

Game Over

How Amazon's Dream Alliance With Toys 'R' Us Went So Sour

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In August 2000, Amazon.com Inc. and Toys "R" Us Inc. signed a groundbreaking agreement: For 10 years Amazon would devote part of its Web site to Toys "R" Us's toy-and-baby-products. The toy retailer would choose the hot products to stock and buy the inventory for the virtual shelves.

The pact was widely heralded as an example of how young Internet companies like Amazon would soon be tying up with "bricks and mortar" retailers to mutual benefit. Instead, the deal has turned into a case study of how quickly promising alliances can turn into acrimonious business disputes as companies adjust to the shifting realities of the Web.

Amazon and Toys "R" Us are facing off in Superior Court in Passaic County, N.J., each claiming it was deceived by the other. Toys "R" Us alleges Amazon violated its promise that Toys would be the sole seller of toys, games and baby products on Amazon's Web site. Amazon claims Toys failed to deliver on its promise to maintain a certain selection of toys.

"We are at a point in the relationship with Amazon where we have no trust whatsoever in dealing with this organization," testified John Eyler, Toys "R" Us's then-chief executive, in the trial, which began last September. Amazon, for its part, argued in the trial that Toys has a different interpretation of what "exclusivity" means.

A ruling is expected shortly. The spat goes to the heart of Amazon's two-pronged strategy. Amazon derived more than 90% of its nearly \$7 billion in 2004 revenue from selling books, CDs and other products, shipping them from its own warehouses, analysts say. But analysts figure it gets nearly a third of its profit from money it collects from a host of other retailers it has lined up to establish shops on the Amazon site. The dual strategy aims to make Amazon a one-stop shopping mall for consumers.

More than one million merchants, from national retailers to part-time one-man operations, now sell on Amazon's site, up 29% from a year ago. Guess? Inc., Eddie Bauer and J&R Music and Computer World have recently agreed to extend their agreements to keep shops on Amazon. "We've been very successful in re-signing merchants who are adding value to the platform," says Cayce Roy, Amazon's vice president of services.

Some retailers suggest that conflicts like the one with Toys "R" Us are inevitable on Amazon's site. Unlike Amazon, other Web shopping malls, such as those of Google Inc. and Yahoo Inc., don't peddle their own wares in competition with the tenants.

Pinny Gniwisch, executive vice president of online jeweler Ice.com, began selling jewelry through Amazon's site in April 2002. In 2004, Mr. Gniwisch says, Ice.com executives noticed that Amazon itself had begun selling pearl necklaces and diamond earrings—some of Ice.com's best-selling products. Ice.com still generates revenue from its presence on Amazon, but Mr. Gniwisch says it's possible that his company will terminate its relationship some day.

Circuit City Stores Inc. ended a pact with Amazon in February 2005, saying in a statement it wanted to focus on its own Web site rather than on "the small amount of sales the relationship with Amazon.com has generated." A Circuit City spokesman declined to comment further. A former Circuit City executive, who was involved in internal discussions about the Amazon partnership, says that, after placing a store on Amazon in 2001, the electronics retailer found itself competing with Amazon's own electronics store on the site.

Amazon's Mr. Roy declines to comment on individual merchants. Conflicts and competition on the Web and Amazon's site are no different than in conventional retailing, he says.

Under Assault

Keeping merchants on the site is crucial for Amazon. Its retail business is under assault from online rivals, as companies such as Wal-Mart Stores Inc. improve their Web sites. Meanwhile, companies like Google increasingly offer technology for Web merchants. Amazon's profit-growth rate, excluding one-time items, has fallen to 22.7% in the third quarter of 2005 from 52% in the year-ago period, according to Piper Jaffray analyst Safa Rashtchy. Its third-quarter 2005 operating margins, excluding items such as amortization, fell to 6.5% from 7.5% in the second quarter of 2005, he says.

Attracting other retailers to sell through its site and providing them technology or order-fulfillment services is highly profitable. Such business generates about 5% of Amazon's revenue but contributes about 30% of its profitability, estimates Jeetil Patel, a Deutsche Bank Securities analyst.

But teaming up with other retailers has proved a delicate balancing act, as a look at the failed relationship with Toys "R" Us shows.

The deal seemed like a perfect match. Amazon, which had begun as an online book seller and gradually branched out into other areas, had failed to accurately forecast demand for toys in 1999 and was stuck with left-over inventory, resulting in a 1999 fourth-quarter charge of about \$39 million, according to an annual SEC filing. As the Internet bubble began to burst in early 2000, Amazon faced growing criticism from investors and analysts as costs, debt and losses mounted.

Toys "R" Us, which had by then already lost the mantle of the No. 1 U.S. toy retailer to Wal-Mart, approached Amazon around that time seeking a partnership. The Wayne, N.J., retailer had failed to deliver some Web orders in time for the 1999 holidays, resulting in a \$350,000 fine from the Federal Trade Commission.

Negotiations began in June 2000, according to court testimony. The fault lines quickly surfaced: The two sides clashed over Toys "R" Us's request that it be the exclusive seller of toys and baby products on the Amazon site for a decade, and over Amazon's insistence that Toys provide a more-extensive product line.

To break the impasse, John Eyler, Toys "R" Us's chief executive, flew to Seattle and met Amazon Chief Executive Jeff Bezos at his headquarters on June 28, 2000. Mr. Bezos explained that "someone

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ought to be able to find everything” in the online toy store, testified Mr. Eyler. Mr. Eyler explained that toy sellers cannot carry a limitless product line and be profitable.

Glimmers of Trouble

Messrs. Eyler and Bezos compromised: Toys would supply enough products for Amazon to stock a wide selection but not so many that Toys “R” Us would lose money buying toys unlikely to sell, according to both companies’ testimony. Amazon agreed that Toys would be the exclusive toy and baby-products seller on its site. In a concession that later became a major sticking point, Toys agreed to give up its Web address, toysrus.com, which would simply direct shoppers to Amazon’s site. Amazon and Toys signed a contract Aug. 9, 2000. The next day in New York, they announced their agreement.

The first glimmers of trouble came soon. On Sept. 11, 2001, Amazon announced an extensive partnership with Target Corp., a major Toys “R” Us rival. Toys “R” Us executives complained to Amazon that the Target deal was an end-run around its exclusivity agreement, according to Mr. Eyler’s testimony. Amazon responded that the Target pact was different from the Toys deal and that Target wasn’t allowed to sell toys, games or baby products on Amazon, testified Ray Arthur, a Toys “R” Us executive.

Another problem: Online toy-store sales weren’t growing as fast as the companies expected. Messrs. Eyler and Arthur met Mr. Bezos and some of his team at Mr. Bezos’s mother’s Aspen, Colo., house late in 2001. The Toys executives wanted to change the fee structure of their partnership so the Toys “R” Us section of the Amazon site could become profitable, according to both companies’ testimony.

Mr. Bezos agreed to amend the contract to limit Toys’ annual fee to \$50 million, the amount Toys paid in 2001, and not raise some other fees, according to a contract amendment signed in April 2002.

The partnership flourished in 2002. The joint toy store had become the No. 1 site for kids in its very first year, up from toysrus.com’s third-place ranking before the Amazon deal, said David Goodnight, Amazon’s lawyer, in court. Toys, videogames and baby-product sales met or exceeded Amazon’s expectations, according to a September 2002 Amazon memo submitted at trial.

Yet Amazon wasn’t quite satisfied. That same year, Amazon added Eddie Bauer and Nordstrom as sellers and introduced apparel and office-products categories. It wanted to broaden the toy product line it carried during the 2001 holidays. It was concerned that eBay Inc.’s auction site was offering more and more toys, including some that went out of stock on Amazon, recalled Jorrit Van der Meulen, Amazon’s liaison on the Toys partnership.

Amazon began to consider ways to expand its toy and baby merchandise. Mr. Van der Meulen drafted a September 2002 document titled “Kids Products 2003 Plan.” Toys “R” Us “will be unhappy with any move we make,” said the memo, submitted in court. “Amazon has effectively ceded control of the toy and baby stores to [Toys ‘R’ Us]. This is not always a good thing.”

The memo listed several options, including adding other retailers and sharing revenue with Toys. “We should expect swift legal

reaction from [Toys ‘R’ Us] in this case,” the memo noted.

In the spring of 2003, Toys “R” Us noticed other merchants selling toys and baby products on Amazon. Amazon offered to share revenue, but Toys “R” Us refused.

Amazon didn’t remove the products, claiming that the sales fell under a provision allowing Amazon or other merchants to sell up to 3.5% of the toys, games and baby products on the site, Mr. Arthur testified. Toys complained that Amazon was also displaying links to its competitors when they typed in search words for toys and baby products such as strollers, which only Toys was supposed to sell, according to an email submitted at trial.

Fundamental Difference

This marked a fundamental difference in how the two companies interpreted their contract. Toys “R” Us believed it had the exclusive right to sell products in the entire toys and baby categories. Amazon interpreted Toys’ exclusive right as applicable to those toy and baby products that Toys was selling, leaving other merchants or Amazon the right to sell products that Toys wasn’t selling.

Amazon proposed adding toy and baby products from other retailers using technology that would let them offer products that Toys “R” Us didn’t sell or had out of stock. It offered to share revenue with Toys, too. Though Toys didn’t want to accept those terms, it agreed to try to negotiate an agreement.

In September 2003, Toys complained to Amazon that its competitors’ toy and baby products were showing up through search-related advertising on other parts of Amazon. The next month, Toys notified Amazon that it had breached their agreement. Toys requested calculations of all toy sales to gauge whether Amazon had exceeded the 3.5% limit. Amazon failed to provide the data and added more toy and baby sellers, testified Mr. Arthur.

The following April, after Toys notified Amazon it discovered 4,000 toys and baby products in its stores not sold by Toys, the two companies agreed to mediation. A two-day Oakland, Calif., meeting failed to produce a consensus. Twenty minutes after the meeting ended, Toys “R” Us filed a lawsuit in Superior Court in Passaic County, N.J., alleging that Amazon violated its contract exclusivity rights. In a later amendment, Toys sought \$74 million in damages.

Two weeks later, Toys obtained a restraining order prohibiting Amazon from using new technology to post other retailers’ toys, games and baby products. Superior Court Judge Margaret Mary McVeigh converted it into a preliminary injunction on June 23, 2004, which was later overturned by an appellate court. Two days later, Amazon countersued, alleging “chronic failure” of Toys “R” Us to keep items in stock and otherwise adhere to their agreement. Amazon sought dissolution of the agreement and \$4.71 million in damages.

Since then, Judge McVeigh allowed Amazon to add new toy and baby retailers, but barred those new merchants from selling the same products offered by Toys “R” Us. She required Amazon to offer Toys “R” Us the opportunity to sell any new product those sellers wanted to add, which would preclude those stores from selling those products.