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Hazlett on the Apple e-books case: The Apple case is a throwback to Dr. Miles, and that's not a good thing
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The Apple e-books case is throwback to *Dr. Miles*, the 1911 Supreme Court decision that managed to misinterpret the economics of competition and so thwart productive activity for over a century. The active debate here at TOTM reveals why.

The District Court and Second Circuit have employed a *per se* rule to find that the Apple e-books agreement with five major publishers constituted a violation of Section 1 of the Sherman Act. Citing the active cooperation in contract negotiations involving multiple horizontal competitors (publishers) and the Apple offer, which appears to have raised prices paid for e-books, the conclusion that this is a case of horizontal collusion appears a slam dunk to some. "Try as one may," writes Jonathan Jacobson, "it is hard to find an easier antitrust case than *United States v. Apple*."

I'm guessing that that is what Charles Evans Hughes thought about the *Dr. Miles* case in 1911.

Upon scrutiny, the apparent simplicity in either instance evaporates. *Dr. Miles* has been revised as per *GTE Sylvania*, *Leegin*, and (thanks, Keith Hylton) *Business Electronics v. Sharp Electronics*. Let's here look at the pending Apple dispute.

First, the Second Circuit verdict was not only a split decision on application of the *per se* rule, the dissent ably stated a case for why the Apple e-books deal should be regarded as pro-competitive and, thus, legal.

Second, the price increase cited as determinative occurred in a two-sided market; the fact asserted does not establish a monopolistic restriction of output. Further analysis, as called for under the *rule of reason*, is needed to flesh out the totality of the circumstances and the net impact of the Apple-publisher agreement on consumer welfare. That includes evidence regarding what happens to total revenues as market structure and prices change.

Third, a new entrant emerged as per the actions undertaken — the agreements pointedly did not "lack…. any redeeming virtue" (*Northwest Wholesale Stationers*, 1985), the justification for *per se* illegality. The fact that a new platform — Apple challenging Amazon's e-book dominance — was both cause and effect of the alleged anti-competitive behavior is a textbook example of ancillarity. The "naked restraints" that publishers might have imposed had Apple not brought new products and alternative content distribution channels into the mix thus dressed up. It is argued by some that the clothes were skimpy. But that fashion

statement is what a *rule of reason* analysis is needed to determine.

Fourth, the successful market foray that came about in the two-sided e-book market is a competitive victory not to be trifled. As the Supreme Court determined in *Leegin*: A "*per se*rule cannot be justified by the possibility of higher prices absent a further showing of anticompetitive conduct. The antitrust laws are designed to protect interbrand competition from which lower prices can later result." The Supreme Court need here overturn *U.S. v. Apple* as decided by the Second Circuit in order that the "later result" be reasonably examined.

Fifth, lock-in is avoided with a *rule of reason*. As the Supreme Court said in *Leegin*:

> As courts gain experience considering the effects of these restraints by applying the rule of reason… they can establish the litigation structure to ensure the rule operates to eliminate anticompetitive restraints….

The lock-in, conversely, comes with *per se* rules that nip the analysis in the bud, assuming simplicity where complexity obtains.

Sixth, Judge Denise Cote, who issued the District Court ruling against Apple, shows why the *rule of reason* is needed to counter her *per se* approach:

> Here we have every necessary component: with Apple's active encouragement and assistance, the Publisher Defendants agreed to work together to eliminate retail price competition and raise e-book prices, and again with Apple's knowing and active participation, they brought their scheme to fruition.

But that cannot be "every necessary component." It is not in Apple's interest to raise prices, but to lower prices paid. Something more has to be going on. Indeed, in raising prices the judge unwittingly cites an unarguable pro-competitive aspect of Apple's foray: It is competing with Amazon and bidding resources from a rival. Indeed, the rival is, arguably, an incumbent with market power. This cannot be the end of the analysis. That it is constitutes a throwback to the anti-competitive *per se* rule of *Dr. Miles*.

Seventh, in oral arguments at the Second Circuit, Judge Raymond J. Lohier, Jr. directed a question to Justice Department counsel, asking how Apple and the publishers "could have broken Amazon's monopoly of the e-book market without violating antitrust laws." The DOJ attorney responded, according to an article in The New Yorker, by advising that

> Apple could have let the competition among companies play out naturally without pursuing explicit strategies to push prices higher—or it could have sued, or complained to the Justice Department and to federal regulatory authorities.

But the DOJ itself brought no complaint against Amazon — it, instead, sued Apple. And the admonition that an aggressive innovator should sit back and let things "play out naturally" is exactly what will kill efficiency enhancing "creative destruction." Moreover, the government's view that Apple "pursued an explicit strategy to push prices higher" fails to acknowledge that Apple was the *buyer*. Such as it was, Apple's effort was to *compete*, luring content suppliers from a rival. The response of the government is to recommend, on the one hand, litigation it will not itself pursue and, on the other, passive acceptance that avoids market disruption. It displays the error, as Judge Jacobs' Second Circuit dissent puts it, "That antitrust law is offended by gloves off competition." Why might innovation not be well served by this policy?

Eighth, the choice of *rule of reason* does not let Apple escape scrutiny, but applies it to both sides of the argument. It adds important policy symmetry. *Dr. Miles* impeded efficient market activity for nearly a century. The creation of new platforms in Internet markets ought not to have such handicaps. It should be recalled that, in introducing its iTunes platform and its vertically linked iPod music players, circa 2002, the innovative Apple likewise faced attack from competition policy makers (more in Europe, indeed, than the U.S.). Happily, progress in the law had loosened barriers to business model innovation, and the revolutionary ecosystem was allowed to launch. Key to that progressive step was the bulk bargain struck with music labels. Richard Epstein thinks that such industry-wide dealing now endangers Apple's more recent platform launch. Perhaps. But there is no reason to jump to that conclusion, and much to find out before we embrace it.

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