E-books, Collusion, and Antitrust Policy: Protecting a Dominant Firm at the Cost of Innovation

Nicholas Timchalk[*]

I. INTRODUCTION

Technological progress will inevitably drive the law toward a path of modernization. Specifically, antitrust law must remain aware of the ever-changing economic environment driven by innovation.[1] Amazon led the charge with one such innovation by transforming the reading experience into the modern digital age with the e-book. Amazon catalyzed the inception of the e-book market by introducing the Kindle to gain widespread commercial acceptance in 2007.[2] Amazon became the dominant firm in the sale of e-books and e-book readers by controlling about 90% of the market.[3] As an innovator, Amazon had the luxury of determining the retail price for its books as well as the supply arrangement with its publishers. Thus, its market positioning as a large online discount retailer influenced its decision to use a wholesale model[4] and use a discount pricing strategy by charging $9.99 for certain new release and bestselling e-books.[5] With a digital book discount, Amazon's $9.99 price point roughly matched the wholesale price of many of its e-books.[6]

---

[*] J.D. Candidate, Seattle University School of Law, 2015; B.A., University of Idaho, 2011. I would like to especially thank Professor John B. Kirkwood for his thoughtful contributions and feedback throughout the development of this Note. He has been a remarkable professor and mentor throughout my education.

1. *See* PHILLIP E. AREEDA & HERBERT HOVENKAMP, 2B ANTITRUST LAW ¶ 407a (3d ed. 2006) (arguing that "technological progress contributes significantly more to consumer welfare than does the elimination of non-competitive prices").

2. United States v. Apple Inc., 952 F. Supp. 2d 638, 649 (S.D.N.Y. 2013).

3. *Id.*

4. The wholesale model makes sense for Amazon because this is what the physical book market has always used. Moreover, the model allows Amazon to control the retail price to consumers, which is vital for a large discount retailer.

5. *Apple Inc.*, 952 F. Supp. 2d at 649.

6. *Id.* The non-settling defendants and several public comments contend that the $9.99 price point was below the wholesale price paid by Amazon. *See generally id.* Evidence also showed that "wholesale prices for e-books typically fell in the range of $13 to $15, and some were even sold at prices as high as $17.50." *Id.* at 656.

Rival firms quickly positioned themselves to enter and compete in the e-book market after witnessing Amazon's substantial success and the changing consumer preferences towards the digital consumption of media.[7] Indeed, Apple's iPad and Barnes & Noble's Nook were the two potential competitors in the beginning and are still currently Amazon's main competitors.[8]

United States v. Apple Inc. arose from the aftermath of firms attempting to pressure Amazon's initial dominance in the e-book market.[9] In short, book publishers were unhappy with Amazon pricing their new releases and bestsellers below the wholesale price Amazon paid.[10] Apple—preparing to launch its iBookstore in conjunction with its iPad—recognized the publishers' discontent with Amazon's prices and offered the publishers a different supply arrangement.[11] This arrangement (known as an agency arrangement) allowed the publishers to set the retail prices and allowed Apple to receive a commission on the books it sold.[12] For this plan to work, each publisher had to commit to the new arrangement to pressure Amazon to abandon its discount pricing strategy.[13] In the end, Apple launched the iBookstore with the publishers under an agency arrangement.[14] The publishers attempted to compel Amazon to switch to similar agency agreements in order to have more control over the retail price for their books.[15] Consequently, Amazon complained to the Federal Trade Commission about the publishers' simultaneous demands for it to switch to an agency contract.[16] The Department of Justice filed a suit against Apple and the publishers for violating Section 1 of the Sherman Act, alleging a price-fixing conspiracy between all the defendants.[17] After a bench trial in the Southern District of New York, Judge Cote found Apple liable for a price-fixing conspiracy with the publisher defendants in restraint of trade.[18]

---

7. "Apple strongly hoped to announce its new iBookstore when it launched the iPad, . . . but would only do so if it had agreements in place with a core group of [p]ublishers by that date, could assure itself it would make a profit in the iBookstore, and could offer e-book titles simultaneously with their hardcover releases." *Id.* at 647.

8. *See id.* at 648–49.

9. *See id.* at 654–55.

10. *Id.* at 649–50.

11. *Id.* at 659.

12. *Id.*

13. *Id.* at 652.

14. *Id.* at 679.

15. *Id.*

16. *Id.* at 681.

17. *Id.* at 645.

18. *Id.* at 709.

Although the e-book market has leveled out to a competitive marketplace with diverse participants due to the increase of market entry,[19] a period of time existed during the market's inception when the innovator's—Amazon's—market share was highly suggestive of monopoly power.[20] Antitrust enforcement can better spot red flags and use greater discretion if they properly consider the market conditions created by the innovator and the resulting market structure post enforcement. This is important because now that e-reader prices have generally dropped due to market saturation, Amazon will likely not need to go back to the deep e-book discounts to promote the Kindle.[21] In essence, even after the enforcement of Section 1 of the Sherman Act against Apple, e-book prices rose, which may or may not have harmed consumers[22] when compared to the alternative of the status quo before the publishers and Apple colluded. Hence, an understanding of the unique market conditions prior to the illegal conduct can help antitrust law adapt to future cases by understanding the incentives and market forces that influenced the publisher defendants' collusion and Apple's risky agency agreement switch.

This Note argues that the combination of Amazon's 90% market share, network externalities, and an innovative technology market creates an environment that highly incentivizes a dominant firm to exclude potential rivals for as long as possible. Accordingly, when cases like *United States v. Apple Inc.* arise, there must be serious concern for not only price increases for consumers, but also diminished innovation in the market, which further harms consumers. I attempt to show that the market structure for e-books failed in some respects, which created an incentive for Apple—being a sophisticated and very large firm—to take highly risky steps to enter the e-book market. While Apple's decision to coordinate with the publishers could have been out of greed, the market might have also failed by allowing substantial barriers to entry[23] created by Amazon's pricing strategy. Although antitrust law attempts to keep firms from harming consumers with entry barriers for rivals, substantial barri-

---

19. The competitiveness could result from the market maturing or the publisher agency agreements opening up the market to entry because of Amazon's aggressive pricing strategy coupled with an oligopolistic publisher market that possibly created barriers to entry.

20. Although the definition of monopoly power has been phrased differently, the United States Supreme Court has defined it as "the power to control prices or exclude competition." United States v. Grinnell Corp., 384 U.S. 563, 571 (1966). In economic terms, it is the power to profitably raise price above the competitive level for a long period of time.

21. This is assuming that the pricing strategy was purely promotional as opposed to predatory pricing. *See infra* Part IV.

22. Although e-book prices have risen, e-reader prices have fallen substantially; thus, it is unclear whether consumers are harmed overall on balance.

23. "A barrier to entry is any factor that makes entry into a market unprofitable . . . ." PHILLIP E. AREEDA & HERBERT HOVENKAMP, 3A ANTITRUST LAW ¶ 729a (3d ed. 2006).

ers for Apple to enter the e-book market would necessarily be substantial for smaller potential e-book retailers as well. Thereby, Amazon's dominant position in the market could still harm consumers. While the district court found that the higher prices resulting from Apple and the publishers' agreements harmed consumers, the de facto protection of Amazon's dominant position could also harm consumers through reduced innovation in the marketplace. Accordingly, when the government challenges practices in markets with a dominant buyer in the future, it should give extra care to ensure that the dominant firm is not de facto protected in a way that harms innovation in the marketplace. *United States v. Apple Inc.* exemplifies a modern trend of enforcement agencies pursuing claims based on collusive conduct as opposed to unilateral exclusionary conduct, which might not give sufficient weight to innovation concerns.

To be clear, I am not arguing against the district court's ruling that Apple violated Section 1 of the Sherman Act when it coordinated a switch from wholesale to agency contracts with publishers. My primary inquiry is into the potential effects on innovation when enforcement occurs against rivals of a dominant firm in an innovative technology market. Amazon's main rival, Apple, went to great lengths and took major risks to enter the e-book market. Why did Apple simply choose not to compete on the merits of its product and brand equity (the iPad and iBookstore) as it does with its other products? Why did Apple decide not to continue to rely on its earlier success of situating its products differently in the market than other electronics and working hard to be different and cutting-edge with its e-book delivery?[24] I argue that the market failed in some respects. I explore the theory that entry could not occur without an increase in price and, further, without entry, harm to innovation would result over time.[25]

---

24. Because firms are profit-maximizing, one possible argument is that Apple did not rely on its competitive advantage because it saw an opportunity to be greedy and change the supply of e-books; thus, it would receive a 30% commission on sales as opposed to the retail margin it would have received in the wholesale model. *See* United States v. Apple Inc., 952 F. Supp. 2d 638, 659 (S.D.N.Y. 2013). However, a profit-maximizing firm would also take into account the potential liabilities resulting from regulatory enforcement and potential litigation costs. Accordingly, the decision to coordinate the agency model switch with the publishers involves a cost–benefit analysis that takes into account the potential legal costs. The fact that Apple disregarded the risk could imply that Apple believed any regulatory challenge could be mitigated because of Amazon's pricing behavior with the publishers.

25. In Apple's appellate brief for its pending appeal in the Second Circuit, Apple suggests that it did not need higher prices to enter the market because its 30% commission could make it profitable at any price point. *See* Appellant Apple Inc.'s Opening Brief at 22, United States v. Apple Inc., No. 13-3741 (2d Cir. Feb. 25, 2014), ECF No. 157, 2014 WL 889710, at *22. Judge Cote stated that the record is "equivocal on whether Apple desired higher e-book prices . . . ." *Id.* Although I argue that the market required higher prices for entry to occur, Apple must argue it did not need higher prices to support its position on appeal; otherwise, it would place itself in a corner by attempting to

This Note is structured as follows: Part II discusses antitrust policy and innovation as a metric for consumer welfare. Part III discusses the facts of the Apple price-fixing case with a particular focus on the market conditions during the window where Amazon possessed 90% of the e-book market. Part IV considers whether the market needed new entry. In other words, whether Amazon's buyer power or the market structure gave rise to potential consumer harm. Market entry would thus be desirable to promote competition and innovation. This includes an analysis of Amazon's pricing strategy before Apple entered the market and whether anticompetitive effects were present. Finally, Part V suggests that innovation concerns in the e-books case were left on the backburner, and proposes how antitrust enforcement should keep innovation concerns as a primary goal to best fulfill the goals of protecting consumer welfare. Part VI concludes.

II. BACKGROUND ON ANTITRUST LAW AND BUY-SIDE POWER

Antitrust law attempts to solve an incentive problem of the free market. Economic analysis provides insight into how firms will act in the free market and, at the same time, reveals the potential harm that can result to the economy and consumers if marketplace regulation did not exist. In 1890, Congress passed the Sherman Antitrust Act to advance consumer welfare by outlawing business arrangements that harm consumers.[26] Section 2 of the Sherman Act reads: "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States . . . shall be deemed guilty of a felony."[27] To understand how Section 2 attempts to create the right incentives for a healthy economy and protection for consumers, I will briefly discuss the economic theory behind the Sherman Act.

At the core of economics is the assumption that firms are profit maximizing.[28] This assumption is the foundational incentive that drives firm behavior; hence, different market conditions will dictate different behavior for firms to satisfy that core drive. For example, in the textbook perfect competition model,[29] a profit-maximizing firm will sell products

---

justify raising e-book prices. But its statement does not speak to the potential for market-specific conditions requiring higher prices for entry to occur.

26. ROBERT BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF 19–20 (1978).

27. 15 U.S.C. § 2 (2004).

28. BORK, *supra* note 26, at 116, 120 (noting that firms do not always maximize profit, but firms behave as if they are striving to maximize profit).

29. Perfect competition is described as a market with many participants, each of whom is too small to affect the market price, an upward sloping marginal cost curve (production costs increase as quantity sold increases), and easy market entry and exit.

at the intersection of marginal cost[30] and marginal revenue[31] to be at an efficient equilibrium.[32] Conversely, when a monopoly exists, the monopolist has an incentive to restrict its output to maximize profit. In effect, the monopolist can produce less than the competitive level of production and charge higher than the competitive price. A comparison of these two models illustrates that monopoly power can harm consumers by subjecting them to higher prices than they would face otherwise. Hence, in the most basic sense, antitrust exists to prohibit a firm's behavior that restricts output, thereby harming consumers with higher prices.[33]

In determining whether monopoly conduct exists, courts look for market power[34] and anticompetitive conduct.[35] The ability for a monopolist to charge supracompetitive prices[36] generally harms consumers and exhibits what antitrust law attempts to prevent. Supracompetitive prices harm consumers and reduce economic efficiency.[37] In some instances, supracompetitive prices may be justified because of innovation in a marketplace.[38] For example, Amazon first introduced the Kindle and, for a period, maintained a monopoly until a rival entered to constrain Amazon.[39] Justified monopoly power can induce new entrants into the market to capture some of the profits made by the monopolist.[40] As more new entrants arrive, the supracompetitive prices will naturally fall until they reach the competitive level because new entrants will compete by charging consumers lower prices. Therefore, an additional requirement for determining monopoly power is whether the monopolist's conduct creates barriers to entry. The combination of monopoly power and barriers to entry creates a market environment where the monopolist can sustain its output restrictions, limit new competition, and ultimately harm con-

30. Marginal cost is the incremental cost of each additional unit produced.

31. Marginal revenue is the incremental revenue for each additional unit sold.

32. *See* MARK A. LEMLEY & CHRISTOPHER LESLIE, GILBERT LAW SUMMARIES: ANTITRUST §§ 609, 612, 615 (10th ed. 2004).

33. BORK, *supra* note 26, at 122.

34. Market power is the power to profitably raise price above the competitive level in the relevant product and geographic market. *See* WILLIAM HOLMES & MELISSA MANGIARACINA, ANTITRUST LAW HANDBOOK § 3:4 (2013).

35. There are several well-established forms of anticompetitive conduct. *See, e.g.*, Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585 (1985) (refusals to deal with a rival); Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993) (predatory pricing); United States v. Microsoft Corp., 253 F.3d 34, 45 (D.C. Cir. 2001) (exclusive dealing and tying).

36. Supracompetitive prices are prices set above the competitive level.

37. *See* AREEDA & HOVENKAMP, *supra* note 1, ¶ 403b.

38. *See id.* ¶ 407a.

39. United States v. Apple Inc., 952 F. Supp. 2d 638, 649 (S.D.N.Y. 2013) ("[T]hrough 2009, Amazon dominated the e-book retail market, selling nearly 90% of all e-books.").

40. *See* AREEDA & HOVENKAMP, *supra* note 1, ¶ 407c.

sumers.[41] Of course, barriers to entry naturally exist in the marketplace;[42] thus, the proper inquiry is whether artificial barriers exist that limit entry.[43] Examples of conduct that create artificial barriers to entry include expanding capacity in advance of demand[44] and predatory pricing.[45]

Until now, this Part has discussed antitrust law in the traditional "sell-side" case, meaning that the law aims to protect consumers purchasing from a monopolist. Conversely, antitrust law is also concerned with "buy-side" cases. A buy-side case protects upstream suppliers from a dominant buyer. Although the principle concern for antitrust is to prevent a monopolist from transferring wealth from consumers to itself,[46] the legislative history of the Sherman Act supports the same concern for dominant buyers transferring wealth from suppliers to themselves.[47] Moreover, the harm to supplier welfare has the potential to harm consumer welfare by limiting options available to consumers.[48]

Anticompetitive conduct harms consumers with "lower market output, higher prices, reduced innovation, or some other indicator of diminished competitiveness."[49] Higher prices charged to consumers provide tangible and empirical characteristics that are calculable through market research. But consumer harm resulting from a reduction of innovation is more abstract. A monopolist can harm market innovation because (1) it has a sense of security from potential rivals, which lowers the monopolist's incentive to innovate, and (2) a monopolist may have less to gain from innovative investments than a competitive firm because it already has a dominant position in the market.[50] To counteract these negative

---

41. *See id.* ¶ 403.

42. For example, a firm's superior efficiency or a large capital investment requirement might limit the ability for new entrants, but neither are the type of barriers antitrust is concerned with because both benefit consumers by ensuring efficient firms compete in the market. If a firm can produce a product so efficiently that entrants are unable to compete, consumers still benefit from the efficiencies and antitrust will not step in.

43. BORK, *supra* note 26, at 311.

44. *See* United States v. Aluminum Co. of Am., 148 F.2d 416, 431 (2d Cir. 1945).

45. *See, e.g.*, Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 223–24, (1993) (artificial barriers to entry can exist when a firm prices below an appropriate measure of cost, and the defendant has a reasonable prospect of recouping the profits sacrificed by pricing below cost).

46. By a firm restricting its output below the competitive level and charging higher prices than it would at the competitive level, a monopolist is receiving revenue that a consumer would not normally give the firm if it was a competitive market.

47. John B. Kirkwood & Robert H. Lande, *The Fundamental Goal of Antitrust: Protecting Consumers, Not Increasing Efficiency*, 84 NOTRE DAME L. REV. 191, 234–35 (2008).

48. *See infra* Part IV (monopsony and countervailing power).

49. PHILLIP E. AREEDA & HERBERT HOVENKAMP, 3 ANTITRUST LAW ¶ 651e (3d ed. 2006).

50. AREEDA & HOVENKAMP, *supra* note 1, ¶ 407c4. Although at the same time, monopoly power arguably has the potential to provide an incentive to innovate because the monopolist has

externalities, competition spurs innovation by providing consumers with better, less expensive products because the innovating firm is forced to improve its processes or product in order to compete.[51] Moreover, potential rivals indirectly benefit because they build off the innovating firm and improve upon the recent innovation to compete, which provides consumers with even greater benefits.[52] The Department of Justice's (DOJ) protection of Amazon's dominance represents a potentially dangerous enforcement policy that places price concerns above market innovation. Without proper concern for innovation, DOJ's enforcement policy might not guard consumer welfare in the long run.

This Note will analyze the potential antitrust issues in light of Amazon's dominant position in the e-book market. Accordingly, the analysis will entail a buy-side inquiry where the upstream suppliers are considered the "protected class," by which the conduct of the dominant buyer (Amazon) can adversely affect the suppliers in a way that harms consumers. Amazon's dominant position not only has the potential to harm suppliers, but it could affect potential rivals in the e-book retailing market. Consumer harm will be analyzed through inhibited innovation in light of the e-book market structure and antitrust enforcement against Apple.

III. BACKGROUND ON UNITED STATES V. APPLE INC.

From the publishers' perspective, they needed to work with Amazon to widely distribute their digital titles because no other e-retailer could reach Amazon's customer base. As a result, if Amazon wanted to sell e-books for $9.99, the publishers had little negotiating power to argue otherwise. Although the publishers initially agreed to the $9.99 price to enter the market and maintain competitiveness with the other publishers, they were concerned that, in the long term, consumers would grow accustomed to e-books priced at $9.99 and that the $9.99 price would erode prices for all books.[53] The publishers felt that Amazon undervalued

---

additional funds and a desire to invest in securing its position in the market, which can provide the monopolist with a perceived larger reward. *See id.* ¶ 407c2.

51. Jonathan B. Baker, *Beyond Schumpeter vs. Arrow: How Antitrust Fosters Innovation*, 74 ANTITRUST L.J. 575, 587 (2007).

52. *Id.* at 587–88.

53. United States v. Apple Inc., 952 F. Supp. 2d 638, 649 (S.D.N.Y. 2013) ("Prior to 2009, many publishers set a wholesale price for e-books at a 20% discount from the equivalent physical book wholesale price to reflect the many cost savings associated with the distribution and sale of e-books."). With Amazon's discount pricing below the wholesale prices, the disparity between physical book prices and e-books was even greater than the 20% associated with cost reduction. *See id.*

the books and failed to distinguish the quality between books if they were all at the same price.[54]

In response to this price concern, the publishers sought to use their power to increase the price to what they perceived as the competitive level. In an attempt to induce higher retail prices, the publishers set the wholesale price several dollars above the $9.99 price; yet, Amazon maintained its pricing policy for bestsellers.[55] The publishers felt that raising prices a few dollars would solve the undervaluing problem.[56] Additionally, publishers discussed withholding new bestseller e-books from Amazon to gain revenues from hardcovers before the e-books were available at the "artificially low $9.99 price point."[57] However, this was a risky—and ultimately unrealistic—strategy because publishers feared that Amazon would use its large buyer power to retaliate against them.[58]

In late 2009, Apple prepared to launch the iPad tablet.[59] Because e-book wholesale prices typically ranged from $13 to $15,[60] new retail entrants were concerned about their ability to compete with Amazon's pricing strategy. The combination of the publishers' concern over the low price point and Apple's concern over low (or negative) margins for e-books and its ability to compete with Amazon led the parties to negotiate mutually beneficial supply terms.[61] These negotiations led to a mutual desire for an agency model supplier agreement.[62] An agency model allowed the publishers to control the retail price of e-books and Apple would receive a percentage of each e-book sold. However, for this scheme to be successful, and to force Amazon to switch to the new pricing model, all of the publishers had to agree to the switch from wholesale to agency.[63]

Accordingly, all of the publisher defendants agreed to use agency contracts with Apple, and then each successfully pressured Amazon to change from wholesale to agency contracts.[64] Although Amazon is a dominant firm with leverage over its suppliers, the publishers were able to pressure Amazon to switch supplier contracts by threatening to withhold new releases from Amazon for seven months after their release.[65]

---

54. *Id.*
55. *Id.* at 650.
56. *Id.*
57. *Id.* at 652.
58. *See id.* at 650.
59. *Id.* at 654.
60. *Id.* at 656.
61. *Id.* at 656–57.
62. *Id.*
63. *Id.*
64. *Id.* at 679.
65. *Id.* at 687.

As a result of increased prices from the coordinated actions of the publishers and Apple, the court convicted Apple of per se price fixing in violation of Section 1[66] of the Sherman Act.[67]

IV. THE E-BOOKS MARKET AND AMAZON'S BUYER POWER

A. Description of the E-books Market

Justified monopoly power[68] does not, by itself, harm consumers; in fact, a firm with justified monopoly power can benefit consumers by attracting new participants into the market to capture the monopolist's profit share, which drives prices down to the competitive level in the long run.[69] Nevertheless, because market innovators initially hold high market share, it is important to determine whether barriers to entry that harm consumer welfare exist.[70] Aggressive competitive conduct by a monopolist benefits consumers because it provides valuable innovative products, whereas aggressive exclusionary conduct harms consumers by inhibiting benefits from competition; the problem, however, is that both "[c]ompetitive and exclusionary conduct look alike."[71] On the one hand, Amazon innovated the e-book market by developing a successful e-reader in conjunction with a distribution system that allowed for low-cost, expansive digital retailing. Amazon's initial success directly resulted from pleasing consumers and providing a strong product. On the other hand, it seems strange that a sophisticated party like Apple would take such great risks to enter the market unless a market barrier existed.[72]

---

66. 15 U.S.C. § 1 (2004) ("Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce . . . is declared to be illegal." In essence, the agreements between Apple and the publishers that switched e-book supply from wholesale to agency contracts constituted a contract in restraint of trade).

67. *Apple Inc.*, 952 F. Supp. 2d at 709. Apple filed a timely appeal with the Second Circuit Court of Appeals on February 25, 2014. *See generally* Appellant Apple Inc.'s Opening Brief , United States v. Apple Inc., No. 13-3741 (2d Cir. Feb. 25, 2014), ECF No. 157, 2014 WL 889710.

68. Innovation can justify monopoly power because new innovative products both benefit consumers and naturally induce entry into the market. Assuming the innovating firm does not create artificial entry barriers, this could exemplify justified monopoly power.

69. *See* Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 407 (2004) ("The opportunity to charge monopoly prices—at least for a short period—is what attracts 'business acumen' in the first place; it induces risk taking that produces innovation and economic growth. To safeguard the incentive to innovate, the possession of monopoly power will not be found unlawful unless it is accompanied by an element of anticompetitive *conduct.*").

70. Consumer welfare can be defined simply as the happiness of consumers. For example, consumer welfare is harmed when prices are increased, choices are limited, or there is asymmetrical information without any benefits that might outweigh the harms caused.

71. Frank H. Easterbrook, *On Identifying Exclusionary Conduct*, 61 NOTRE DAME L. REV. 972, 972 (1986).

72. An economist would argue that a profit-maximizing firm would act rationally when making business decisions; thus, the firm will weigh opportunity costs and potential returns when deciding

Whether or not that barrier was artificial or a result of a competitive marketplace can dictate whether any harm to consumers actually occurred.

An understanding of the players in the market and their unique characteristics helps to analyze whether barriers existed in the new market. To begin, Amazon—a dominant firm with large buying power and a low-cost business model—will affect how its suppliers act in the market. Amazon is an attractive retailer for publishers because of its ability to efficiently reach a large consumer base. Second, six large publishers exist in the book industry.[73] Each publisher holds an effective monopoly on its titles; thus, they compete with each other through the quality of authors signed, marketing, price, etc. With the context of this particular market in mind, the following analysis will discuss the potential for exclusionary conduct that could harm consumers.

1. Monopsony Power

The first structural analysis of buyer power considers whether Amazon had monopsony power during the e-book market's inception. A firm has monopsony power when "a single buyer faces a large number of suppliers, each too small to affect the market price and each operating on an upward-sloping marginal cost curve."[74] In effect, the numerous suppliers are in a competitive supplier market and, as the quantity sold increases, the marginal cost of each additional unit sold increases due to increasing costs of production.[75] Thus, prices for the buyer increase as quantity sold increases. As a result, to keep costs low, a dominant buyer will buy fewer units than it would if it was in a competitive buyer market.[76] Although this reduces supplier welfare because a competitive buyer's market would result in greater quantity purchased, the real question for antitrust law is whether this structure can harm consumer welfare. In

---

to enter into a market and how to go about doing that. However, an argument exists that Apple, like Microsoft in the 1990s, was acting like a "lone wolf" in terms of its legal considerations and its interactions with the Government and the marketplace. Accordingly, in its effort to maximize profits, Apple might be have been downplaying other risks, like treble damages from antitrust liability. *See* Steve Friess, *Apple's Lone Wolf Strategy Backfires*, POLITICO (July 31, 2013), http://www.politico.com/story/2013/07/apple-finds-dc-is-tough-without-friends-94948.html?hp=l5.

73. The large publishers include: Hachette Book Group, Inc.; HarperCollins Publishers LLC; Holtzbrinck Publishers LLC d/b/a Macmillan, Penguin Group (USA), Inc.; Simon & Schuster, Inc.; and Random House, Inc. Random House was not a party to the suit because they did not initially join Apple's agency agreements until after the other five publishers executed the agreements. United States v. Apple Inc., 952 F. Supp. 2d 638, 648 (S.D.N.Y. 2013).

74. John B. Kirkwood, *Powerful Buyers and Merger Enforcement*, 92 B.U. L. REV. 1485, 1495 (2012).

75. *Id.*

76. *Id.*

theory, by purchasing fewer units than the competitive level, the monopsonist will have a lower output than the competitive level, which could result in higher prices for consumers.[77]

Several reasons exist for why this model does not apply to Amazon's control of the e-book market. First, the publishers face a relatively flat marginal cost curve. The publishers' cost for each additional e-book sold to Amazon is little to none.[78] A flat marginal cost curve results in no incentive for Amazon to purchase less than the competitive amount. In other words, Amazon could buy as many e-books as it wanted without the fear of facing increased costs associated with publishers having to print, ship, or warehouse more books.

Second, there are a limited number of publishers rather than a large number that the monopsony model requires. Each of the publishers holds an effective monopoly over its own titles, so each has the power to affect market price for their individual titles. Although Amazon held a 90% share of the e-book market, the publishers could exert power over Amazon, such as when they attempted to withhold bestsellers and successfully got Amazon to switch to agency agreements.[79]

As a result, it is unlikely that Amazon held monopsony power over the publishers in the e-book market. The market conditions and unique nature of the publishing business model depict a market that is unlike those where monopsony power might be exhibited.[80]

The next step is to consider whether Amazon demonstrated an alternate form of buyer power: countervailing power.

2. Countervailing Power

The second form of buyer power is countervailing power.[81] This power arises when there are relatively few suppliers with market power and a constant or downward sloping marginal cost curve.[82] As a result, the powerful buyer may exert countervailing power with either procompetitive or potentially anticompetitive consequences.[83] Because the small number of publishers can result in oligopolistic behavior,[84] coun-

77. *Id.* at 1498.

78. Digital books provide publishers numerous cost savings that result in flattening a supply curve: printing, storage, packaging, shipping, or return of e-books all provide cost savings in the e-book industry. *See Apple Inc.*, 952 F. Supp. 2d at 649.

79. *See id.* at 687.

80. Kirkwood, *supra* note 74, at 1496–97 (stating that cases of monopsony power have been found in the agricultural, natural resource, and labor markets).

81. *Id.* at 1500.

82. *Id.*

83. *Id.* at 1500–01.

84. An oligopoly exists when a small number of firms make pricing decisions based on the anticipated action of a competitor rather than competition in the market (supply and demand). This

tervailing power can help consumers by bringing the previously supracompetitive prices down to the competitive level.[85] Hence, a dominant firm can use its buyer power to force prices to a level where an oligopoly would not get to on its own by inducing competition, which increases consumer welfare through lower prices.[86]

There are several situations, however, where countervailing power might result in harm to consumer welfare. First, a large buyer may be able to get "substantial, discriminatory discounts" from suppliers in order to push smaller buyers out of the market with its competitive advantage.[87] The key question is whether the substantial discounts leveraged over the suppliers are used to compete aggressively, which would benefit consumers, or as a means to bar competition in the marketplace, which harms consumers. For example, this type of conduct exemplifies pushing out retail rivals or preventing retail rivals from entering the market so the dominant firm can raise prices. Second, by inducing competition among a small number of suppliers, the dominant buyer might create adverse effects on small buyers because they are unable to utilize the leverage over the suppliers to get prices lower; hence, the result might create less options for consumers until the smaller buyers reach efficiencies to compete with the dominant firm.[88] In effect, even if the dominant firm did not drive out or prevent other retailers from competing, it could reduce consumer choice by inhibiting buyers' growth or entry into the market.

In this case, the countervailing model aligns well with the e-book market prior to Apple's entry. As stated earlier, e-book publishers face a relatively flat marginal cost curve due to the digital nature of e-books creating little or no additional cost for each e-book sold. The procompetitive effects of countervailing power probably do not apply here because of the lack of supracompetitive pricing at the publisher level. The facts show that the publishers were unhappy with Amazon's pricing strategy, yet they were unable to leverage Amazon to use the prices they felt were competitive. The wholesale model gave Amazon the power to set retail prices. Further, the extent to which oligopolistic behavior existed was in terms of each publisher fearing attempts to raise prices on its

---

concept incorporates game theory such that if supplier A is concerned about supplier B dropping prices, A could drop prices first, which risks B dropping prices even lower. B necessarily would face the same situation; thus, both A and B will keep prices higher than the competitive level to maintain their margins, and, as a result, harm consumers with higher prices just as if a monopoly existed. *See* AREEDA & HOVENKAMP, *supra* note 1, ¶ 404a.

85. Kirkwood, *supra* note 74, at 1505.

86. *Id.*

87. *Id.* at 1506.

88. *Id.*

own. The evidence shows that the wholesale prices the publishers charged Amazon ranged from $13.00 to $17.50;[89] yet, Amazon persisted to sell bestsellers at $9.99. If Amazon has countervailing power, then the retail prices prove that Amazon—as a dominant firm—has the potential to act anti-competitively because it is not fully constrained by a perfectly competitive retail market in e-books. Whether Amazon utilized its countervailing power to maintain its monopoly in e-books or whether it merely competed aggressively is a difficult question to answer. In order to make this determination, further analysis of Amazon's conduct is needed.

Although Amazon's countervailing power has the potential to be anticompetitive, it is not strong enough to justify Apple's collusion with the publishers.[90] First, if Amazon used its power against the publishers, the publishers would receive lower revenues, and the variety and quality of books released by the publishers would presumably decrease due to less available resources.[91] The evidence, however, does not support this inference.[92] Second, countervailing power would inhibit a supplier from pressuring the buyer; nevertheless, the publishers considered challenging Amazon on several occasions by withholding e-book bestsellers in order to promote hardcover sales.[93] Although withholding titles is risky for each individual publisher, the effective monopoly on individual titles allows the publishers to potentially constrain Amazon's countervailing power.[94] As a result, consumer choices for books were not limited by Amazon's buyer power.[95] Professor Kirkwood argues that the sharp rise in prices resulting from the publishers' collusion does not benefit consumers by balancing out the potential harms from buyer power.[96]

Even though Amazon's buyer power might not justify the publishers' collusion to switch supply arrangements, consumer choice could be limited by the e-reader options if artificial barriers to entry existed at the

89. United States v. Apple Inc., 952 F. Supp. 2d 638, 656 (S.D.N.Y. 2013).

90. John B. Kirkwood, *Collusion To Control a Powerful Customer: Amazon, E-Books, and Antitrust Policy*, 69 U. MIAMI L.R. 8 (forthcoming 2014).

91. *Id.* at 60.

92. *Id.* at 80–81; *See generally Apple Inc.*, 952 F. Supp. 2d 638.

93. Kirkwood, *supra* note 90, at 16.

94. *See also* Jonathan Mahler, *Hachette Chief Leads Book Publishers in Amazon Fight*, N.Y. TIMES (June 1, 2014), http://www.nytimes.com/2014/06/02/business/media/hachettes-chief-at-front-lines-in-fight-with-amazon-over-e-books.html (explaining that "Amazon is delaying shipments and preventing preorders of certain Hachette books" because Hachette is strongly negotiating new terms of supply to address Amazon's deep discounts). This current controversy provides a clear example of what the publishers were afraid of when confronting Amazon about the pricing policy in the first place. As Mahler discusses, the other publishers have all let Hachette take the lead against Amazon as they sit silently out of concern for any retaliation that Amazon might pursue if they speak up. *Id.*

95. Kirkwood, *supra* note 90, at 62.

96. *Id.*

time. The emergence of the e-book market combined with the network externalities[97] of e-reader users creates a large incentive to exclude competition at the market's inception. The longer rivals are barred from market entry, the more time the innovator has to capture e-reader users who will be locked into to purchasing e-books for that specific e-reader in the future. Accordingly, excluding potential rivals from the e-book market via Amazon's countervailing power could harm consumers by limiting available options in the short term. If Amazon's behavior makes the e-book market one such that rivals cannot compete on the merits—incentivizing Apple to coordinate supply agreements with the publishers—then it is questionable whether the government should enforce antitrust law that effectively protects this dominant behavior and power.[98] Thus, the DOJ's enforcement against Apple and the publishers without a strong inquiry[99] into Amazon's behavior could be seen as not fulfilling the goal of protecting consumer welfare. Of course, Amazon could be utilizing efficiencies to outperform potential rivals, which benefits consumers by providing a superior product.[100]

If countervailing power exists, one way to determine whether or not it should be condemned is to consider the function of the restraint in the particular market.[101] It is important to consider the characteristics of competitive forces in the market and whether or not the market can remain competitive notwithstanding the countervailing restraint.[102] This inquiry requires consideration of whether market entry was desirable at the time Amazon held 90% of the e-book market. Focusing on the par-

---

97. A network externality means that "each additional user of a given e-books system confers benefits on existing users of that system." *See* United States v. Apple Inc., 889 F. Supp. 2d 623, 640 (S.D.N.Y. 2012). Here, the more people Amazon can get to use the Kindle means more people who will purchase e-books from Amazon; hence, a strong incentive exists for Amazon to get as many people using the Kindle in the beginning to ensure that it secures revenues from future e-book sales.

98. Professor Kirkwood outlines a proposal for a narrow defense to collusion in order to control buyer power, yet he concludes that it would not provide a defense for Apple in this case. *See* Kirkwood, *supra* note 90, at 65.

99. "DOJ claims that it closely examined allegations that Amazon engaged in predatory pricing, and found persuasive evidence lacking." *Apple Inc.,* 889 F. Supp. 2d at 641. As argued in Part V, *infra*, there is an empirical bias towards pursuing collusion claims as opposed to claims of exclusionary conduct. The economic inefficiencies and consumer harm that result from both collusion and exclusion are the same, yet the government consistently challenges collusion more often than exclusion.

100. *See* United States v. Aluminum Co. of Am., 148 F.2d 416, 430 (2d Cir. 1945) (recognizing that "[a] single producer may be the survivor out of a group of active competitors, merely by virtue of his superior skill, foresight and industry. In such cases a strong argument can be made that, although the result may expose the public to the evils of monopoly, the [Sherman] Act does not mean to condemn the resultant of those very forces which it is its prime object to foster.").

101. Barbara Ann White, *Countervailing Power—Different Rules for Different Markets? Conduct and Context in Antitrust Law and Economics*, 41 DUKE L.J. 1045, 1074 (1992).

102. *Id.* at 1081.

ticular market emphasizes the importance for antitrust law to remain flexible in its application to ensure the ultimate goal of protecting consumer welfare.

B. Predatory Pricing or Loss Leading?

An existing market failure that prevents new entrants in the e-book market could explain why Apple decided to conspire with the defendant publishers. An argument put forward in Apple's defense was that Apple's cartel opened up the market and allowed participants to compete on a level playing field.[103] Indeed, in the two years following the switch to agency agreements, Amazon's market share fell from 90% to 60%.[104] Moreover, because of the network externalities[105] that exist between e-readers and e-books, Amazon had a large incentive to entrench itself as the dominant e-book retailer early on.[106] These considerations could show either that Amazon's pricing strategy before the agency agreements was an artificial barrier to entry, or that the e-book market naturally matured to attract entrants because of Amazon's clear success.

1. Predatory Pricing

Apple and the publishers voiced concern that Amazon created barriers to entry via predatory pricing of its e-books.[107] Predatory pricing is an anticompetitive strategy in which a firm drives out or excludes rivals by selling at below-cost prices[108] to prevent rivals from competing on the product's merits.[109] In addition to setting below-cost prices, the second requirement for predatory pricing is a dangerous prospect of recouping the profits sacrificed from below-cost pricing.[110] In theory, predatory pricing harms consumers because artificially low prices drive out competitors and allow the predatory firm to charge high prices after entry is discouraged.[111] In reality, however, antitrust enforcement and courts pro-

103. *Apple Inc.*, 889 F. Supp. 2d at 639–40.

104. *Id.* at 640.

105. A network effect exists in this case because the supply of e-books necessarily hinges on the amount of Kindle users. Amazon has a large incentive to get as many Kindle users as possible to ensure sales of its e-books.

106. *Apple Inc.*, 889 F. Supp. 2d at 641.

107. *See id.* at 653.

108. No clear consensus exists as to what the proper metric for determining what below-cost prices are. Although two theories exist, there is consensus that pricing below the average variable cost (or marginal cost) is presumptively illegal. *See* Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697, 712 (1975).

109. *Id.* at 697.

110. Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 210 (1993).

111. Daniel A. Crane, *The Paradox of Predatory Pricing*, 91 CORNELL L. REV. 1, 3 (2005).

ceed cautiously with predatory pricing claims because lower prices clearly benefit consumers; thus, the second prong of the analysis is critical to determine whether a particular conduct is anticompetitive.[112]

In this case, the anticompetitive conduct of predatory pricing could potentially create a barrier to entry for rival e-book retailers. A barrier to entry makes entry unprofitable, which discourages entry by making the cost of doing business higher for new firms than it is for established firms.[113] In this case, Amazon's pricing policy made it prohibitively more costly for a rival to do business because it would be forced to take losses on e-books to compete.

Because Amazon's Kindle and e-books are complementary products, the analysis of below-cost pricing is difficult. To begin, Amazon's 90% market share highly suggests monopoly power, yet it depends on the relevant market definition and entry barriers. Amazon sold many e-books at a price below wholesale cost. Indeed, Amazon maintained a $9.99 price point for books it paid $13 to $17 wholesale.[114] Therefore, the below-cost price point could be satisfied for the purposes of predatory pricing if the relevant market definition is e-books. Notably, however, Amazon's below-cost pricing was not pervasive across all of the books it offered for sale. Nevertheless, new releases and bestsellers make up the majority of sales.[115]

Currently, the second element to a predatory pricing claim requires a plaintiff to show a dangerous prospect of the defendant recouping the profits sacrificed by pricing below cost.[116] Whether or not the profits sacrificed by selling e-books below the wholesale price were worth it for Amazon requires a bit of speculation; nonetheless, plausible theories of recoupment exist. The first, and most obvious, is that the profits sacrificed by selling e-books below wholesale prices could be recouped through the profits received from Kindle sales.[117] Because of the com-

---

112. *See* Areeda & Turner, *supra* note 108, at 704 ("A firm may voluntarily assume shortrun losses in situations where monopoly is neither sought nor possible, and where, as in the case of a new entrant seeking to become established in a market, such action promotes rather than retards competition.").

113. *See* AREEDA & HOVENKAMP, *supra* note 1, ¶ 729a.

114. United States v. Apple Inc., 952 F. Supp. 2d 638, 650, 656 (S.D.N.Y. 2013).

115. *See id*. (noting that the $9.99 price was limited to new releases and New York Times bestsellers).

116. Brooke Grp. Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 210, 224 (1993) ("Evidence of below-cost pricing is not alone sufficient to permit an inference of probable recoupment and injury to competition. The determination requires an estimate of the alleged predation's cost and a close analysis of both the scheme alleged and the relevant market's structure and conditions.").

117. In 2009, the cost of building a Kindle 2 was about $185 with a retail price of $359, for a margin of $174. Within that margin, Amazon will necessarily be recouping its research and development investment and other associated costs of production; however, it is clear that there is poten-

plementary nature of Kindles and e-books—combined with Amazon's market power in the e-reader market—a reduction in the price for e-books will increase demand for Kindles.[118] By charging below-cost prices for e-books, Amazon can increase its profits from Kindles and, thus, exclude potential rivals from entering the market because rivals cannot compete without taking substantial losses on e-books.[119] This exclusion is especially true for smaller firms attempting to compete in retailing e-books. But, it is possible to argue that Apple—a large firm with many resources—could reach efficiencies and use a pricing policy similar to Amazon's in order to compete effectively. Yet antitrust law attempts to prevent firms from using predatory conduct to create an anticompetitive marketplace. By using a predatory pricing strategy, firms prevent the free-market from determining prices by using their dominant position to exclude and harm competition. Even more, the network externalities of the e-book market create a huge incentive for Amazon to preserve its market power.[120]

Moreover, further support for Amazon's potentially predatory conduct involves Amazon's pricing strategy as a company rather than solely in the e-book market. In the third quarter of 2013, Amazon made $17.09 billion in net sales; however, it posted a net loss of 9¢ per share.[121] After releasing these financials, Amazon's publicly traded shares rose 1.5 percent.[122] This paradox seems to support Amazon's greater company strategy of not focusing on short-run profits, but rather capturing market share by taking net losses in the short run. While this evidence, alone, does not fully support a claim based on predatory conduct, it provides an example of the strong incentives driving Amazon's pricing strategy. If share value increases substantially despite net profit loss, then the shareholders value Amazon's ability to capture market share with the potential for long-run gains greater than short-run losses. Furthermore, because Amazon utilizes advanced pricing strategies based on complex algorithms, losses incurred from e-books could easily be recouped elsewhere in their diverse sales. Although this might be an unprofitable strategy in the short term and, thus, is not going to occur often because of the as-

---

tial to recoup each $3 to $4 loss from an e-book sale within the sale of a Kindle. *See* Brennon Slattery, *Amazon's $359 Kindle 2 Costs $185.49 to Build*, TECHHIVE (Apr. 22, 2009), http://www.techhive.com/article/163609/amazon_kindle_markup_cost_revealed.html.

118. *See* Christopher R. Leslie, *Predatory Pricing and Recoupment*, 113 COLUM. L. REV. 1695, 1721 (2013).

119. *See id.*

120. *See* Steven C. Salop & R. Craig Romaine, *Preserving Monopoly: Economic Analysis, Legal Standards, and Microsoft*, 7 GEO. MASON L. REV. 617, 639 (1999).

121. Brad Stone, *Same Old Amazon: All Sales, No Profit*, BLOOMBERG BUSINESSWEEK (Oct. 24, 2013), http://www.businessweek.com/articles/2013-10-24/same-old-amazon-all-sales-no-profit.

122. *Id.*

sumption that firms maximize profits, evidence shows that Amazon is not afraid to take losses to maintain or gain market power.[123] However, a fine line exists between pricing strategies used to capture market share and those used to keep rivals out.

The point of the foregoing analysis is not to argue that a predatory pricing claim should be made against Amazon.[124] In fact, a predatory pricing claim would be extremely difficult because of the high and complex threshold of proving a dangerous probability of recouping the profits sacrificed. Instead, the goal is to bring to light nuances in the evidence and the incentives driving the different parties, which show that the government's de facto protection of Amazon might not fulfill the goal of protecting consumer welfare.

2. Loss Leading

The strongest argument in support of Amazon's conduct is that they engaged in a pro-competitive loss leading strategy.[125] Loss leading refers to the pricing strategy in which a firm discounts a product to promote and market a different product.[126] In this case, Amazon's sales of e-books below the wholesale price could be characterized as loss leading to promote purchases of the Kindle. This, in turn, supports the strong incentives to capture users early because of the network externalities mentioned earlier. Notably, loss leading is a competitive strategy that companies use to compete aggressively with pro-competitive benefits to consumers.[127]

Professor Kirkwood concludes that Amazon most likely used loss leading as opposed to predatory pricing.[128] In support of this position, he argues that (1) Judge Cote and numerous commentators characterized the behavior as loss leading; (2) Amazon never sold all of its books below cost, which it would do if it was truly committed to excluding rivals; (3) Amazon cut back its discounts since prices of e-readers have recently dropped, which evidences Amazon's goal to attain profits from the Kindle as opposed to monopoly power in the e-books market; and (4) rival e-

123. *See, e.g.*, *id*.

124. Judge Cote dismissed Apple's defense that Amazon had conducted predatory pricing by stating that two legal wrongs do not make a right. She states that "the remedy for illegal conduct is a complaint lodged with the proper law enforcement offices or a civil suit or both." United States v. Apple Inc., 952 F. Supp. 2d 638, 708 (S.D.N.Y. 2013).

125. *See id.* at 650 (Judge Cote characterizes the strategy (without much analysis) as loss leading, stating that, "[Amazon] continued to sell many NYT Bestsellers as loss leaders at $9.99.").

126. *See* AREEDA & HOVENKAMP, *supra* note 23, ¶ 742f.

127. Kirkwood, *supra* note 90, at 44 n.171.

128. *Id.* at 54.

book retailers have since entered the market, suggesting a lack of a dangerous probability of monopolization.[129]

While it is simple to characterize Amazon's behavior as loss leading, more emphasis should be given to the fact that it was an innovator in a market with network externalities. Amazon did not need to sell all of its books below cost to successfully exclude rivals from entry into this new market. Because of the network externalities, Amazon merely needed to attract as many users from the outset to ensure continued e-book purchases through its device. Thus, Amazon's below-cost pricing strategy focused on new releases and bestsellers,[130] which would necessarily attract a majority of consumers to purchase a Kindle. As a result, the combination of network externalities and Amazon's position as a market innovator creates a situation ripe for exclusionary conduct at the outset, which greatly benefits the long-term profits of Amazon once users are in the network via a Kindle. Although substantial product discounts used to capture users at the market's inception might benefit consumers in the short-run, if the discounts are done in such a way as to exclude rivals from the ability to enter into the market and compete, then long-run harm could occur via decreased innovation and choices, which might outweigh the pro-competitive effects.

C. Structural Market Failure

While it is arguable whether Amazon unilaterally created barriers to entry at the inception of the e-books market, the unique nature of the market provides support for a structural market failure theory. This theory purports that because of the unique nature of the e-book market, entry would not have occurred without an increase in price. Further, without entry occurring, innovation in the marketplace would be diminished over time.

As Professor Kirkwood argues, the publishers' collusion was likely not justified in light of the unique market conditions with a dominant buyer;[131] yet, the government's de facto protection of Amazon's pricing behavior and market dominance to enforce a relatively simple per se price fixing case does not necessarily ensure a competitive marketplace that promotes innovation. The resulting protection of Amazon's dominance could impede innovation because if Apple found it challenging to enter the market, then it would follow that smaller retailers would certainly find it challenging as well. For example, only three e-book retail-

129. *Id.* at 51–52.

130. *See Apple Inc.*, 952 F. Supp. 2d at 649 ("Amazon utilized a discount pricing strategy through which it charged $9.99 for certain New Release and bestselling e-books.").

131. Kirkwood, *supra* note 90, at 8.

ers effectively make up the market: Amazon, Apple, and Barnes & Noble.[132] Barnes & Noble's Nook continues to lose money because it is unable to compete with Amazon's below-cost e-book prices.[133] Although antitrust law does not exist to help rivals compete,[134] it does exist to protect consumers from a firm's conduct that limits consumer choices or inhibits innovation by excluding potential rivals. The stark impact on the Nook shows how the protection of a dominant firm in a concentrated market can harm competition in the marketplace.

Alternatively, the small number of competitors in the market could evidence a version of a natural monopoly. A natural monopoly occurs when a relevant market does not support more than one firm.[135] Competition is not possible because a rival's entry would be irrational and actually harm consumers.[136] A natural monopoly could theoretically arise due to three factors: (1) thin demand that only supports one firm in the market; (2) changes in consumer preference or cost that drive out all but the most efficient or highly demanded firm; or (3) superior skill and efficiencies that other firms cannot compete with.[137] Here, Amazon's 90% share and the difficulty for potential rivals to enter and compete effectively could be a result of its superior skill and efficiencies resulting from its economies of scale. Because e-books are not Amazon's sole source of revenue and it successfully reaches a large customer base, Amazon might hold a type of superior skill and efficiency.

But when considering the situation of a new entrant into the e-book market after Amazon secured its footing as a dominant firm, the structure is not akin to normal natural monopolies.[138] The publishers were already upset with Amazon's pricing; thus, it is unlikely they want a new retailer to continue with a similar policy. However, a new retailer must compete

---

132. *See* Jeremy Greenfield, *Is Apple Now the No. 2 Ebook Retailer in the U.S.?*, DIGITALBOOKWORLD (Mar. 24, 2014), http://www.digitalbookworld.com/2014/is-apple-now-the-no-2-ebook-retailer-in-the-u-s/ (noting that data is difficult to attain because of its sensitive nature, yet Amazon is definitively number one while no consensus exists pertaining to the number two spot).

133. Joshua Brustein, *Barnes & Noble Won't Stop Making New Money-Losing Nooks*, BLOOMBERG BUSINESSWEEK (Feb. 26, 2014), http://www.businessweek.com/articles/2014-02-26/barnes-and-noble-wont-stop-making-new-money-losing-nooks (for Amazon, e-books are just one product among its diverse product line; however, for Barnes & Noble, its markedly less diverse product line means that it does not have the flexibility to take losses on e-book sales as Amazon is able to.).

134. *Apple Inc.*, 952 F. Supp. 2d at 709.

135. AREEDA & HOVENKAMP, *supra* note 49, ¶ 658b. (an example includes a small town that cannot support more than one movie theater; competition would push both theaters out of business because neither would be able to cover operating costs to maintain profitability).

136. *Id.*

137. *Id.* at ¶ 658b2.

138. Examples generally do not include consumer goods.

with Amazon. Assuming Amazon was not acting predatorily, unless the new retailer can match the same efficiencies as Amazon and take losses in e-book sales in order to secure a position in the market, competition to constrain Amazon would not exist unless the retailers also introduced an e-reader with which to compete. This result effectively forces any potential rival to adopt the same business model as Amazon, which could stifle innovation in e-book retailing. The stifling could occur by deterring potential entrants because of the enormous costs of developing an e-reader, or, conversely, it could deter Amazon from innovating e-book retailing because it faces little realistic competition from rivals. While both externalities exist, the inhibiting of innovation by new market entrants is arguably more important.[139]

On the other hand, it could be argued that Barnes & Noble should simply innovate in order to compete with Amazon. While this may push Barnes & Noble to innovate in areas such as e-readers or digital content, Amazon's dominance can impede the incentive to innovate in the e-book retailing market because, from Barnes & Noble's perspective (or any potential rival in the e-book market), it is difficult to attain a return on the investment if the firm cannot compete on e-book prices.[140] A rival retailer could gain returns from digital content and e-readers, but not from the books themselves. Higher e-book prices, however, would "induce[] risk taking that produces innovation and economic growth"[141] in the e-book retail market.

The increase in e-book prices would provide the necessary incentive for competitors to enter the market and constrain Amazon's dominant power. This new competition would properly incentivize innovation in e-book retailers, which benefits consumers in the long run. Instead, protecting Amazon's dominant power potentially creates disincentives

---

139. *See* Tim Wu, *Taking Innovation Seriously: Antitrust Enforcement if Innovation Mattered Most*, 78 ANTITRUST L.J. 313, 318 (2012) (explaining that "external innovation is more likely to be of a 'disruptive' nature—a giant leap forward," and internal innovation (e.g., innovation by Amazon) depends on external constraints (e.g., rivals' innovation)).

140. Competition with e-books would exist to the extent that potential rivals would compete based on how great of a loss they are willing to take in order to match Amazon's prices. The profit maximization assumption would lead firms to simply match Amazon's price; thus, e-book pricing competition is effectively inhibited by Amazon's market dominance and the unique market conditions. Amazon's dominance effectively rids the e-book market of competition and forces potential competitors to compete on other merits, such as e-readers, digital content, etc.

141. Verizon Commc'ns Inc. v. Law Offices of Curtis V. Trinko, LLP, 540 U.S. 398, 407 (2004). Although the *Trinko* decision was made in light of maintaining a monopoly because of a lack of anticompetitive conduct, the principle of higher prices inducing firms to innovate holds strong. *See also Content Pricing Consultant: Ebooks Should Be (Much) More Expensive*, DIGITALBOOKWORLD (Apr. 2, 2014), http://www.digitalbookworld.com/2014/content-pricing-consultant-ebooks-should-be-much-more-expensive/ (arguing that e-book prices should be higher to reflect the added convenience and consumer benefits when compared to print books).

for innovation in the e-book market. While the unique characteristics of the market might not justify collusion,[142] the clear innovation concerns should speak to how the government utilizes its discretion when bringing claims against firms in markets characterized by a dominant firm, a small number of players, network externalities, and technology.[143]

V. DID ANTITRUST ENFORCEMENT PROMOTE INNOVATION IN THE E-BOOK MARKET?

Assuming that firms maximize profits and act rationally, the resulting collusion between Apple and the defendant publishers exemplifies the adverse results of Amazon's dominant power. The unique nature of the market and Amazon's pricing policy contributed, in part, to incentivizing the "supreme evil of antitrust: collusion."[144] Thus, an issue raised in this case is whether the government should give more deference to innovation concerns before it brings a claim that, if successful, protects a dominant buyer in an innovative market characterized with network externalities. The dichotomy between the government's pursuit of exclusionary claims and collusion claims poses a much-discussed policy issue for antitrust law. As Professor Baker advocates, although greater weight seems to be given toward enforcing antitrust litigation against collusion, exclusionary conduct is a vital aspect at the core of sound antitrust policy.[145] Even though collusion and exclusion arise from different business strategies, one should not be given more weight over the other in terms of enforcement.[146] In other words, the DOJ should not enforce the Sherman Act against collusion at the cost of protecting another party's exclusionary behavior because both harm consumer welfare.

Taking this idea a step further, if competition favors innovation and the purpose of antitrust law is to adequately promote increased innova-

142. *See* Kirkwood, *supra* note 90, at 64–65.

143. *See* Wu, *supra* note 139, at 320 ("[I]nnovation-centered antitrust policy must make scrutiny of exclusion of innovators its primary concern and a focus of resources. In practice, this means pursuing challenging cases with few opportunities to rely on rules of per se illegality.").

144. *Trinko*, 540 U.S. at 408.

145. Jonathan B. Baker, *Exclusion as a Core Competition Concern*, 78 ANTITRUST L.J. 527, 589 (2013). Professor Baker describes two main reasons for the pursuit of collusion claims over exclusion: (1) the difficulty in distinguishing harmful and beneficial exclusionary conduct, and (2) a chilling effect that can result from false positives when firms benefit consumers in a manner that could be seen as exclusionary. *Id.* at 575–76. For example, the exclusionary conduct of predatory pricing walks the thin line between harming and benefiting consumers because lower prices obviously increase consumer welfare; yet, if the prices are being cut in order for a firm to maintain or increase its monopoly power in the future, then consumers are harmed in the long run through higher future prices or decreased innovation and choices. On the other hand, collusion claims encompass more tangible and cognizable characteristics that are obviously anticompetitive, which is why the per se standard still exists for bilateral horizontal agreements claims.

146. *Id.* at 529.

tion, then the government should give more weight to potential exclusionary conduct from a dominant firm that inhibits innovation than short-term price increases in the market. Price increases might harm consumers in the short run, but long-run harm to innovation in the market can outweigh the higher price concerns on balance. At the very least, claims should steer away from a per se analysis when issues of innovation are at play in a unique market such as this.

Although measuring the effects on innovation is a much more vague and abstract goal when compared to a price increase from a per se price fixing cartel, protecting innovation is much more important.[147] In this case, enforcement could harm innovation by penalizing and disadvantaging the one potential rival that could constrain Amazon's power, which resulted in de facto protection of Amazon—a dominant firm. Inhibiting the only real rival able to constrain Amazon's dominant position in the market could harm innovation by decreasing Amazon's incentive to innovate and improve e-book delivery to consumers because it faces less competition in the marketplace.[148]

To support this theory, evaluation of the market and Apple's behavior shows the potential for consumer harm in the long run. The combination of Amazon's market power, network externalities, and an innovative marketplace provide a unique incentive structure for innovation concerns in antitrust enforcement and litigation. While these factors create an environment ripe for exclusion at the market's inception, the effects on innovation of enforcement are difficult to measure without more information about the rate of innovation before and after enforcement. If antitrust enforcement against Apple promoted innovation, then the result of *United States v. Apple Inc.* should point to firms using innovative strategies of e-book retailing post-enforcement.[149] Today, however, price remains the "weapon of choice" for capturing market share, with Amazon being the price leader.[150]

United States v. Apple Inc. exemplifies the tension between the two types of anticompetitive conduct and antitrust policy. It makes complete sense for the DOJ to attack the cartel that Apple and the publishers created because it overtly resulted in higher prices as a result of the supply contract switch. However, when a dominant market innovator—like Amazon—uses pricing policies that have the potential to bar entry in an in-

147. Wu, *supra* note 139, at 328.

148. *See* Jonathan B. Baker, *Beyond Schumpeter vs. Arrow: How Antitrust Fosters Innovation*, 74 ANTITRUST L.J. 575, 580 (2007) (explaining that "a firm that faces less competition has less need to work hard to escape competition.").

149. *See id*. at 591–92.

150. *Content Pricing Consultant: Ebooks Should Be (Much) More Expensive*, *supra* note 141.

novative technology market with network externalities, antitrust enforcement should take extra care to not protect the dominant firm. Protecting a dominant firm's power has the potential to diminish incentives to innovate in the market, which harms consumers.

VI. CONCLUSION

Antitrust enforcement that fulfills the goal of protecting consumer welfare within innovative industries entails some substantial challenges. Anticompetitive conduct that affects price clearly provides tangible evidence, whereas harm to innovation is a much more abstract proposition. Nevertheless, when the government challenges practices in concentrated markets with a dominant buyer in the future, it should give greater deference to innovation to ensure that the dominant firm is not de facto protected in a way that harms consumers in the long-run. *United States v. Apple Inc.* exemplifies a modern trend of enforcement agencies pursuing claims based on collusive conduct as opposed to unilateral exclusionary conduct, which might cost consumers in terms of market innovation in the long run. While enforcement agencies pursue per se claims because of the high probability for a "win," there must be greater concern for long-term harm to consumer welfare from inhibited innovation in the market post-enforcement.