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Court Rules Against Amazon In Toys Dispute

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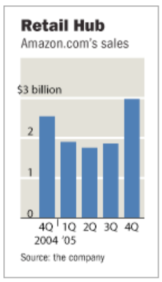
In a case that has been closely watched by online retailers, a New Jersey judge ruled that **Amazon.com** Inc. violated its agreement to give toy retailer **Toys "R" Us** Inc. the exclusive right to sell toys and baby products on Amazon's Web site.

In the ruling released yesterday, New Jersey Superior Court Judge Margaret Mary McVeigh said Toys "R" Us can sever the agreement it signed with Amazon in August 2000, in which it agreed to sell toys on Amazon.com's Web site, effectively putting Amazon in control of the Web address www.toysrus.com. The ruling paves the way for Toys "R" Us to operate the Web site independently. Judge McVeigh denied monetary damages to both parties.



The ruling is the latest chapter in a nearly two-year court battle between closely held Toys "R" Us, of Wayne, N.J., and Amazon, of Seattle, the biggest Internet retailer in terms of annual sales.

Over the past few years, as Amazon has expanded into gourmet food, jewelry, beauty products and other new categories, it has increasingly relied on outside merchants, such as Toys "R" Us. Toys "R" Us and some retailers have complained that they must compete against other rivals -- or Amazon itself -- on Amazon's Web site. Amazon has said that its merchant partners are aware they might compete with other sellers and that its mission is to provide customers with the broadest product line possible. But several high-profile retailers, including **Gap** Inc., **Circuit City Stores** Inc. and **Drugstore.com** Inc. have terminated agreements to sell on Amazon's site in recent years.

Back in 2000, when Amazon and Toys "R" Us crafted their original pact, both companies had run into trouble with their online toy stores during the 1999 holiday season. Toys "R" Us had failed to ship some orders made through its Web store; Amazon took a fourth-quarter charge that year related to leftover toy inventory. The two companies decided to cooperate, evenly sharing revenue from a joint toy store operated on Amazon's Web site.

The agreement was designed to last 10 years. But problems quickly surfaced. In late 2001, Amazon signed a wide-ranging agreement with **Target** Corp., prompting complaints from Toys "R" Us. Amazon offered to share revenue with Toys "R" Us if it would allow other toy merchants to sell products on Amazon.com. Toys "R" Us declined, but couldn't help noticing that other retailers' toy products were cropping up on the Web site.

The relationship deteriorated quickly after an August 2003 meeting between the two companies' chief executives. Amazon insisted that it wanted to add other retailers' toy and baby products to the site; Toys "R" Us insisted it had exclusive rights to sell those products.

Toys "R" Us filed suit in the New Jersey state court in May 2004 alleging Amazon breached the contract. Amazon countersued in June 2004, alleging the toy retailer failed to keep items in stock and otherwise adhere to their agreement.

In her ruling, Judge McVeigh said Amazon's conduct since 2004 breached the exclusivity of its contract with Toys "R" Us, by selling toys from some of its other merchant partners on the Amazon.com Web site. In addition, the judge cited a more subtle example, in which Amazon appeared to vary its definition of a "boutique" on its Web site. For instance, the Amazon site at one point directed shoppers to the Toys "R" Us Web site via a "tab" labeled Toys and Games; then Amazon altered the tab, so that it directed shoppers to "all 32 product categories," including toys.

Yesterday, Amazon said it was disappointed. "We strongly disagree with the judge's ruling, and we are in the process of reviewing a number of different options," said company spokeswoman Patty Smith. "Regardless of the outcome, we remain committed to ensuring a great selection of toys for our customers at great prices."

For its part, Toys "R" Us in a statement said it was "pleased." John Sullivan, senior vice president of Toysrus.com, said the company has been preparing for the decision and is committed to providing customers online access to its Web store.

"There are now a lot of retailers who are very, very skeptical of any attempt to get into bed with [Amazon]," said Sucharita Mulpuru, an analyst at market research firm Forrester Research. "The terms [for retailers] aren't as favorable as they'd like them to be, and Amazon is known to be a tough negotiator."

An Amazon spokesman said that the company disagrees with the suggestion that other retailers will be wary of working with it. "This ruling is specific to Toys "R" Us and it really doesn't have any impact on other relationships with merchants and partners," said Amazon spokesman Craig

Berman.

The court will formally enter its ruling within three weeks, which will trigger the companies' 90-day separation agreement. That means starting as soon as this summer, customers who visit Toysrus.com will be directed to an independent Toys "R" Us Web site, rather than to Amazon's Web site. Amazon shares fell 24 cents to $36.88 in 4 p.m. composite Nasdaq Stock Market trading.

In a research note on the ruling, Goldman Sachs Group Inc. analyst Anthony Noto said it constitutes a "net negative" for Amazon, because the company's financial forecast includes some revenue from the Toys "R" Us partnership. Toys "R" Us paid an annual fee of $50 million to Amazon in connection with the Web site's operation, and paid other fees according to how many items Amazon fulfilled and shipped for Toys "R" Us.

Mr. Noto estimates that Toys "R" Us generates about $100 million in revenue and $40 million in operating income annually for Amazon. Amazon, however, won't lose that entire amount, because it will take up the slack with sales of its own toys and those of other partners.