

PAPER TRAIL

Did publishers and Apple collude against Amazon?

BY KEN AULETTA



At four o'clock in the morning on January 22, 2010, John Sargent was pedalling furiously on an exercise bicycle in the basement of his Brooklyn brownstone. Sargent, the C.E.O. of Macmillan Books, had a difficult decision to make. In five days, Steve Jobs would announce the first iPad, and he was pressing Sargent to agree to a new way of selling books. For more than a hundred years, publishers had maintained a wholesale business: they sold books to bookstores

at a discount, and bookstores marked them up and sold them to consumers. The advent of e-books called that model into question. Because e-books didn't carry many of the costs of bound books, no one could agree on how they should be priced.

Amazon had the loudest voice in the conflict. Since introducing the Kindle, in 2007, it had come to dominate the e-book market, with about ninety per cent of sales. In the effort to gain even greater market

share, it was selling books at a loss: while publishers typically sold e-books to Amazon for about fifteen dollars apiece, Amazon was selling many of them, especially best-sellers, for \$9.99. Publishers were making money, but they were concerned that consumers would come to believe that \$9.99 was what books were worth, and they were desperate to have greater influence on prices.

The deal with Jobs offered a way: an arrangement called the agency model, which Apple used for selling music and apps. The publishers would set prices, and Apple, acting as their "agent," would take a thirty-per-cent commission and give them the rest. Apple had a stipulation, though. There are six large publishers in the United States, and if Apple didn't get four of them to join its program it wasn't going to sell books.

Sargent was vexed. Amazon accounted for a third of the major publishers' U.S. sales. What if it refused to carry Macmillan's books? But if he didn't consent to Apple's plan, he feared, Apple would choose not to compete against Amazon, solidifying its monopoly.

This confrontation had been simmering for some time. In 2009, the Hachette Book Group, another of the Big Six publishers, sent a team to Washington to petition the Antitrust Division of the Justice Department, hoping for help in curbing what publishers saw as Amazon's predatory practices. The team gave Justice a report asserting that Amazon was selling e-books below cost in order to induce readers to buy Kindles, and to drive bookstores out of business; if publishers resisted the lower prices, Amazon threatened not to sell their books at all. Justice wasn't interested in the case. "They just turned around to us and said, 'Sorry, we can't help, because the consumer is the winner,'" David Young, the chairman and C.E.O. of Hachette U.S.A., said.

The Justice Department believed that Amazon was serving consumers well by reducing book prices and by developing a popular device for reading e-books. Publishers believed that Amazon was attempting to control every part of the industry. It had formed a publishing arm that offered editing and promotional services, and wooed authors with promises of higher royalties; it bought BookSurge, to print its own books on demand, and Audible, a major provider of

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recorded books. Richard Howorth, the owner of Square Books, a well-regarded bookstore in Oxford, Mississippi, says, "Amazon not only wants to sell books to everyone—they act as publisher and agent and distributor and retailer and manufacturer."

There is a certain bluster about Sargent; confrontations did not discomfit him. His parents divorced when he was young, and his mother moved him and his sister to an isolated part of Wyoming. "It was cowboy country," an editor at Macmillan says. "John grew up spending lots of time alone." But he also had strong links to publishing—his grandfather Frank Nelson Doubleday founded Doubleday & Company, and his father, John Turner Sargent, Sr., built it into a respected firm—and as an adult he moved back to New York and joined the family business. At Macmillan, he oversees sixteen publishing houses. Before the Apple deal, he recalls, "I had half the staff saying, 'Do it,' and half the staff saying, 'Don't do it.'" Unlike other publishers, his parent company, Holtzbrinck Publishing Group, was privately owned, so his bosses were not responsible to shareholders. They said it was his decision. He told Apple yes.

Five days later, Steve Jobs announced that five of the six publishing giants—Macmillan, Hachette, Simon & Schuster, HarperCollins, and Penguin—would sell their books through Apple's iBookstore. (Only Random House said no, retaining the more lucrative wholesale model.) In addition to the agency model, the five publishers had agreed to a clause assuring Apple that it would have the right to match any other retailer's lowest price. Sargent flew to Seattle to confront Amazon. He argued that the agency model was a good deal for Amazon, too; it would pay the same price as any other bookseller, but, instead of losing money on the best-selling e-books, it would make a commission of thirty per cent. He also warned that if Amazon would not accept the agreement he would no longer allow it to carry his company's e-books.

In response, Amazon stopped selling Macmillan's books altogether. But Sargent did not back down, and two days later Amazon put up an announcement on its Web site: "We will have to capitulate and accept Macmillan's terms because Macmillan has a monopoly over their own titles." Within a few weeks, all

five publishers that had accepted the deal with Apple had forced Amazon to agree to the agency model.

By 2012, it seemed that Sargent's gambit had worked. Amazon's share of the e-book market had dropped from about ninety per cent to sixty. Apple had about ten per cent of the market, and Barnes & Noble, which had introduced an e-reader called the Nook, had about twenty-five. Bookstores were hopeful. Richard Howorth, of Square Books, said, "It at least enables me to say to our customers that not only do I sell e-books but eighty per cent of them are available at the same cost as anywhere." William Lynch, the C.E.O. of Barnes & Noble, says that without the increased revenue that came with the agency model the Nook might have failed. "We invested over two hundred million dollars this year," he said, introducing the first color reader and developing a way for store visitors to sample books on the Nook. "If Amazon had maintained its monopoly, we would not have been able to make that level of investment."

It was a peculiar victory, though. Under the agency model, many consumers paid higher prices, and Amazon made more money, while the publishers made less—according to one C.E.O., a hundred million dollars less each year. E-books are cheaper to produce, by about twenty per cent per book, because they do away with the cost of paper, printing, shipping, and warehousing. They also eliminate returns of unsold books—a significant expense, since thirty to fifty per cent of books are returned. But they create additional costs: maintaining computer servers, monitoring piracy, digitizing old books. And publishers have to pay authors and editors, as well as rent and administrative overhead, not to mention the costs of printing, distributing, and warehousing bound books, which continue to account for the large majority of their sales.

Publishers were terrified. Print revenues had declined fifteen per cent since the year before, and in just a couple of years e-books were projected to make up about a third of all book sales. Publishers worried that bookstores, burdened by the costs of rent and staff, were unable to compete with Amazon. Without the stores, publishers would lose their primary

customers, and their strongest ally in marketing. “In bookstores, readers are open to trying new genres and new authors,” Scott Turow, the president of the Authors Guild, has said. “It’s by far the best way for new works to be discovered.” Because each book is a unique product, large-scale advertising is usually unfeasible, so publishers work with stores to guide readers to books, in the belief that the tactile experience of shopping leads people to books they would not otherwise find.

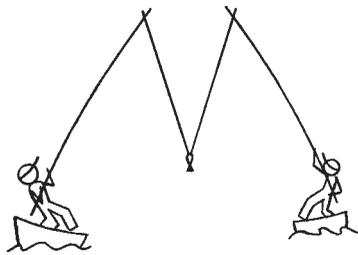
“This idea of going into a store and being able to see a range of books that you never knew you wanted to buy, or you didn’t know existed, is very important,” David Young, of Hachette, says. On Amazon, publishers have little say in how a book is presented; buyers looking for a particular book are led to similar titles, chosen by an algorithm. A striking book jacket matters much less. John Mackinson, the C.E.O. of Penguin, said, “Once you lose the ability to display a book and you have to rely on a consumer to discover a book, then publishers are not going to be able to publish anything like the range of books we do today. It will make absolutely no difference to some best-selling authors we publish. But breaking out the new author becomes a virtual impossibility.”

Jeff Bezos, the founder of Amazon, believes that the book industry is infuriatingly wasteful. He says that his company intends to disrupt traditional “gatekeepers”—publishers, bookstores, agents, and other middlemen—who “slow innovation” and impede “self-service platforms.” If books were all digitally produced, the process would be much more efficient, and the savings could be passed along to consumers. Bezos is a businessman, but, like the founders of Google and Facebook, he frames his business as a force for social good. In his terms, Amazon offers consumers the lowest prices, and allows authors who otherwise might not be published to sell books directly to readers. The Kindle best-seller list, Bezos wrote in 2011, “is chock-full of books from small presses and self-published authors, while the New York *Times* list is dominated by successful and established authors.”

Russ Grandinetti, Amazon’s vice-president of Kindle content, says, “Clearly, consumers are paying higher prices for books” under the agency model. “I don’t

see how not allowing price competition preserves competition.” He argues that Amazon “is getting people to read more,” pointing to Amazon surveys showing that readers who had a Kindle bought three times as many books as they did before. The ease of purchasing a book online “is powerful for the whole business,” he says.

Yet, when I asked Grandinetti why publishers should view Amazon as a partner, he said, “We’ve always been a



company focussed on customers, not competitors”—a peculiar way of describing your suppliers. By offering low prices on everything from books to designer clothes, power tools, and groceries, Amazon has made many business adversaries. It recently developed an app that allows people to scan the price of a product—a book at Barnes & Noble or a television at Best Buy—and instantly learn whether Amazon offers the same item cheaper. Stores complain that Amazon is stealing their customers, and that it often pays no sales tax on its goods.

In May, 2011, Amazon hired the veteran publisher Laurence Kirshbaum to lead a new general-interest imprint called Amazon Publishing, and in December it established a six-million-dollar fund to pay self-published authors. A publishing executive who has had extensive dealings with Bezos told me, “Going into publishing was a last option. But when publishers went into ‘agency’ it shifted the agenda for Bezos. He felt publishers were so irrational that he shifted to a predatory mode.”

Grandinetti denies trying to put publishers out of business. Amazon, he argues, is simply acknowledging that consumers have many choices for entertainment—TV, e-mail, Facebook, games—and that the challenge is to make books both cheaper and more enticing. He believes that publishers are failing to keep up with change, and that traditionalists are missing the point when they ask, “Why

doesn’t the book business stay the same?”

The traditional model has advantages for authors, though, particularly in publishers’ function as venture-capital firms. When an author sells a book proposal to a publisher, he receives an advance against royalties, which helps underwrite research and writing. Most of these advances are never earned back. But books that sell well support the ones that don’t. In a good year, this earns the publishers a modest profit, and it allows more authors to take risks in starting new projects—which is to say, it supports a class of professional writers. In a more efficient world, publishers would pay authors who write best-selling books and rarely pay those who don’t, an alarming prospect for most serious readers and writers. According to a recent survey by the Web site Taleist, half of all self-published authors make less than five hundred dollars a year from their writing. If publishers don’t have the money to pay advances, Young says, “we’re going to have fewer books of quality. The impact on authors could be huge.”

The first sign that Sargent and the publishers had won a Pyrrhic victory came in August, 2011, when a class-action lawsuit was filed in California, claiming that Apple and the five publishers had colluded to fix prices. Many in the publishing business pointed out that a lead attorney for the suit, Steve W. Berman, worked out of a building in Seattle where Amazon has several floors of office space. Although Berman insisted that he was working only for his clients, it is clear that Amazon provided much of the evidence in the eighty-three-page complaint: accounts of meetings, phone calls, and e-mails between Amazon and publishers. Oren J. Teicher, the C.E.O. of the American Booksellers Association, asserts that Amazon helped organize the suit in order “to open up yet one more front in their effort to dominate the entire book business,” and to “increase the pressure” on government to intervene.

The Justice Department’s Antitrust Division soon began inquiries, as did the attorneys general of several states, and the European Commission. Unlike class-action lawyers, Justice can issue subpoenas, and it retrieved phone records from Apple and the five publishers, notes from meetings, and e-mails—twenty

thousand from Penguin alone, according to an executive there. On April 11th, Attorney General Eric Holder announced that an antitrust suit had been filed against Apple and the five big publishers for “a conspiracy to raise, fix and stabilize retail prices.”

In a thirty-six-page complaint, the Justice Department argues that publishers communicated by telephone and e-mail, and in meetings—including meals “in private dining rooms of upscale Manhattan restaurants”—to determine how to subvert Amazon’s pricing strategy. The complaint noted that they “took steps to conceal their communications with one another, including instructions to ‘double-delete’ e-mail and taking other measures to avoid leaving a paper trail.” In violation of Section 1 of the Sherman Antitrust Act, it said, they had stifled competition and forced consumers to pay an average of two to three dollars more per book, for a total of at least a hundred million dollars.

Courts recognize various forms of price-fixing. One is horizontal collusion, in which competitors conspire to set prices. Another is vertical collusion, between, say, a manufacturer and a retail store. Justice’s charge was a hybrid: “hub and spoke” collusion, in which a retailer coordinates manufacturers to gain control of prices. Between December, 2009, and January, 2010, the complaint said, an Apple executive named Eddy Cue shuttled between the publishers, keeping “each Publisher Defendant informed of the status of its negotiations with the other Publisher Defendants.” (Apple denied the charges, and, through a spokesman, Cue declined to comment.) According to Justice, Penguin (which published my last three books) asked for assurances that other publishers would join with Apple, and Cue supplied them; two other publishing executives told me they had similar conversations with him. When Sargent threatened, in January, 2010, to pull Macmillan’s e-books from Amazon, D.O.J. claims, Cue told him that other publishers were on board.

A number of publishers insist that they did not collude. “It was my decision alone,” Sargent says. “That’s why the whole thing about collusion is ludicrous to me. I was in a silo. It was just me.” In places, the D.O.J.’s evidence is thin. The complaint says that, in September, 2008,

the C.E.O.s of the Big Six publishers met in a private room at Picholine, a French restaurant near Lincoln Center, and notes, rather unsurprisingly, that “business matters were discussed.” David Young says that he organized the dinner to welcome the new C.E.O. of Random House, Markus Dohle, and several C.E.O.s maintain that if there was any business discussed it was the sort of gossip and stray publishing talk common among executives who often encounter each other at awards ceremonies and public dinners. Sargent recalls, “I talked to him about getting his kids into schools. How do you get collusion on price and a business model from that?” In any case, the dinner was held a year and a half before Apple adopted the agency model—and before it had announced that it was going into the book business.

But the complaint provides several pieces of strongly suggestive evidence. Around the time that Apple presented the agency model, it notes, one C.E.O. called David Shanks, Penguin’s U.S. publisher, to tell him, “Everyone is in the same place with Apple.” In an e-mail, another executive discussed a prospective joint venture among publishers to create their own online books site, saying, “The goal is less to compete with Amazon as to force it to accept a price level higher than 9.99.” One C.E.O. admitted under oath to calling two other publishers, including Sargent, in order to find out whether they planned to sign with Apple.

In responses to the Justice Department, Penguin and Macmillan insisted that they were innocent. Sargent, sounding incredulous, told me, “I cannot comment on a phone call that I may or may not have received. There was no collu-

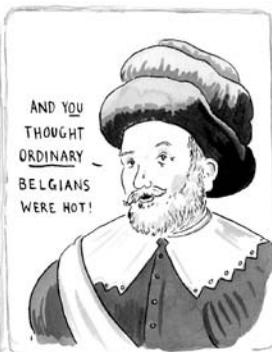
sion.” And though the publishers welcomed Apple’s terms, they insist that they arrived at them independently. In March, one of the five publishers defended Cue, saying, “He was telling me, ‘Look, I’m not going to do the iBookstore unless I get three.’ That was an absolutely fair and sensible thing to say. Otherwise, he’d be misrepresenting Apple’s intent. He wasn’t going to do an iBookstore if he got just my books. He needed some substance in that store to make Apple look like a player.” Others pointed out that they hadn’t profited from the deal with Apple. Young told me in March, “I had always understood that antitrust was about people colluding to make money. We were making less money on the agency model. We were playing the long game in the absolute belief that if we didn’t do this the bookshops would suffer.”

Nonetheless, lawyers for the defendants explored the possibility of a settlement. A public suit would embolden the European Commission, which can impose severe financial penalties—as much as ten per cent of the parent company’s annual revenues—and it might fortify the class-action lawsuits. In April, Arnaud Nourry, the international chairman and C.E.O. of Hachette Publishing, sat in Hachette’s midtown offices and explained unhappily that his company had agreed to settle. “It’s been a tough decision,” he said, and added, “I would have liked to convince D.O.J. we did not misbehave.” The lawsuits had already cost Hachette eight million dollars in legal fees and were projected to cost as much as twenty million more. “It’s a waste of time and a diversion for management. We’re a small company compared to the

LESS POPULAR DATING SITES



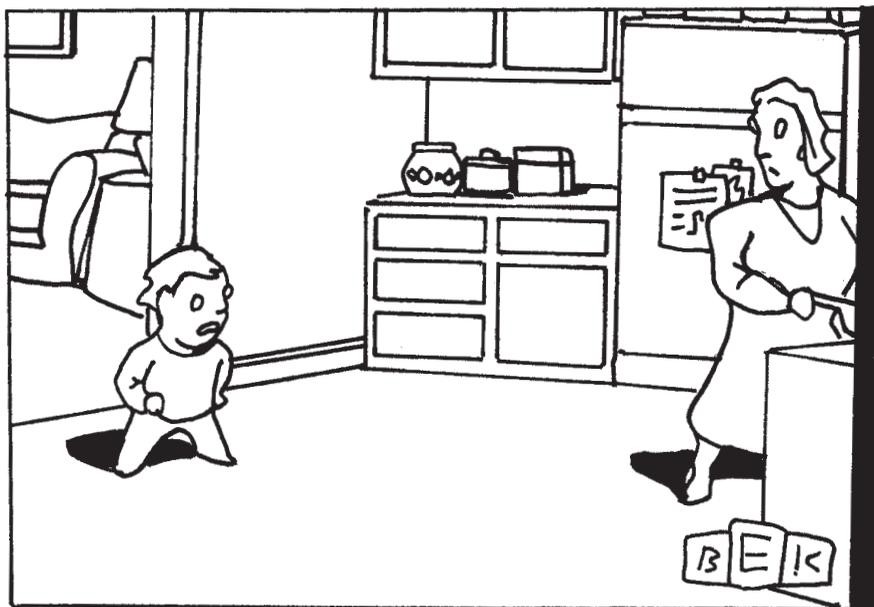
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“Can you reinvent the classic grilled cheese for me?”

big guys, like Apple and Amazon.” Lagarère SCA, Hachette’s parent company, has two and a half billion dollars in yearly revenue; Amazon has fifty billion, and Apple a hundred and eight billion.

In the end, three of the five publishers—Hachette, HarperCollins, and Simon & Schuster—agreed to settle. Justice did not file a criminal complaint, as is common in price-fixing cases, and it imposed no fines (although Hachette and HarperCollins agreed to pay at least fifty-one million dollars to tentatively settle the class-action suits). Under the terms of the settlement, the three publishers were allowed to maintain the agency model, but for the next two years they had to permit discounts of up to thirty per cent, the amount of booksellers’ commission.

Effectively, publishers lost the ability to set a floor price, while Amazon could still offer deep discounts. As long as its total discounting did not exceed its commission, it could sell a typically priced e-book at \$9.10, or discount select best-sellers to far less. The publishing consultant Mike Shatzkin wrote on his blog, the Shatzkin Files, “Every company in the industry is going back to the drawing boards. Only one is not unhappy about it.” On the day that Justice announced its filing, Amazon released a statement: “This is a big win for Kindle owners, and we look forward to being allowed to

lower prices on more Kindle books.”

Apple, Macmillan, and Penguin decided to fight the suit. John Makinson, the chairman and C.E.O. of Penguin, disputed the D.O.J.’s evidence, saying, “Most fundamentally, we don’t think we’ve done anything wrong. We did not collude with other publishers in reaching an independent decision.” Nor, he believed, had they colluded with Apple. And since publishers were challenged in five different legal arenas—by Justice, state attorneys general, the European Commission, and class-action lawsuits in the U.S. and in Canada—“if we were to say in one jurisdiction, ‘O.K., we will not admit liability, but we will settle,’ we would be sending a signal that, in some way, we acknowledged the justice of the Department of Justice’s position.”

Sargent released a statement saying that “the terms the D.O.J. demanded were too onerous” and could allow “Amazon to recover the monopoly position it had been building.” In April, I met him in his office on the nineteenth floor of the Flatiron Building, a triangular room with tall windows and views in three directions. He told me that many people in publishing thought that Amazon was enabled by the Justice Department, and that his colleagues’ response had been “Thank you. Somebody had to stand up.” Justice, he believed, had targeted

the wrong party: “I felt the antitrust department should be addressing the predatory pricing that was keeping others out of the marketplace.”

Every prosecutor has the power to choose what cases to bring before the courts. In 1940, Attorney General Robert H. Jackson, who later served on the Supreme Court, addressed a conference of U.S. attorneys, attempting to distinguish between justice and the rigid adherence to legal code. “Law enforcement is not automatic. It isn’t blind,” he said. “What every prosecutor is practically required to do is to select the cases for prosecution and to select those in which the offense is the most flagrant, the public harm the greatest, and the proof the most certain.”

The D.O.J. could have chosen not to bring this case. But, once it did, the law is clear, according to Christine A. Varney, who led the Antitrust Division until she returned to private practice last fall. “The fact that publishers or record labels or movie producers say their business models may not survive the digital revolution is not a particular concern of the antitrust laws. The antitrust laws look to preserve competition and innovation.” Publishers might have had admirable intentions, she says, but if they colluded with Apple they violated the law.

But the Justice Department’s complaint doesn’t address the question of Amazon’s attempt to monopolize the market. Nor does it concede that the publishers’ and Apple’s actions generated competition—helping to allow Apple and Barnes & Noble into the e-book market and driving up sales of the Nook and the iPad, which spurred a reduction in tablet prices. “I believe publishers decided to lower their income on e-books and are making the kind of long-term decisions we often accuse businesses of not making,” the literary agent Simon Lipskar told me.

Tim Wu, a Columbia law professor who spent last year as a senior adviser to the Federal Trade Commission, defends Amazon. “It is possible that online book sales are a better business model than actual bookstores,” he says—just as iTunes delivers a greater variety of music at lower prices than Tower Records did. “If Amazon was losing money on the sale of each e-book, who is the harm to? Not consumers. Barnes & Noble gets hurt. Is

protecting booksellers worth it if consumers are paying more?"

But, if Barnes & Noble closes, Amazon will have an effective monopoly on all books, electronic and otherwise. What makes Amazon "dangerous," Sargent says, is that "there could come a day, if they get back up to ninety per cent of the e-book market and if the e-book format becomes the predominant way that people read, that we will be in a world where one company can decide what books get widely distributed."

David Young believes that Amazon's low prices—what he called "predatory pricing"—would have forced bookstores into bankruptcy, and perhaps driven prices below what it costs publishers to produce books. Wu disagrees, saying, "A predatory pricing theory relies on the idea that Amazon plans later on to raise prices. I don't know of strong evidence for that claim." But what Amazon did with Diapers.com provides at least one example. First, it competed to lower diaper prices; then it acquired the smaller business; then it raised prices. Amazon's profit margins are slim, especially compared with its stock-market value. The pressure from stockholders to increase profits will only grow, and, like conventional publishers, Amazon may want to make more money on its best-selling books.

Amazon is already using its position in the market to intimidate less powerful publishers. Although the Justice Department focussed on the Big Six, the majority of books are produced by independent publishers. "Amazon is using its monopoly power to dictate to these companies that they will continue to discount our books below cost," one small publisher says. "Amazon continues to insist that these publishers sell their books at prices that threaten their business."

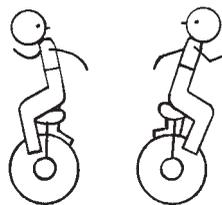
On May 15th, the U.S. District Court for the Southern District of New York denied a petition from Apple, Macmillan, Penguin, and Simon & Schuster to dismiss the class-action lawsuits. The court acknowledged the publishers' concern for bookstores and their sacrifice of income under the agency model. Nevertheless, it decided that there was enough evidence of a horizontal conspiracy to proceed.

As Apple and the publishers fight the suit, courtroom precedents are stacked against them. Barry Hawk, the director of Fordham Law School's Competition Law Institute, says that courts invoke two tests

to adjudicate antitrust cases. In cases of vertical collusion, they typically use the "rule of reason," which allows defendants to argue that they were acting in the interest of healthy competition. For horizontal collusion, they use the per-se rule, in which agreements to fix prices are illegal under any circumstances. Hawk told me that he can't think of a single horizontal-conspiracy case in which defendants were found to have engaged in price-fixing and still won. "That's how strong this is," he says.

For the traditional publishing industry, the consequences of a loss could be dire. The consultant Mike Shatzkin says, "If Macmillan and Penguin were to lose their appeals, and the settlement between the D.O.J. and the three other publishers were allowed to stand, it would accelerate what is already an increasing concentration of book customers under Amazon's control." Amazon is the only publisher with ready access to consumers, and to their credit-card information. In the worst case, Shatzkin says, it will become the only company that can effectively create books and sell them to consumers. "The American trade-book publishing network of many publishers, wholesalers, and retailers will be effectively dismantled," he says. "It will be too late then to recognize the dangers of concentration. It will not be possible to rebuild what will have been destroyed."

In boxing, there's the main event, and there's the undercard—the warmup bouts that precede it. The fight between Amazon and book publishers could have profound repercussions for publishers,



bookstores, and authors, yet to Amazon that fight is the undercard. The main event is a free-for-all among the five U.S. digital giants: Amazon, Apple, Google, Facebook, and Microsoft.

In late April, Microsoft invested three hundred million dollars in the Nook tablet. For Barnes & Noble, it was a tremendous boon, allowing it to keep alive, in however attenuated a form, the old-fashioned idea of the bookstore. For Microsoft, it was a hardware solution: a way to produce

a more popular tablet computer. Although Amazon is intensely secretive about its data, the figures it has released show that content—books, music, movies, TV shows, newspapers, and magazines—produces less than half of its revenues. For Apple, too, content is a small part of its business. The real fight is elsewhere. The iPad and the Kindle Fire compete as mobile platforms, and all five companies will likely compete in collecting credit-card information. Google is testing a one-day shipping service for online shopping which targets Amazon. Google and Microsoft compete with Apple and Amazon to provide operating systems for mobile devices. Four of the five firms are working on some form of search, and all are interested in cloud computing, games, social media, and selling ads.

The fierce competition among them "is the next iteration of the U.S. v. Microsoft case," Christine Varney, the former antitrust chief, says. The government has tried, with varying degrees of success, to police these companies: their privacy policies, their market dominance, their patent claims, their outsourcing of manufacturing, and their meagre tax payments. "Competition is good, so long as innovation remains viable for new entrants," Varney said. "That's the difficult thing to balance. Where does the competition between the big players promote our consumer welfare, and where does it inhibit new innovation?"

Tim Wu, who is sympathetic to Amazon in the fight against publishers, says, "I change my position," when he considers the battle between digital giants. "The Internet industries are incredibly concentrated, and probably more concentrated than old media. We need to watch Amazon, Google, and Apple and the rest very carefully."

Publishers know that they don't have the money for a prolonged struggle with Amazon. John Sargent says, "These are huge companies, who are fighting a very large game. Whether it be for the sale of devices, or to own the shopper, or to own a particular set of tools that people use—they are fighting to get as big a piece of that as they can get." Books, he says, are "in danger of becoming roadkill in that larger war." ♦