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COMPETITION

Judging a book by its cover price – apple and the great e-book swindle

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INTRODUCTION

No one can deny that since Apple launched its first iPod in October 2001, the company has seen enormous growth in product sales, revenue and in its ever growing support base. This has been achieved through innovation, elegant design and the pursuit of simplicity.

Over time Apple has made headlines illustrating just how successful its business has become. For example –

- since 2011, Apple has held more money in cash than the United States Federal Reserve;
- in 2015, Apple generated a profit of approximately $53.4 billion making it the most profitable company in the world; and
- the Apple brand is currently worth a staggering $154 billion.

However, more recent headlines have raised concerns about the calibration of Apple's ethical compass and its dogmatic pursuit of profit.

In July 2013, United States District Court Judge Denise Cote found that Apple together with five of the big six United States publishers (including Hachette, HarperCollins, MacMillan, Penguin Group and Simon and Schuster (collectively referred to as "**the publishers**")) conspired with each other to eliminate retail price competition in the e-book market. All of the publishers conceded wrongdoing and decided to settle with the Department of Justice. Apple, however, chose to challenge the allegations against it. Judge Cote's 160 page decision is not happy reading for Apple loyalists. She found that Apple played a central role in facilitating and executing the conspiracy to raise e-book prices, together with the publishers, in contravention of American antitrust (competition) laws.

THE E-BOOK MARKET

The entry of Apple into the e-book market in 2010 would appear, *prima facie*, to have benefited competition. Up until 2009, nearly 90% of all e-books were sold by Amazon, primarily for use on its Kindle device, making it the market leader in the e-book market. The entry of a formidable competitor such as Apple could have led to a variety of consumer benefits associated with fierce competition. Consumers would have been hoping for innovation, price wars and added choice. However, according to Judge Cote's decision, Apple and the publishers seized the opportunity to raise prices in the e-book market, virtually overnight.

The judgment details how the CEOs of the publishers held fairly regular dinners in the private dining rooms of New York restaurants, without counsel or assistants present, to discuss the common challenges they faced including, most prominently, Amazon's pricing policy of selling e-books for $9.99 (which was viewed by the publishers as being too low). The publishers feared that Amazon's pricing strategy –

- was cannibalising sales from their more profitable hardcover books;

- was threatening the continued existence of brick-and-mortar bookshops which sold hardcover books;
- was threatening the profitability of the publishing industry; and
- failed to reflect the true value of books and the differing effort required to produce books of varying quality.

THE LAUNCH OF THE IPAD AND THE IBOOKSTORE

Apple knew that the publishers were unhappy with Amazon's pricing strategy and that they wanted to raise e-book prices above the $9.99 prevailing price charged by Amazon. Apple was just about to launch the iPad as well as its iBookstore and identified that this would be the perfect opportunity to assist the publishers with raising e-book prices. The iPad was expected to be a transformational e-reader displaying text, illustrations, colour photographs and would have audio and video capability and was expected to have a significant impact on the e-book market. Furthermore, promoting the iBookstore at the launch of the iPad was expected to garner maximum consumer exposure and introduce a significant number of new consumers to and disrupt the e-book market.

WHOLESALE SALES MODEL VERSUS AGENCY SALES MODEL

At the time in the industry, publishers made use of a wholesale sales model which, for fear of engaging in prohibited resale price maintenance, prevented them from stipulating to the e retailers (i.e. Amazon) the price at which the e-books must be on-sold to consumers. Apple proposed that the publishers move away from a wholesale sales model to an agency sales model. The agency model allowed the publishers to stipulate the retail price that e-books must be sold to consumers with e-retailers acting only as the publishers' agent through the electronic sales platform (such as the iBookstore).

MOST FAVOURED NATIONS CLAUSE

In addition to convincing the publishers to change to an agency model, Apple entered into agreements with the publishers which contained a most favoured nation clause that imposed severe financial penalties on the publishers if they did not force all other e retailers to move on to the agency model. A most favoured nation clause is a pricing parity contractual provision which ensures that a party in whose favour the most favoured nation clause is drafted (in this instance, Apple) will be given the best terms for a particular good or service (i.e. sales of e-books) which the counterparty to the contract (i.e. a publisher) makes available to any other party (i.e. other e-retailers). The most favoured nation clause protected Apple by guaranteeing that, despite the publishers dictating the price at which the e-books must be sold, it could match the lowest retail price listed on any competing e-book store (eliminating retail price competition).

EFFECT OF THE AGENCY SALES MODEL AND THE MOST FAVOURED NATIONS CLAUSE

The introduction of the iPad, iBookstore and the inclusion of the most favoured nation clause provided the publishers with the impetus necessary to adjust its approach to the market and move all e-retailers to the agency sales model. If the publishers did not move all other e-Book retailers on to an agency model, their ability to dictate the sale price of e-books using an agency model would be overridden by the most favoured nation clause. In order to avoid this from happening, the publishers threatened to stop supplying any e-retailer that refused to move to the agency model, thereby forcing compliance.

After implementing the agency sales model, prices in the e-book industry shifted upward virtually overnight, in some instances by as much as $5 per e-book. Not only did the increase in the retail price of e books make the publishers happier, it also ensured that Apple could comfortably take a 30% agency commission which was Apple's standard practice across all sales in its app and music stores.

JUDGE COTE'S FINDING

In September 2013, Judge Cote granted final injunctive relief against Apple, preventing it from continuing to engage in the conduct described above. The relief granted by Judge Cote was widely viewed as containing an unprecedented level of sanctions against Apple which are too numerous to detail here. It is of interest to note that the Judge did not rule that the agency model or any one of the clauses included in the agreements (including the most favoured nations clause) was inherently illegal; going on to state that entirely lawful contracts may include most favoured nations clauses, price caps or

pricing tiers. However, what she found in this particular case was that Apple had specifically used all of these components to ensure that it had no retail price competition and thus facilitated a wrongful price fixing conspiracy with the publishers.

Following the outcome of Judge Cote's decision, Apple lodged various appeals which were unsuccessful. Apple ultimately entered into a settlement agreement in order to finalise the litigation in which it agreed to pay $400 million to e-book consumers, $20 million to the relevant US states that were parties to the litigation and $30 million in legal fees. The $400 million payable to e-book consumers was rolled out by offering those consumers who overpaid for e-books credits which they could use when making future e-book purchases.

CONCLUSION

The facts of this case highlight how, amongst other things, a most favoured nation clause can in certain circumstances have the effect of raising prices to consumers. Competition authorities globally are scrutinising the rationale and the effect of such clauses not only on consumers but also on suppliers who might be prevented from entering into or expanding within a particular market. This also applies in South Africa. As demonstrated in this case, it is critically important to ensure that the effect of, among others, a most favoured nation clause should be thoroughly and critically considered in order to safeguard against financial and reputational harm.

In many instances, businesses protect their market position and exploit a competitive advantage for themselves. Fierce contractual negotiations take place and different approaches are put forward and agreed on that seem to benefit all parties. It is, however, important always to consider how an agreement will be regarded by the competition authorities. It is therefore crucial for businesses to check whether their agreements will pass muster in terms of the South African Competition Act to ensure that they not assume unnecessary risk.



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