate them under the rule of reason. *See Blue Cross Blue Shield of Mich.*, 809 F. Supp. 2d at 671 ("The parties agree that in order to assess whether

the MFN clauses unreasonably restrain trade, the 'rule of reason' is applied."); *United States v. Delta Dental of R.I.*, 943 F. Supp. 172, 182 (D.R.I. 1996) (similar). Indeed, Penguin is aware of no court that has condemned a most-favored-nation clause as *per se* illegal. Thus, if anything, the existence of the most favored nation clause in this case mitigates in *favor* of rule of reason, not *per se*, treatment.

2. The hub-and-spoke conspiracy alleged is not illegal *per se*.

Second, and as noted, the States allege, at most, a "rimless" hub-and-spoke conspiracy—*i.e.*, a series of vertical price restraints. The Supreme Court has, however, recently rejected *per se* liability for vertical price restraints. *Leegin*, 551 U.S. at 907 ("Vertical price restraints are to be judged according to the rule of reason."). Accordingly, after *Leegin*, there is no longer a viable antitrust theory of a "rimless" hub-and-spoke conspiracy subject to *per se* liability. The Courts of Appeals have recognized as much, consistently rejecting hub-and-spoke conspiracies in the absence of a cognizable rim. *See PSKS, Inc. v. Leegin Creative Leather Prods., Inc.*, 615 F.3d 412, 420 (5th Cir. 2010) ("In the absence of an assertion that retailers agreed to RPM among themselves, there is no wheel and therefore no hub-and-spoke conspiracy, and that allegation was therefore properly dismissed."); *Dentsply Int'l*, 602 F.3d at 255 ("[T]he amended complaint lacks any allegation of an agreement among the Dealers themselves . . . . In other words, the 'rim' connecting the various 'spokes' is missing."); *Total Benefits Planning Agency, Inc. v. Anthem Blue Cross & Blue Shield*, 552 F.3d 430, 436 (6th Cir. 2008) ("[T]he critical issue for establishing a *per se* violation with the hub and spoke system is how the spokes are connected to each other. The amended complaint falls short of presenting such a connection, offering only a rimless theory."). Because the States cannot establish anything more than a series of vertical price restraints in the form of agency agreements between the publishers and Apple, there is no antitrust theory by which that vertical agreement would be evaluated for *per se* liability.

Neither can the States obtain *per se* analysis of the vertical agreement in question by invoking *Interstate Circuit, Inc. v. United States*, 306 U.S. 208 (1939). The defendants in *Interstate Circuit* were a group of movie theaters and a separate group of movie distributors. Interstate Circuit, one of the theater groups, held a monopoly on the exhibition of movies in first-run theaters in a number of Texas cities. *See id.* at 214–15. Interstate's general manager sent identical letters to eight distributors (film suppliers), proposing identical deal terms that would require the distributors, *inter alia*, to refuse to sign a deal with any theater that charged less than 25 cents for certain films. Each of the letters included the names of all eight companies as addressees, and all eight distributors ultimately complied with Interstate's demands.

Although there was no evidence of direct communication between the distributors, the Supreme Court inferred the existence of an illegal horizontal agreement, the purpose of which was to exclude Interstate's competitors. The Court concluded:

> It was enough that, knowing that concerted action was contemplated and invited, the distributors gave their adherence to the scheme and participated in it. Each distributor was advised that the others were asked to participate; each knew that cooperation was essential to successful operation of the plan. They knew that the plan, if carried out, would result in a restraint of commerce, which, we will presently point out, was unreasonable within the meaning of the Sherman Act, and knowing it, all participated in the plan.

Id. at 226–27.

The glaring difference between the defendants in *Interstate Circuit* and Penguin here is that those defendants could not articulate any procompetitive benefit to the distributor agreements.[4] Instead, they conceded that the "purpose and ultimate effect" of the distributor agreements "was to restrain [Interstate's] competitors in the theatre business by forcing an

[4] The same can be said with respect to *Toys "R" Us, Inc. v. F.T.C.*, 221 F.3d 928 (7th Cir. 2000), in which the court found direct evidence of anticompetitive effects and rejected the defendant's suggested business justification out of hand. *Id.* at 938 (noting that defendant "has fundamentally misunderstood the theory of free riding").

increase in their admission price." *Id.* at 228–29. Here, by contrast, the States do not dispute that the agreement encouraged entry against Amazon, the dominant firm in the market—thereby *increasing* overall competition.

Interstate Circuit also relies on precedent that is no longer good law. Specifically, Interstate Circuit was decided at a time when vertical price restraints were still *per se* illegal. The Court in *Interstate Circuit* compared the effects of the price restriction at issue to "the effect of resale price maintenance agreements, which have been held to be unreasonable restraints in violation of the Sherman Act." *Id.* at 476–77. In so doing, the Court relied on *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911)—the case explicitly overturned by *Leegin,* 551 U.S. at 885 .

Although the States cherrypick language from *Interstate Circuit* to infer the existence of a horizontal agreement in this case, and then leap to the conclusion that the agreement was *per se* illegal, *Interstate Circuit* does not support that leap. Indeed, the same passage of *Interstate Circuit* that the States would use to infer the existence of an agreement makes clear that the *per se* holding is contingent on a separate finding that the restraint at issue was unreasonable. *Interstate Circuit,* 306 U.S. 226-27 ("They knew that the plan, if carried out, would result in a restraint of commerce, *which, we will presently point out, was unreasonable within the meaning of the Sherman Act*, and knowing it, all participated in the plan." (emphasis added)). Thus, the Court in *Interstate Circuit*, after finding the existence of a horizontal agreement, separately analyzed whether the distributor contracts were unreasonable. In so doing, it relied on precedent that has since been overturned.

3. Penguin's actions are not unlawful *per se* because they could reasonably have been believed to promote enterprise and productivity.

In any event, even horizontal agreements that would normally be considered illegal *per se* must be evaluated under the rule of reason if the concerted activity in question could reasonably have been believed to promote enterprise and productivity. Given the starkly procompetitive nature of Penguin's conduct at issue in this case, the States cannot meet their burden to show an *unreasonable* restraint of trade.

In *BMI*, the Supreme Court rejected *per se* treatment of a horizontal price-fixing arrangement where the agreement had demonstrably procompetitive effects. *See id.* at 24 ("Not all arrangements among actual or potential competitors that have an impact on price are . . . unreasonable restraints."). The Seventh Circuit recently elaborated on the holding of *BMI* as follows:

> [W]e know from *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.*, 441 U.S. 1, 24 (1979), that even price fixing by agreement between competitors . . . [is] governed by the rule of reason, rather than being per se illegal, if the challenged practice when adopted *could reasonably have been believed to promote enterprise and productivity.*

In re Sulfuric Acid Antitrust Litig., 703 F.3d 1004, 1010–11 (7th Cir. 2012) (internal citation and quotation marks omitted) (emphasis added). Judge Posner further observed that "the entry of [defendants] into the U.S. sulfuric acid market was likely to result in an eventual fall in the price of acid in that market, an unequivocally socially beneficial effect from an economic standpoint. If the agreements facilitated that entry, their net effect on economic welfare may well have been positive [.]" *Id.* at 1011.

Here, as in *Sulfuric Acid*, Penguin's conduct facilitated the entry of a new competitor, Apple, into the eBooks retail market, thereby introducing a new competitor—the iBookstore. Apple's entry, in turn, stimulated new eBook sales and marketing opportunities and prompted the

development of a new breed of full-color eBooks for use with the iPad. Indeed, the States do not foreclose the possibility that Penguin's agency agreement had *some* procompetitive effects; they dispute only whether any procompetitive effects outweighed allegedly higher consumer prices. *See* States' Responses and Objections to Penguin Group (USA), Inc.'s Contention Interrogatories, Am. Response to Contention Interrogatory No. 8 (citing Jonathan B. Baker, Rebuttal Report, March 1, 2013, at 20). But given that the question is whether the practice "could reasonably *have been believed* to promote enterprise and productivity," *In re Sulfuric Acid Antitrust Litig.*, 703 F.3d at 1011 (internal quotation marks omitted), the States' confession of some procompetitive effects *alone* demonstrates that the agency agreement must be evaluated under the rule of reason.

Beyond that, and as *BMI* and *In re Sulfuric Acid* indicate, there is no precedent for *per se* condemnation of an alleged agreement that facilitates the entry of a new competitor into the relevant marketplace. To the contrary, *Leegin* recognized the procompetitive benefits of even price-fixing agreements that "facilitat[e] market entry for new firms and brands." *Leegin*, 551 U.S. at 891. Given the undisputed procompetitive effects, the rule of reason must apply.[5]

IV. UNDER THE GOVERNING RULE OF REASON, PENGUIN MUST PREVAIL

Evaluated under the rule of reason, any agreement (real or alleged) involving Penguin does not violate Section 1 of the Sherman Act. Rule of reason analysis proceeds in three steps. *Arkansas Carpenters Health & Welfare Fund v. Bayer AG*, 604 F.3d 98, 104 (2d Cir. 2010). First, the plaintiff bears the initial burden of showing that the defendant's conduct "had an actual adverse effect on competition as a whole in the relevant market." *Capital Imaging*

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[5] For the same reason, namely that the "arrangement 'might plausibly be thought to have a net procompetitive effect, or possibly no effect at all on competition,' more than a 'quick look' is required." *Major League Baseball Props. v. Salvino, Inc.*, 542 F.3d 290, 318 (2d Cir. 2008) (quoting *Cal. Dental Ass'n v. FTC*, 526 U.S. 756, 771 (1999)).

Assocs., P.C. v. Mohawk Valley Med. Assocs., Inc., 996 F.2d 537, 543 (2d Cir. 1993). If the plaintiff carries its initial burden, the burden then shifts to the defendant to offer evidence that its conduct had procompetitive effects. *Arkansas Carpenters*, 604 F.3d at 104. If the defendant is able to offer such proof, the burden shifts back to the plaintiff, who must prove that any legitimate competitive effects could have been achieved through less restrictive alternatives. *Id.*

It is well established that the threshold issue in any rule of reason analysis is the appropriate definition of the relevant market, including both a product market and a geographic market. *See Integrated Sys. & Power, Inc. v. Honeywell Int'l, Inc.*, 713 F. Supp. 2d 286, 298 (S.D.N.Y. 2010); *Abrams,* 811 F. Supp. at 870. Market definition, which is "a deeply fact-intensive inquiry," *Todd*, 275 F.3d at 199, is also "an absolutely essential element of the rule of reason case," *Hayden Publishing Co. v. Cox Broadcasting Corp.*, 730 F.2d 64, 70 (2d Cir. 1984). *See Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 768 (1984) (equating the rule of reason with "an inquiry into market power and market structure designed to assess [a restraint's] actual effect").

In this case, the States have made no real attempt to define a relevant market by identifying the "area of effective competition" that "correspond[s] to the commercial realities" of the eBook industry. *Brown Shoe Co. v. United States*, 370 U.S. 294, 324, 336 (1962). Instead, the States simply assert a relevant product market in "the market for the sale of e-books" and a relevant geographic market in the United States. (Second Am. Compl. ¶¶ 113–14). Neither of the States' experts have undertaken the serious empirical analysis necessary to determine a product market. (PSOF ¶¶ 148–150). And the experts' attempts to characterize the Agency Model as anticompetitive amount to no more than cherrypicking from the sales of certain publishers. (Id. ¶¶ 196).

In any event, the States' burden under the rule of reason is not to show *some* anticompetitive effect, but rather to prove that the alleged restraint is "unreasonable because its 'anticompetitive effects outweigh its procompetitive effects'." *E & L Consulting Ltd. v. Doman Indus. Ltd.*, 472 F.3d 23, 29 (2d Cir. 2006). Given the demonstrable procompetitive benefits of Penguin's conduct in the eBook market described above, the States cannot carry that burden in this case at trial.

CONCLUSION

For the foregoing reasons, the States cannot prove liability against Penguin on either Count I or Count III, and Penguin is entitled to judgment in its favor on both Counts.

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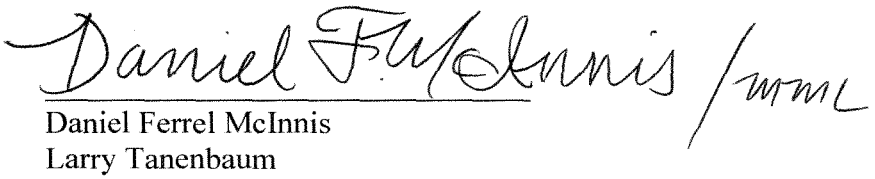
Respectfully submitted,



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