

## CHAPTER 6

# BUNDLED DISCOUNTS AND SINGLE-PRODUCT LOYALTY DISCOUNTS

### I. Bundled Discounts

#### A. Introduction

Bundled discounting is the practice of offering discounts or rebates contingent upon a buyer's purchase of two or more different products, including bundled rebates where the amount of rebates a customer receives is based on the quantities of multiple products bought over some period.<sup>1</sup> Bundled discounting is common, usually benefits consumers, and generally does not raise antitrust concerns.<sup>2</sup>

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<sup>1</sup> The offering of discounts or rebates conditioned upon the level or share of purchases of a single product is addressed *infra* part II. Also, conditioning the sale of one product upon the purchase of another is tying, which is the subject of chapter 5. One of the ways that firms tie is through what economists call "pure bundling," which is selling two or more products together in fixed proportions and not selling any of the products separately. This chapter addresses the situation where the products are available separately as well as in a bundle, a practice economists call "mixed bundling." See generally DENNIS W. CARLTON & JEFFREY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 321–24 (4th ed. 2005).

<sup>2</sup> See, e.g., Sherman Act Section 2 Joint Hearing: Academic Testimony Hr'g Tr. 136, Jan. 31, 2007 (Rubinfeld) (stating that bundled discounting is "quite ubiquitous and often is procompetitive"); Sherman Act Section 2 Joint Hearing: Loyalty Discounts Session Hr'g Tr. 59, Nov. 29, 2006 (Kattan) (stating that "the prevalence" of bundled discounts and discounts having a retroactive feature "by firms that don't have market power and have no hope of excluding competitors would suggest . . . that there is a good possibility that the efficiency explanation for these practices is the dominant one"); *id.* at 122–23 (Crane) (stating that "bundled discounting is pervasive and has many pro-competitive or competitively neutral reasons" and that the pervasiveness of a practice suggests there are often good explanations for it);

But even though the practice typically results in consumers paying lower prices in the short term, bundled discounting by a monopolist may nonetheless harm competition in some circumstances.<sup>3</sup>

There have been very few federal court decisions – and no Supreme Court decisions – analyzing bundled discounts under section 2, and the standards used in those decisions are not entirely consistent.<sup>4</sup> The United States took the position in its 2004 brief recommending against certiorari in *LePage's Inc. v. 3M*<sup>5</sup> that "although the business community and consumers would benefit from clear, objective guidance on the application of Section 2 to bundled rebates . . . it would be preferable to allow the case law and economic analysis to develop further."<sup>6</sup> Since then, there has been

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Sherman Act Section 2 Joint Hearing: Tying Session Hr'g Tr. 29, Nov. 1, 2006 (Evans) (noting that "when practices are common in pretty competitive markets, . . . there should be a presumption that these practices are procompetitive"); RICHARD A. POSNER, ANTITRUST LAW 253 (2d ed. 2001) ("If the practice is one employed widely in industries that resemble the monopolist's but are competitive, there should be a presumption that the monopolist is entitled to use it as well.").

<sup>3</sup> See *infra* Part I(C)(1). See generally Nov. 29 Hr'g Tr., *supra* note 2, at 7–23 (Nalebuff); Patrick Greenlee et al., *An Antitrust Analysis of Bundled Loyalty Discounts*, 26 INT'L J. INDUS. ORG. 1132 (2008); Barry Nalebuff, *Bundling As a Way to Leverage Monopoly* (Yale Sch. of Mgmt., Working Paper No. ES-36, 2004) [hereinafter Nalebuff, *Bundling*]; Barry Nalebuff, *Loyalty Rebates* (Oct. 29, 2006) (hearing submission); Janusz Ordovery & Greg Shaffer, *Exclusionary Discounts* (Aug. 25, 2006) (hearing submission).

<sup>4</sup> See *infra* Part I(B).

<sup>5</sup> 324 F.3d 141 (3d Cir. 2003) (en banc).

<sup>6</sup> Brief for the United States as Amicus Curiae at 19,

additional case law as well as an explosion of discourse and debate among legal and economic academics and practicing lawyers about the economic effects of and proper legal approach to bundled discounts.<sup>7</sup>

This chapter explores whether appropriate standards for analyzing bundled discounting by a monopolist are now more discernable. It examines the case law and the potential anticompetitive and procompetitive effects of bundled discounting. The chapter also discusses ways to analyze bundled discounting under section 2, including whether there are appropriate safe harbors that can be used in that analysis.

### B. Background

Relatively few decisions address the legality of bundled discounting under section 2. As discussed below, most, but not all, courts that have considered the issue employ some type of a cost-based test to determine if the price of the bundle is below some measure of costs, but no consensus exists regarding the particular form of that test.

One of the earliest cases involving bundled discounts was *SmithKline Corp. v. Eli Lilly & Co.*<sup>8</sup> In that case, before SmithKline entered the market, Lilly had used a volume-rebate plan to sell four patented antibiotics known as cephalosporins to nonprofit hospitals.<sup>9</sup> When SmithKline licensed a fifth cephalosporin from

a foreign firm and sold it in competition with Lilly, Lilly responded by licensing the same drug and selling it as Kefzol.<sup>10</sup> Lilly then modified its rebate plan by simultaneously reducing the rebate offered by roughly three percent and adding a “bonus dividend” of three percent provided that a hospital bought specified minimum quantities of three specific cephalosporins.<sup>11</sup> Lilly expected that hospitals would meet the target on its two dominant cephalosporins and would have to purchase the minimum quantities specified for Kefzol to qualify for the bonus dividend.<sup>12</sup>

The court found that SmithKline would have had to offer a rebate of more than twenty percent on its one product to match Lilly’s bundled rebate.<sup>13</sup> If SmithKline had lowered its price to Lilly’s effective level, the court concluded, SmithKline’s drug would not have been sufficiently profitable to justify remaining in the market, even if SmithKline had been able to “reduce its costs of goods to Lilly’s level.”<sup>14</sup> Thus, Lilly’s bundled rebates would have excluded SmithKline even if the latter firm were an equally efficient producer, and the court held that Lilly had violated section 2 when it used its monopoly power in two products to exclude the “slightly less efficient” SmithKline from the market for the competitive product.<sup>15</sup>

About twenty years after *SmithKline*, a different federal court analyzing a similar bundled-pricing plan found that the plan did not violate section 2. *Ortho Diagnostic Systems, Inc. v. Abbott Laboratories, Inc.* involved five assays that blood donor centers (BDCs) required to test blood for various viruses.<sup>16</sup> Only defendant Abbott made and sold all five assays, and it had seventy to ninety percent of sales of four of them.<sup>17</sup> The Council of

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3M v. LePage’s Inc., 542 U.S. 953 (2004) (No. 02-1865), available at <http://www.usdoj.gov/atr/cases/f203900/203900.pdf>.

<sup>7</sup> See, e.g., 3 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 749b2 (Supp. 2007); Daniel A. Crane, *Mixed Bundling, Profit Sacrifice, and Consumer Welfare*, 55 EMORY L.J. 423 (2006); Greenlee et al., *supra* note 3; Thomas A. Lambert, *Evaluating Bundled Discounts*, 89 MINN. L. REV. 1688 (2005); Nalebuff, *Bundling*, *supra* note 3; Timothy J. Muris, *Antitrust Law & Economics: Exclusionary Behavior and Bundled Discounts* (Nov. 29, 2006) (hearing submission). See generally Nov. 29 Hr’g Tr., *supra* note 2, at 23–40 (Lambert) (describing various tests suggested by commentators).

<sup>8</sup> 427 F. Supp. 1089 (E.D. Pa. 1976), *aff’d*, 575 F.2d 1056 (3d Cir. 1978).

<sup>9</sup> *Id.* at 1093–94.

<sup>10</sup> *Id.* at 1093.

<sup>11</sup> *Id.* at 1105.

<sup>12</sup> *Id.* at 1106.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* at 1108–09.

<sup>15</sup> *Id.* at 1128–29.

<sup>16</sup> 920 F. Supp. 455, 458 (S.D.N.Y. 1996).

<sup>17</sup> *Id.* at 459.

Community Blood Bank Centers solicited bids on a contract to supply assays to member BDCs, asking for different pricing schedules depending on whether the BDC bought all five assays from the chosen seller.<sup>18</sup> Abbott won the contract with pricing schedules that gave significant discounts on each assay if a BDC bought all five from Abbott.<sup>19</sup> Ortho alleged that BDCs “felt that they had to buy” at least two assays from Abbott and maintained that the discount plan created a significant incentive to buy all five from Abbott.<sup>20</sup>

Drawing on *SmithKline*, the court framed the key question as “whether a firm that enjoys a monopoly on one or more of a group of complementary products, but which faces competition on others, can price all of its products above average variable cost and yet still drive an equally efficient competitor out of the market.”<sup>21</sup> The court explained that a plaintiff “must allege and prove either that (a) the monopolist has priced below its average variable cost or (b) the plaintiff is at least as efficient a producer of the competitive product as the defendant, but that the defendant’s pricing makes it unprofitable for the plaintiff to continue to produce” the product.<sup>22</sup> Because Ortho did not claim that it could not sell its products at a profit as a result of Abbott’s bundled discounting, the court found no section 2 violation.<sup>23</sup>

*Virgin Atlantic Airways Ltd. v. British Airways*

<sup>18</sup> *Id.* at 459–60.

<sup>19</sup> *Id.* at 460–62.

<sup>20</sup> *Id.* at 461 (quoting court papers).

<sup>21</sup> *Id.* at 467.

<sup>22</sup> *Id.* at 469. While *Ortho* focused on whether the actual plaintiff was an equally efficient competitor, the Ninth Circuit’s decision in *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883, 905–08 (9th Cir. 2008), discussed below, concluded that the focus should instead be on whether a hypothetical equally efficient producer of the competitive product could meet the defendant’s discount. Commentators similarly criticize focusing on the actual plaintiff’s costs, rather than on those of a hypothetical equally efficient competitor. See, e.g., AREEDA & HOVENKAMP, *supra* note 7, ¶ 749a, at 241–42; Lambert, *supra* note 7, at 1729.

<sup>23</sup> 920 F. Supp. at 469–70.

*PLC*,<sup>24</sup> while primarily viewed as a single-product loyalty discount case,<sup>25</sup> also involved a bundled-discount claim. British Airways had entered into incentive agreements with travel agents and corporate customers that bundled routes by setting various targets for all British Airways routes or regional groups of routes and providing incentive payments each time a target was met.<sup>26</sup> Virgin Atlantic alleged that a corporate customer that purchased tickets on British Airways monopoly routes thus had an incentive to purchase British Airways tickets on routes where Virgin Atlantic competed, even though Virgin Atlantic charged less on those routes.<sup>27</sup> The court cited *Ortho* as holding “that there would be an antitrust violation if the competitive product in the bundle were sold for a price below average variable cost after the discounts on the monopoly items in the bundle were subtracted from the price of that competitive product.”<sup>28</sup> However, Virgin had little or no factual evidence that this situation had ever arisen in the varied bundling patterns, and the court refused to impose liability merely on the theoretical possibility of below-cost pricing.<sup>29</sup>

In each of these cases, the court analyzed the discount based on the relationship between defendant’s prices and its costs to produce the goods that made up the bundle. The 2003 *LePage’s* decision represents a departure from this practice.<sup>30</sup> In *LePage’s*, a manufacturer of private-label transparent tape charged that 3M maintained a monopoly in the market for transparent tape through a bundled-rebate program for large retail chains.<sup>31</sup> That program conditioned certain rebates on retail customers meeting multiple target-growth rates for their

<sup>24</sup> 69 F. Supp. 2d 571 (S.D.N.Y. 1999), *aff’d*, 257 F.3d 256 (2d Cir. 2001).

<sup>25</sup> Single-product loyalty discounts are discussed *infra* part II.

<sup>26</sup> 69 F. Supp. 2d at 574.

<sup>27</sup> *Id.* at 580.

<sup>28</sup> *Id.* at 580 n.8.

<sup>29</sup> *Id.* at 580–81.

<sup>30</sup> 324 F.3d 141 (3d Cir. 2003) (en banc).

<sup>31</sup> *Id.* at 147.

purchases of 3M products in diverse product lines, such as home-care products, home-improvement products, and stationery products.<sup>32</sup> The rebate program allegedly shifted purchases away from LePage's private-label tape and towards 3M's branded and private-label tape by inducing customers to meet targets for purchases of 3M tape or risk losing rebates on 3M's other products.<sup>33</sup> LePage's alleged that it would have to compensate customers for the loss of rebates across those product lines, not just for the loss of tape-specific rebates, to defeat this shift.<sup>34</sup> LePage's also argued that 3M's bundled rebates and other conduct shielded 3M's higher-priced Scotch brand tape against competition from LePage's private-label tape and thereby helped to maintain 3M's transparent-tape monopoly.<sup>35</sup> The jury found 3M liable for monopoly maintenance in violation of section 2.<sup>36</sup>

The Third Circuit ultimately affirmed the judgment in an en banc decision. Notably, the court did not require LePage's to prove that either it or a hypothetical equally efficient competitor could not meet the discount without pricing below cost. Rather, the jury instructions, which the Third Circuit upheld, provided that conduct is illegal under section 2 when it "has made it very difficult or impossible for competitors to engage in fair competition."<sup>37</sup>

Other courts, looking for more objective, cost-based standards such as those suggested by *Ortho* and other decisions, have disagreed with *LePage's*. In *Masimo Corp. v. Tyco Health Care Group, L.P.*, for example, the court vacated a jury finding of liability based on bundled discounts.<sup>38</sup> Disagreeing with the reasoning of *LePage's*, the court concluded "that as a general matter, absent evidence of predatory pricing or

tying, the practice of offering a discount on two or more bundled products is not anticompetitive under Section 2."<sup>39</sup> And in *Information Resources, Inc. v. Dun & Bradstreet Corp.*,<sup>40</sup> the court made no mention of *LePage's*, but rather cited *Virgin Atlantic* for the proposition that "[w]hen price discounts in one market are bundled with the price charged in a second market, the discounts must be applied to the price in the second market in determining whether that price is below that product's average variable cost."<sup>41</sup> Similarly, in *Invacare Corp. v. Respironics, Inc.*, the court granted defendant summary judgment on section 2 claims where plaintiff and others bundled the same products as defendant and there was no allegation that defendant's bundles were priced below cost.<sup>42</sup>

In *PeaceHealth*, the Ninth Circuit also disagreed with *LePage's* and applied a cost-based standard in evaluating bundled discounts.<sup>43</sup> *PeaceHealth* and *McKenzie* (the predecessor to *Cascade Health Solutions*) were competing providers of primary and secondary acute-care hospital services. *PeaceHealth* also provided tertiary-care services, in which it had a very high market share (approaching ninety percent in certain sub-specialities); *McKenzie* did not provide tertiary services.<sup>44</sup> *McKenzie*, which asserted that it could provide primary- and secondary-care services at a cost lower than *PeaceHealth's*,<sup>45</sup> brought monopolization and attempted-monopolization claims against *PeaceHealth* based on evidence that *PeaceHealth* offered bundled-service packages to some customers (insurance companies). These bundled offerings provided discounts on all services if insurance companies

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<sup>39</sup> *Id.* at \*13. However, the court also affirmed the jury's finding of liability based on single-product discounts, without applying a price-cost test. *See infra* Part II.

<sup>40</sup> 359 F. Supp. 2d 307 (S.D.N.Y. 2004).

<sup>41</sup> *Id.*

<sup>42</sup> No. 1:04 CV 1580, 2006 WL 3022968, \*12 (N.D. Ohio Oct. 23, 2006).

<sup>43</sup> *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883 (9th Cir. 2008).

<sup>44</sup> *Id.* at 891.

<sup>45</sup> *Id.* at 897.

<sup>32</sup> *Id.* at 154.

<sup>33</sup> *Id.* at 157, 160-61.

<sup>34</sup> *Id.* at 161.

<sup>35</sup> *Id.* at 162.

<sup>36</sup> *Id.* at 163.

<sup>37</sup> *Id.* at 168 (quoting trial court).

<sup>38</sup> No. CV 02-4770 MRP, 2006 WL 1236666, \*14 (C.D. Cal. Mar. 22, 2006).

made PeaceHealth their sole preferred provider for primary, secondary, and tertiary care.<sup>46</sup>

In analyzing PeaceHealth's bundled offerings, the Ninth Circuit rejected the *Lepage's* non-cost based approach in explaining that "the fundamental problem . . . is that it . . . concludes that all bundled discounts offered by a monopolist are anticompetitive with respect to its competitors who do not manufacture an equally diverse product line" and that it fails to consider whether such discounts may be procompetitive.<sup>47</sup> The Ninth Circuit also noted that the Supreme Court, which in *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*<sup>48</sup> and *Weyerhaeuser Co. v. Ross-Simmons Hardware Lumber Co.*<sup>49</sup> applied a cost-based test to predatory-pricing and predatory-bidding claims, respectively, "forcefully suggested that we should not condemn prices that are above some measure of incremental cost."<sup>50</sup> The court reviewed various applications of a price-cost test and ultimately adopted a "discount attribution" standard, under which defendant is not liable under section 2 where, when the full amount of its discount on the bundled offering is allocated to the competitive product or products, the resulting price is above defendant's incremental cost to produce the competitive product or products.<sup>51</sup>

Thus, the handful of federal courts analyzing bundled discounts under section 2 have developed conflicting standards. In particular, while the Third Circuit's 2003 en banc decision in *LePage's* did not apply an objective, cost-based test for determining the legality of bundled discounts under section 2, other cases, both before and after *LePage's* – including *PeaceHealth* – have applied a cost-based standard, albeit not always focusing on the same costs. As many panelists stressed, this lack of legal clarity makes

<sup>46</sup> *Id.* at 892.

<sup>47</sup> *Id.* at 899.

<sup>48</sup> 509 U.S. 209 (1993).

<sup>49</sup> 127 S. Ct. 1069 (2007).

<sup>50</sup> *PeaceHealth*, 515 F.3d at 901.

<sup>51</sup> *Id.* at 906–10. It is not entirely clear whether the court's standard was for a safe harbor or for liability.

antitrust counseling and compliance difficult.<sup>52</sup>

### C. Analysis

Commentators and panelists recognize the ubiquity of bundled discounting and the benefits that can flow from it. But they also agree that, under certain circumstances, a monopolist's bundled discounting can potentially harm consumers.<sup>53</sup> However, there is no consensus among courts or commentators on the appropriate analysis of such potential harm.<sup>54</sup> This part of the chapter discusses the two principal theories of competitive harm from bundled discounting by a monopolist, the potential procompetitive benefits of bundled discounting, and a framework for analyzing bundled discounts under section 2, including potential safe harbors.

#### 1. Theories of Competitive Harm

One theory of harm from bundled discounts is similar to the theory of harm from price predation of a single product and applies where bundle-to-bundle competition is reasonably possible—whether because an individual competitor can provide all the

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<sup>52</sup> See, e.g., Sherman Act Section 2 Joint Hearing: Conduct as Related to Competition Hr'g Tr. 14, May 8, 2007 [hereinafter May 8 Hr'g Tr.] (Rill); *id.* at 75 (Melamed); Sherman Act Section 2 Joint Hearing: Business Testimony Hr'g Tr. 63–64, 83, Feb. 13, 2007 [hereinafter Feb. 13 Hr'g Tr.] (Stern); Nov. 29 Hr'g Tr., *supra* note 2, at 167 (Crane).

<sup>53</sup> See generally Crane, *supra* note 7, at 443–47; Daniel L. Rubinfeld, *3M's Bundled Rebates: An Economic Perspective*, 72 U. CHI. L. REV. 243, 252–62 (2005); Greenlee et al., *supra* note 3, at 15; Nalebuff, *Bundling*, *supra* note 3; Muris, *supra* note 7, at 28–35. But see May 8 Hr'g Tr., *supra* note 52, at 61 (Muris) ("[E]mpirically we know almost nothing that tells us that there are anticompetitive problems from bundling.").

<sup>54</sup> See generally Sherman Act Section 2 Joint Hearing: Section 2 Policy Issues Hr'g Tr. 153–54, May 1, 2007 [hereinafter May 1 Hr'g Tr.] (Jacobson) (describing bundled discounting as having aspects of predatory pricing, tying, and exclusive dealing); Nov. 29 Hr'g Tr., *supra* note 2, at 75 (Sibley) ("[I]f there is a general legal theory of bundled discounts . . . it is not predatory pricing and it is not always going to be the same as tying either. It is going to be something else, and I don't know what it is."); AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b2.

products in the bundle, multiple competitors can team together to provide their own bundle, or sophisticated customers can assemble their own bundles. The primary difference is that with bundling there are multiple products, in contrast to one product in the predatory-pricing context. In either case, the below-cost pricing may force competitors to exit the market, after which a firm potentially could charge supracompetitive prices. Without below-cost pricing, equally efficient competitors would be able to match the bundled price, and competition would not be harmed.

A second theory of competitive harm may apply when no rival can offer a competing bundle. In the simplest case, Firm A has a monopoly in Product X and bundles X with Product Y, at a discount. Firm B only sells Product Y, and no one other than Firm A sells X. In this situation, Firm A's bundled discounting can have anticompetitive effects similar to those flowing from some anticompetitive ties. Specifically, it may allow Firm A to use its monopoly power in X to obtain a second monopoly in Y, or it may assist Firm A in maintaining its monopoly in X.

The tying theory of bundled-discounting harm can further be illustrated with a hypothetical from the *Ortho* opinion.<sup>55</sup> The hypothetical assumes that only A makes conditioner, that both A and B make shampoo, and that consumers must use both products. A's average variable costs are \$2.50 for conditioner and \$1.50 for shampoo, while B's average variable cost for shampoo is \$1.25. A prices conditioner and shampoo at \$5 and \$3 if bought separately, but offers a bundled price of \$5.25 if the products are bought as a package. This is above A's average variable cost of \$4 for both products. However, in order for B to compete for shampoo sales, it must persuade the customer to buy its shampoo while paying the unbundled price of \$5 for A's conditioner; this means that B can charge no more than \$0.25 for shampoo, which is below both A's average variable cost for shampoo and B's own lower average variable cost.

<sup>55</sup> 920 F. Supp. 455, 467 (S.D.N.Y. 1996).

The harm to the competitive process in this hypothetical does not come about in the same way as it does with predatory pricing, because A is not charging a price—either for the goods that make up the bundle or for the bundle itself—that is less than its average variable cost for both products. Rather, the structure and level of A's prices result in all or most purchasers buying both products from Firm A, because the price of the bundle is lower than the prices customers would have to pay to acquire the bundled goods outside the bundle. Because the anticompetitive potential of such conduct does not arise from the monopolist charging below-cost prices, but from linking the two products, the impact of the conduct described in the hypothetical resembles that of tying more than that of predatory pricing.

## 2. Potential Procompetitive Benefits

Commentators have pointed out many efficiencies potentially associated with bundled discounting. In much the same way that tying can lower a firm's costs,<sup>56</sup> bundled discounting can lower a firm's costs. As one commentator explains, many of these discounting practices "are explained by economies of scale or scope in either manufacturing or transacting."<sup>57</sup> Bundled discounting also can allow businesses both to induce existing customers to try new product or service offerings and give retailers incentives to promote particular products and services.<sup>58</sup> Firms may also use bundled discounting to price discriminate in a way that

<sup>56</sup> See *supra* Chapter 5, Part III(B).

<sup>57</sup> AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b; see also Daniel A. Crane, *Multiproduct Discounting: A Myth of Nonprice Predation*, 72 U. CHI. L. REV. 27, 40 (2005) ("Diversified firms may achieve economies of scope or scale, reduce transaction costs or stimulate demand by selling products in a package . . ." (footnotes omitted)); David S. Evans & Michael Salinger, *Why Do Firms Bundle and Tie? Evidence from Competitive Markets and Implications for Tying Law*, 22 YALE J. ON REG. 37, 41 (2005) ("Bundling—offering two or more products at a single price—can provide efficiencies such as marginal cost savings, quality improvement, and customer convenience.").

<sup>58</sup> Nov. 29 Hr'g Tr., *supra* note 2, at 111-12 (Muris); see also Crane, *supra* note 7, at 430-43; Muris, *supra* note 7, at 3-7.

increases output and economic efficiency.<sup>59</sup>

### 3. Safe Harbors

Because of the ubiquity of bundled discounting and the disagreement as to the proper antitrust analysis, panelists noted that there would be a substantial benefit from greater clarity and more administrable rules.<sup>60</sup> In particular, the Third Circuit's decision in *LePage's*, upholding jury instructions stating that conduct is illegal under section 2 when it "has made it very difficult or impossible for competitors to engage in fair competition,"<sup>61</sup> has been roundly criticized for its failure to provide any useful guidance.<sup>62</sup> Many commentators suggest that clear, administrable standards for analyzing bundled discounting must start with some kind of price-cost safe harbor or screen,<sup>63</sup> and many panelists agreed.<sup>64</sup>

<sup>59</sup> See, e.g., AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b2, at 263–64 ("[B]undling may take advantage of the fact that different customers have different demand elasticities for individual goods. By bundling them . . . output can go up . . . and production and distribution costs can decline.").

<sup>60</sup> See, e.g., May 8 Hr'g Tr., *supra* note 52, at 14, 76–77 (Rill); *id.* at 75–76 (Melamed); *id.* at 78 (Creighton); May 1 Hr'g Tr., *supra* note 54, at 18–19 (Kolasky); *id.* at 19 (Jacobson); *id.* at 31–32 (Baer); *id.* at 144–145 (Kolasky); Feb. 13 Hr'g Tr., *supra* note 52, at 63–64 (Stern); Nov. 29 Hr'g Tr., *supra* note 2, at 167–68, 170 (Crane). Similarly, the Antitrust Modernization Commission (AMC), before going on to recommend a three-part test for bundled discounts including a price-cost safe harbor, first concluded that "[t]he lack of clear standards regarding bundling . . . may discourage conduct that is procompetitive or competitively neutral and thus may actually harm consumer welfare." ANTITRUST MODERNIZATION COMM'N, REPORT AND RECOMMENDATIONS 94 (2007), available at [http://govinfo.library.unt.edu/amc/report\\_recommendation/amc\\_final\\_report.pdf](http://govinfo.library.unt.edu/amc/report_recommendation/amc_final_report.pdf).

<sup>61</sup> 324 F.3d 141, 168 (3d Cir. 2003) (en banc) (quoting trial court).

<sup>62</sup> See, e.g., May 8 Hr'g Tr., *supra* note 52, at 60–61 (Pitofsky, Muris); *id.* at 78 (Creighton); May 1 Hr'g Tr., *supra* note 54, at 18–19 (Kolasky); Nov. 29 Hr'g Tr., *supra* note 2, at 86–89 (Lambert, Kattan); *id.* at 166–68 (Crane); see also ANTITRUST MODERNIZATION COMM'N, *supra* note 60, at 97 (criticizing the decision as "too vague and therefore . . . likely to chill welfare-enhancing bundled discounts or rebates" (footnote omitted)).

<sup>63</sup> See, e.g., ANTITRUST MODERNIZATION COMM'N,

In *PeaceHealth*, the Ninth Circuit focused on the question whether a price-cost test was needed and invited supplemental amicus curiae briefs addressing whether a plaintiff bringing a section 2 claim based on bundled discounting "must prove that the defendant's prices were below an appropriate measure of the defendant's cost."<sup>65</sup> The vast majority of the amicus briefs supported adoption of a price-cost screen.<sup>66</sup> As discussed above, the *PeaceHealth* decision ultimately adopted a price-cost test.<sup>67</sup>

Support for a price-cost safe harbor for bundled discounting, however, is not universal. For example, while almost all the *PeaceHealth* amici supported a price-cost test, one brief suggested that cost-based tests ignore situations in which less efficient competitors constrain a monopolist's pricing and argued: "Because bundled discounts need not necessarily be below cost to harm competition, the proper legal standard should focus on the conduct's effect on competition rather than its relationship to defendant's cost structure."<sup>68</sup>

In addition, some panelists suggested that a price-cost safe harbor would be inappropriate

*supra* note 60, at 99–100; AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b2, at 252–57; Crane, *supra* note 7, at 480–84; Muris, *supra* note 7, 41–60; Carl Shapiro, Exclusionary Conduct: Testimony Before the Antitrust Modernization Commission 18 (Sept. 29, 2005) (unpublished manuscript), available at [http://govinfo.library.unt.edu/amc/commission\\_hearings/pdf/Shapiro\\_Statement.pdf](http://govinfo.library.unt.edu/amc/commission_hearings/pdf/Shapiro_Statement.pdf).

<sup>64</sup> See Nov. 29 Hr'g Tr., *supra* note 2, at 95–99, 185–94. One panelist who stated that defendant's satisfying an appropriate price-cost test would be "pretty convincing" nonetheless suggested that the price-cost test should not necessarily be part of plaintiff's burden. *Id.* at 186–88 (Tom).

<sup>65</sup> Mar. 20, 2007 Order, *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883 (9th Cir. 2008) (Nos. 05-35627, 05-36153, 05-36202).

<sup>66</sup> See, e.g., *infra* notes 75, 83 and accompanying text.

<sup>67</sup> 515 F.3d 883, 909–10 (9th Cir. 2008).

<sup>68</sup> Brief of Amici Curiae American Antitrust Institute, Consumer Federation of America and Consumers Union Supporting McKenzie-Williamette and Affirmance at 21, *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883 (9th Cir. 2008) (Nos. 05-36153, 05-36202); see also *id.* at 24.

because there could be situations in which the bundled price might not truly be a cost savings to the consumer.<sup>69</sup> They posit that there may be instances where there is not any real price cut involved because “a firm with monopoly power raises the standalone price of its monopoly product—presumably to some above-monopoly level—and then introduces a bundled-rebate program offering a ‘sham’ discount.”<sup>70</sup> In this situation, the bundled discount does not result in lower prices. In particular, one panelist stated that, given certain assumptions about the markets, one can determine whether consumer welfare has gone up or down as a result of bundled discounting, and thus perhaps whether section 2 has been violated, simply by determining whether the out-of-bundle price of the monopoly good is higher than its pre-bundled price. In that case, he maintained, “you don’t need to know anything about costs.”<sup>71</sup>

However, other panelists questioned whether the frequency of such illusory discounts is sufficient to shape legal rules.<sup>72</sup> In particular, one panelist questioned both the likelihood of fictitious discounts and the ability to distinguish them from the more typical bundled discounts that do provide customers the benefit of lower prices.<sup>73</sup> Product attributes may have changed,<sup>74</sup> or prices may have moved for a variety of supply and demand conditions

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<sup>69</sup> May 1 Hr’g Tr., *supra* note 54, at 142–43 (Elhauge); Nov. 29 Hr’g Tr., *supra* note 2, at 69–70 (Nalebuff); *id.* at 170–71 (Tom).

<sup>70</sup> Rubinfeld, *supra* note 53, at 252 (citing authors of contractual-tying theory).

<sup>71</sup> Nov. 29 Hr’g Tr., *supra* note 2, at 95 (Sibley).

<sup>72</sup> *Id.* at 71–74 (Kattan, Lambert).

<sup>73</sup> *Id.* at 71 (Kattan). He also suggested that a price-cost safe harbor could still be applied and may be adequate to address the concerns raised by the sham or fictitious-discount models. *Id.* at 93; *see also id.* at 93 (Sibley) (suggesting that *SmithKline* was a case in which a price-cost safe harbor was in fact applied to what may have been a fictitious discount).

<sup>74</sup> Nov. 29 Hr’g Tr., *supra* note 2, at 71 (Kattan) (suggesting difficulty in assessing whether the bundling caused out-of-bundle prices to increase, because of other changes (e.g., quality, performance, and product attributes) that may take place over the same period).

independent of the bundling or just because a firm with monopoly power decides it was not charging the correct monopoly price.

The Department believes that sound, administrable rules for bundled discounting by a monopolist would be valuable and that screens or safe harbors have the potential to provide more certainty in this area without harming antitrust enforcement. Two different price-cost safe harbors for bundled discounting have been the subject of the majority of the commentary and discussion: the total-bundle predation-based (or aggregate or *Brooke Group*) safe harbor and the discount-allocation (or *Ortho* or AMC) safe harbor. We turn to them now.

#### a. The Total-Bundle Predation-Based Safe Harbor

One proposed safe harbor would protect a firm’s bundled discounting where the discounted price of the bundle exceeds an appropriate measure of the aggregate cost of the bundle’s constituent products. This approach would mirror that followed in predatory-pricing cases, analyzing defendant’s price and cost for the entire bundle.<sup>75</sup>

This safe harbor would allow firms significant latitude in pricing bundles. “[T]he primary advantages of such a rule would be that it is administrable and predictable, and would be the least likely to pose undue risks of overdetering procompetitive behavior.”<sup>76</sup> Support for this safe harbor does not rely on the conclusion that a bundle priced above an appropriate measure of cost can never be anticompetitive. Rather, like the approach in *Brooke Group*, it is based on the reasoning that above-cost bundled discounting very often benefits consumers and “is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate

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<sup>75</sup> Muris, *supra* note 7, at 46–60; *see, e.g.*, Brief of Pacific Bell Telephone Company (D/B/A AT&T California) and Visa U.S.A. Inc. as Amici Curiae Supporting Reversal, *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883 (9th Cir. 2008) (Nos. 05-35627, 05-35640, 05-36153, 05-36202).

<sup>76</sup> Muris, *supra* note 7, at 30.

price cutting.”<sup>77</sup> As one panelist explained this view, “[I]t is simply too difficult to separate the pro-competitive wheat from the anticompetitive chaff and [trying to do so] will end up chilling procompetitive bundled discounting . . . so the best approach is to have a per se legality rule for above-cost bundled discounts, very much along the lines of the *Brooke Group* rule.”<sup>78</sup>

The AMC considered but did not endorse the total-bundle predation-based safe harbor. The AMC Report noted testimony before it that this rule “ignores the effects of bundling insofar as it permits bundled discounts where a monopolist lowered its price in a competitive market below the monopolist’s average variable cost for the competitively priced product.”<sup>79</sup> Similarly, one panelist criticized the total-bundle predation-based safe harbor because it

assumes either (1) that above-cost bundled discounts are so unlikely to exclude equally or more efficient competitors that the search for exclusionary bundled discounts is not worth the effort, or (2) that there is no alternative evaluative approach that is easily administrable and is unlikely to overdeter proconsumer discounts. Both assumptions are probably untrue.<sup>80</sup>

One treatise suggests applying a total-bundle predation-based safe harbor only in instances in which it is likely that other significant rivals would offer a comparable bundle.<sup>81</sup> Where such bundle-to-bundle competition is possible, equally efficient competitors would be able to match an above-cost bundled price.<sup>82</sup>

<sup>77</sup> *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 223 (1993).

<sup>78</sup> Nov. 29 Hr’g Tr., *supra* note 2, at 26–27 (Lambert) (describing but not endorsing the rule).

<sup>79</sup> ANTITRUST MODERNIZATION COMM’N, *supra* note 60, at 98 (citing AMC testimony of Steven Salop).

<sup>80</sup> Lambert, *supra* note 7, at 1705; *see also* Nov. 29 Hr’g Tr., *supra* note 2, at 27 (Lambert).

<sup>81</sup> *See* AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b, at 245–46, 258–59.

<sup>82</sup> *Id.* at 246 (“A rule condemning above-cost package discounts in this situation would run into all the

## b. The Discount-Allocation Safe Harbor

A number of courts and commentators have sought to develop legal standards that reflect the possibility that a monopolist’s bundled discounting could pass a predation-based test applied to the entire bundle and still exclude an equally efficient producer of one or more products in the bundle. These efforts have resulted in the development of the discount-allocation safe harbor, which compares an appropriate measure of defendant’s cost for the competitive product in a bundle to defendant’s “imputed price” of that product: the price after allocating to the competitive product all discounts and rebates attributable to the entire bundle.<sup>83</sup>

One treatise supports a discount-allocation safe harbor in certain cases.<sup>84</sup> A number of panelists at the hearings also expressed qualified support for it,<sup>85</sup> and the *PeaceHealth*

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problems that predatory pricing law faces with respect to single-product pricing.”).

<sup>83</sup> *See, e.g.*, Brief of *Amici Curiae* Law Professors in Support of Defendant-Appellant and Cross-Appellee *PeaceHealth* Supporting Reversal of the Verdict Concerning Bundled Discounts, *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883 (9th Cir. 2008) (Nos. 05-35627, 05-35640, 05-36153, 05-36202) [hereinafter Law Professors’ *Amici* Brief]; Brief of *Amici Curiae* Genentech, Inc., Honeywell International Inc., Kimberly-Clark Corp., Kraft Foods, Inc., The Coca-Cola Company, and United Technologies Corp. in Support of Appellant/Cross-Appellee *PeaceHealth*, 515 F.3d 883 (9th Cir. 2008) (Nos. 05-035627, 05-35640) [hereinafter Genentech et al. *Amici* Brief].

<sup>84</sup> AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b, at 250–59 (supporting a discount-allocation safe harbor in instances where no significant rivals offer or are likely to offer the same package and viewing it as analogous to tying’s requirement that two products are actually tied together).

<sup>85</sup> *See, e.g.*, May 8 Hr’g Tr., *supra* note 52, at 59 (Rill) (preferring the aggregate-cost rule but suggesting as an alternative a discount-allocation safe harbor); *id.* at 64 (Melamed) (supporting what he described as AMC Commissioner Carlton’s approach of using this safe harbor and applying a no-economic-sense test to conduct outside it); *id.* at 68–70 (Rule) (supporting the safe harbor and, for conduct outside it, focusing on exclusion or foreclosure); Nov. 29 Hr’g Tr., *supra* note 2, at 21, 94, 97–98 (Nalebuff), *id.* at 65 (Kattan); *id.* at 77

decision adopted this rule.<sup>86</sup> A panelist who supported this safe harbor maintained that its price-cost test is administrable because “determining average variable cost . . . presents a relatively tractable problem, even though it is a fairly complicated one . . . . It leads to predictable results.”<sup>87</sup> Proponents of a discount-allocation safe harbor also contend that it “brings discipline and structure to pretrial dispositive motions and directed verdict motions, a required matrix for expert reports and testimony, and a frame for jury instructions.”<sup>88</sup>

One panelist, however, saw both operational and analytical difficulties with a discount-allocation test. Operationally, he saw it as creating “something of a daunting task . . . [with] a margin or opportunity for error . . . that I think is quite substantial.”<sup>89</sup> A commentator similarly suggests that “[t]he test is almost certainly not administrable.”<sup>90</sup> He contends that it may be difficult to measure both the discount in multi-product bundle situations, particularly when consumers purchase various combinations of products in the bundle, and the cost of the competitive product, particularly given the difficulty of identifying and allocating joint costs for goods in a bundle.<sup>91</sup>

In addition, the equally efficient competitor concept that is the foundation for the discount-allocation safe harbor may pose theoretical problems.<sup>92</sup> For example, if there are economies of scale, the monopolist may have lower costs

simply because it presently has higher volume. It may similarly have lower costs where there are economies of scope involved in offering multiple products. One panelist, who opposed the discount-allocation safe harbor and supported the *Brooke Group* rule, asked: “[A]ll else equal, how can a firm that offers you less of what you want be equally efficient with a firm that offers you more?”<sup>93</sup> He stated that these problems with the equally efficient competitor concept in this context call into question the underlying premise of the discount-allocation safe harbor.<sup>94</sup>

The AMC proposed a three-part test for bundled discounting.<sup>95</sup> The first “screen” of that test in effect sets forth a discount-allocation safe harbor. It requires plaintiff to show that “after allocating all discounts and rebates attributable to the entire bundle of products to the competitive product, the defendant sold the competitive product below its incremental cost for the competitive product.”<sup>96</sup> If plaintiff cannot show price below cost after this discount allocation, the safe harbor applies and the inquiry ends.<sup>97</sup>

The AMC concluded that its discount-allocation screen provides clarity to businesses and is sufficiently administrable for courts to apply.<sup>98</sup> The AMC also viewed this screen as subjecting to scrutiny under section 2 only those bundled discounts that “could exclude a hypothetical equally efficient competitor.”<sup>99</sup> The AMC recognized that this would permit bundled discounts that could exclude a less efficient competitor that had nevertheless provided some constraint on pricing.<sup>100</sup>

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(Sibley); *id.* at 121, 128–29 (Crane); *id.* at 160, 188–91 (Ordovery); *see also id.* at 151–57 (Tom) (questioning whether a safe-harbor approach rather than use of presumptions is appropriate).

<sup>86</sup> 515 F.3d 883, 903 (9th Cir. 2008). Some other case law appears to suggest it as well. *See supra* Part I(B).

<sup>87</sup> Nov. 29 Hr’g Tr., *supra* note 2, at 62–63 (Kattan).

<sup>88</sup> Law Professors’ Amici Brief, *supra* note 83, at 15.

<sup>89</sup> May 8 Hr’g Tr., *supra* note 52, at 58 (Rill); *see also id.* at 58–60 (concluding that it nonetheless might be appropriate if employed as a safe harbor).

<sup>90</sup> Aaron M. Panner, *Bundled Discounts and the Antitrust Modernization Commission*, ESAPIENCE CENTER FOR COMPETITION POLICY, July 2007, at 6.

<sup>91</sup> *Id.* at 5–7.

<sup>92</sup> *See* Brief for the United States as Amicus Curiae, *supra* note 6, at 13 n.10; Chapter 3, Part III(C).

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<sup>93</sup> Nov. 29 Hr’g Tr., *supra* note 2, at 113 (Muris).

<sup>94</sup> May 8 Hr’g Tr., *supra* note 52, at 61 (Muris).

<sup>95</sup> ANTITRUST MODERNIZATION COMM’N, *supra* note 60, at 99.

<sup>96</sup> *Id.*

<sup>97</sup> *Id.* at 100.

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> *Compare, e.g.,* May 1 Hr’g Tr., *supra* note 54, at 143–44 (Elhauge) (noting both that a less efficient rival may constrain a monopolist’s pricing and that a monopolist can raise its rivals’ costs by denying it

However, the AMC reasoned that the difficulties of assessing those circumstances, the lack of predictability and administrability of any standard that would capture them, and the undesirability of a test that would protect less efficient competitors made reliance on the hypothetical equally efficient competitor concept appropriate for bundled-pricing practices.<sup>101</sup>

As is evident from the above discussion, bundled discounts share characteristics of both predatory pricing and tying. Professor Hovenkamp suggests that they “are best analyzed by a model that draws a little from each area.”<sup>102</sup> The Department agrees and sets forth below two safe harbors for bundled discounts, one applicable to a predation theory and one applicable to a tying theory.

The Department believes that where bundle-to-bundle competition is reasonably possible, the potential competitive harm of bundled discounting mirrors that of predatory pricing. The price-cost safe harbor in this instance should therefore mirror the predatory-pricing safe harbor: the bundled discount should be

lawful if the price of the bundle is not below an appropriate measure of cost of the bundle.<sup>103</sup> In addition, as in ordinary predatory-pricing analysis, a showing that recoupment is likely should be required.

**The Department believes that where bundle-to-bundle competition is reasonably possible, the potential competitive harm of bundled discounting mirrors that of predatory pricing. The price-cost safe harbor in this instance should therefore mirror the predatory-pricing safe harbor.**

Where bundle-to-bundle competition is not reasonably possible because of the inability of any substantial competitor or group of competitors to provide a similar range of items, the Department believes that the potential competitive harm of bundled discounting more closely resembles that from tying than that from predatory pricing. In these circumstances, the Department believes that a discount-allocation safe harbor that compares an appropriate measure of a monopolist’s cost for the competitive product in a bundle to its imputed price of that product—the price after allocating to the competitive product all discounts and rebates attributable to the entire bundle—is the appropriate approach. A plaintiff, therefore, would be required to show that defendant sold the competitive product at an imputed price that was below its incremental cost of that product.<sup>104</sup>

economies of scale), and Steven C. Salop, *Avoiding Error in the Antitrust Analysis of Unilateral Refusals to Deal 5* (Sept. 21, 2005) (unpublished manuscript), available at [http://govinfo.library.unt.edu/amc/commission\\_hearings/pdf/Salop\\_Statement\\_Revised%209-21.pdf](http://govinfo.library.unt.edu/amc/commission_hearings/pdf/Salop_Statement_Revised%209-21.pdf) (“Entry by higher cost . . . competitors can provide competition to a monopolist and cause prices to fall and output to rise, which increases consumer welfare and allocative efficiency.”), with AREEDA & HOVENKAMP, *supra* note 7, ¶ 749a, at 242 (“Requiring the defendant’s pricing policies to protect the trade of higher cost rivals is overly solicitous of small firms and denies customers the benefits of the defendant’s lower costs.”), and *id.* ¶ 749b1, at 249 (“[N]o firm, not even a monopolist, is a trustee for another firm’s economies of scale. To force such a firm to hold a price umbrella over its rivals . . . in order to protect the rivals’ inefficiently small production, would be a blatant example of protecting competitors at the expense of consumers.”).

<sup>101</sup> ANTITRUST MODERNIZATION COMM’N, *supra* note 60, at 100. The AMC also noted that it was not “recommending application of [its three-part test] outside the bundled pricing context, for example in tying or exclusive dealing cases.” *Id.* at 114 n.157.

<sup>102</sup> AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b2, at 251.

<sup>103</sup> See *supra* chapter 4, part I (C)(3) for a discussion of the appropriate cost measures to apply in predatory-pricing cases.

<sup>104</sup> See also ANTITRUST MODERNIZATION COMM’N, *supra* note 60, at 99 (stating that “after allocating all discounts and rebates attributable to the entire bundle of products to the competitive product, the defendant sold the competitive product below its incremental cost for the competitive product”). Where there are multiple competitive products in such a bundle, the Department believes that the discount-allocation safe harbor should apply to all of the monopolist’s competitive products together. For example, if the monopolist produces monopoly good X and competitive goods Y and Z, the discount-allocation safe harbor should apply to goods Y and Z together, regardless of whether plaintiff or any

**Where bundle-to-bundle competition is not reasonably possible, the Department believes that a discount-allocation safe harbor is appropriate.**

The Department recognizes that it is theoretically possible for anticompetitive conduct to come within the discount-allocation safe harbor, particularly where the bundled discount denies competitors the ability to attain economies of scale. The hypothetical equally efficient competitor concept on which the safe harbor is based is imperfect. However, the Department believes that the risk of false negatives posed by employing the safe harbor is insufficient to warrant further consideration of conduct that comes within the safe harbor, given the administrative costs of proceeding, the risk of erroneous condemnations of conduct, and, perhaps most importantly, the potential chilling effect on legitimate price discounting.<sup>105</sup>

#### **4. Analysis of Bundled Discounts Falling Outside a Safe Harbor**

An often overlooked concern with adopting any safe harbor is that conduct falling outside the safe harbor might inappropriately give rise to a negative presumption about the conduct.<sup>106</sup>

other rival produces both goods Y and Z. Because goods Y and Z are competitive, a rival could offer these goods in a package even if the rival did not itself produce both goods. Equally efficient producers of Y and Z could jointly offer a Y-Z package and would not be foreclosed by the monopolist's bundled offering if the monopolist came within the discount-allocation safe harbor as applied to Y-Z together.

<sup>105</sup> The AMC and others have been especially concerned about the risk of false positives in prosecuting bundled discounting, relative to the likelihood of false negatives. See, e.g., ANTITRUST MODERNIZATION COMM'N, *supra* note 60, at 94–100; Nov. 29 Hr'g Tr., *supra* note 2, at 55–64 (Kattan); AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b2, at 243–45; Crane, *supra* note 7, at 465–68; Muris, *supra* note 7, at 8. *But see* Roy T. Englert, Jr., *Defending the Result in Lepage's v. 3M: A Response to Other Commentators*, 50 ANTITRUST BULL. 481, 485–86, 497 (2005) (suggesting that there may be more reason to worry about false negatives relative to false positives for bundled pricing than with predatory pricing).

<sup>106</sup> Two AMC Commissioners, although joining the

Several panelists observed that bundled discounts can exclude equally efficient competitors while increasing consumer welfare.<sup>107</sup> One panelist cautioned that where defendant fell outside a price-cost safe harbor, “you would still want some sensible explanation of how this gives the defendant power over price, how prices go up as a result.”<sup>108</sup> A safe harbor can be counterproductive if businesses or courts assume improperly that failing to come within it creates a presumption of anticompetitive conduct.

**A safe harbor can be counterproductive if businesses or courts assume improperly that failing to come within it creates a presumption of anticompetitive conduct.**

A safe harbor should, therefore, not be misunderstood as a demarcation between legal and illegal conduct. Rather, it is a simple statement of conduct that is clearly legal. Failure to come within it does not by itself indicate harm to competition. If defendant's pricing falls outside the discount-allocation safe harbor, then the bundled discounting is potentially exclusionary. A bundled discount that falls outside the discount-allocation safe harbor still has to be analyzed for competitive effects.<sup>109</sup>

AMC's unanimous recommendation on how to treat bundled discounting, expressed concern that many pricing schemes where exclusion is not an issue would fall outside the safe harbor and thus be subject to further scrutiny. See ANTITRUST MODERNIZATION COMM'N, *supra* note 60, at 99 n.\*; see also *id.* at 398–99 (if the AMC's discount-allocation safe harbor is adopted by courts, there should not be a negative presumption from failing it).

<sup>107</sup> See, e.g., Nov. 29 Hr'g Tr., *supra* note 2, at 41, 43–45 (Sibley); *id.* at 59–60, 92 (Kattan); *id.* at 118 (Muris).

<sup>108</sup> *Id.* at 201 (Tom); see also May 8 Hr'g Tr., *supra* note 52, at 69–70 (Rule) (stressing the importance of focusing on the extent of the exclusion of competition for pricing that falls outside the safe harbor); *id.* at 72 (Melamed) (“I assume everybody agrees here we have to have a rigorous competitive effects test.”).

<sup>109</sup> As discussed above, the Department believes that

The third prong of the AMC's three-pronged test<sup>110</sup> requires plaintiff to show that "the bundled discount or rebate program has had or is likely to have an adverse effect on competition."<sup>111</sup> The AMC Report does not describe how an actual or likely adverse effect on competition would be shown. An amicus brief filed in *PeaceHealth* signed by, among others, two AMC Commissioners, purports to describe the analysis under the AMC's third prong as a rule-of-reason analysis, stating that courts would determine whether the pricing practice, net of efficiencies it may create, is likely to increase prices, reduce output, or otherwise impair competition substantially in a relevant market. Under this approach, the impact on rivals must be found to be so substantial, and the ability of others to enter or expand so limited, that rivals can no longer operate as a meaningful constraint on

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ordinary predatory-pricing analysis should apply if bundle-to-bundle competition is reasonably possible.

<sup>110</sup> The second prong of the AMC's test requires plaintiff to show that defendant is likely "to recoup [its] short-term losses." ANTITRUST MODERNIZATION COMM'N, *supra* note 60, at 99. This requirement effectively serves as another screen. However, the Department believes this requirement is logically problematic, because a defendant that fails the first discount-allocation prong is not necessarily incurring any short-term losses from offering bundled discounts, so there may not be any short-term losses to recoup. The *PeaceHealth* court rejected the recoupment prong of the AMC test on the ground that, as opposed to predatory pricing, "exclusionary bundling does not necessarily involve any loss of profits for the bundled discounter," making it "analytically [un]helpful to think in terms of recoupment of a loss that did not occur." 515 F.3d 883, 910 n.21 (9th Cir. 2008). One AMC Commissioner has suggested that the recoupment prong was inserted largely to make the AMC's bundled-discounting test look more like the *Brooke Group* test for predatory pricing and that, while a recoupment safe harbor is part of the AMC recommendation, he "wouldn't pay an awful lot of attention to it." May 1 Hr'g Tr., *supra* note 54, at 155-56 (Jacobson). Moreover, if the competitive harm that may flow from bundled discounts (where bundle-to-bundle competition is not possible) is not really from predatory pricing, there would appear to be little reason to try to mirror the *Brooke Group* predatory-pricing test.

<sup>111</sup> ANTITRUST MODERNIZATION COMM'N, *supra* note 60, at 99.

defendant's monopoly power.<sup>112</sup> The brief does not provide further detail as to exactly what a plaintiff would have to show to establish this part of its case under the AMC's test.

Panelists addressed the required extent of impact on rivals, considering whether a rival's exit is required for the competitive process to be harmed. Some panelists contended that a plaintiff should not have to show that competitors exited the market, noting that harm to competition can occur even if competitors remain. For example, one panelist stated that "if you are able to keep your rivals at 10 and 15 percent, they may choose not to invest in this business, not to try to expand it . . . and there can be tremendous harm in the long run."<sup>113</sup> Another suggested that bundled discounting is harmful when it allows a competitor to operate profitably but at a scale sufficiently constricted so as to render it much less constraining of the market outcome.<sup>114</sup>

While agreeing that competitive harm could occur even if rivals were not driven to exit the market, other panelists cautioned against antitrust intervention in these instances, especially considering that bundled discounting offers lower prices immediately to consumers. One panelist suggested that the need for efficient legal rules and the concern for false positives dictate that "[a]s a practical matter, we ought to be cautious if the exclusion is partial."<sup>115</sup> Another concluded that plaintiff's claim should fail if the allegedly aggrieved rival is continuing to operate profitably in the market for the competitive good, even if at a much lower volume or market share than previously.<sup>116</sup>

Another topic of debate was how to treat non-exclusionary explanations for discounting. The AMC Report did not address this question, except in the Separate Statement of Commissioner Carlton. He explained that, in

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<sup>112</sup> Genentech et al. Amici Brief, *supra* note 83, at 19, 20.

<sup>113</sup> Nov. 29 Hr'g Tr., *supra* note 2, at 102 (Nalebuff).

<sup>114</sup> *Id.* at 177-79 (Ordovery).

<sup>115</sup> *Id.* at 179 (Muris).

<sup>116</sup> *Id.* at 99-100 (Lambert).

the standard predation model, “it is odd for price to be below marginal cost in the absence of a predatory goal”<sup>117</sup> but that in the context of bundling:

it is *not* odd to have the firm fail the first prong of the AMC test in the absence of a predatory goal. The reason is that bundling can be used as a method of price discrimination and it can be optimal for a firm, with no predation motivation, to set prices that fail the first prong.<sup>118</sup>

Accordingly, he suggested allowing a defense for bundled discounting based on legitimate business reasons unrelated to predation and that there should be no presumption against pricing that fails the first prong.<sup>119</sup> One panelist suggested that Commissioner Carlton’s Separate Statement effectively articulates a no-economic-sense test for bundled discounts falling outside the discount-allocation safe harbor.<sup>120</sup>

Another panelist similarly suggested that “any explanation that the defendant could offer that’s accepted as the true explanation that is not an exclusionary explanation should be legitimate.”<sup>121</sup> He agreed that this sounded like employing a no-economic-sense test to pricing outside the safe harbor and observed that while a profit-sacrifice or no-economic-sense test may be difficult to apply as a starting point, it may make sense as a defense.<sup>122</sup>

One treatise states that “[c]onsideration of competitively benign explanations is particularly critical when the challenged practice is a discount, because low prices are

the most important goal of antitrust policy.”<sup>123</sup> Thus, “Any proven explanation for a package discount that does not depend on exclusion of rivals should indicate legality.”<sup>124</sup> Among the explanations noted are economies of scale or scope and price discrimination. “Bundling explained by price discrimination and/or scale economies is ‘exclusionary’ only in the quixotic sense that any practice that increases a seller’s output is exclusionary. If this firm sells more, then very likely someone else is selling less.”<sup>125</sup>

One panelist suggested, however, that allowing bundled discounts whenever there was any non-exclusionary explanation could ultimately lead to consumers paying higher prices—that efficiency justifications may not lower the monopolist’s costs sufficiently to offset anticompetitive effects.<sup>126</sup> More generally, two other panelists voiced concern about relying on evidence of either anticompetitive intent or business justification. One panelist stated that “trying to . . . look for evidence of intent one way or the other is sufficiently manipulable or hideable that I’m worried about playing that game.”<sup>127</sup> Another stated a preference for relying on a test focusing on two objective factors: whether price was below cost and, if so, whether competitors were excluded.<sup>128</sup>

The Department believes that where bundle-to-bundle competition is not reasonably possible, bundled discounting outside the safe

<sup>117</sup> ANTITRUST MODERNIZATION COMM’N, *supra* note 60, at 398.

<sup>118</sup> *Id.* (emphasis in original).

<sup>119</sup> *Id.* at 399 (further suggesting that a defense showing that the challenged pricing was used either for many years (so that predation was unlikely) or during a time with no possibility of predation should suffice).

<sup>120</sup> May 8 Hr’g Tr., *supra* note 52, at 64 (Melamed).

<sup>121</sup> Nov. 29 Hr’g Tr., *supra* note 2, at 202 (Crane).

<sup>122</sup> *Id.*; see also May 8 Hr’g Tr., *supra* note 52, at 64 (Melamed) (“You ought to allow the defendant and the plaintiff to duke it out over whether the bundling made economic sense.”); Nov. 29 Hr’g Tr., *supra* note 2, at 182, 202 (Ordovery).

<sup>123</sup> AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b2, at 262.

<sup>124</sup> *Id.* Hovenkamp’s acceptance of “any proven explanation” for bundled discounting differs from his general definition of unlawful exclusionary conduct, which does not allow any proven benefits to outweigh competitive harms but instead condemns conduct where the harms produced are disproportionate to the benefits. *Id.* ¶ 651a, at 72 (2d ed. 2002). Hovenkamp’s acceptance of “any proven explanation” for bundled discounts appears to be based on the immediate lowering of prices to consumers provided by such discounts.

<sup>125</sup> *Id.* ¶ 749b2, at 265.

<sup>126</sup> Nov. 29 Hr’g Tr., *supra* note 2, at 203 (Tom).

<sup>127</sup> *Id.* at 103–04 (Nalebuff).

<sup>128</sup> See *id.* at 103 (Kattan).

harbor should not be presumed anticompetitive. Rather, plaintiff must demonstrate actual or probable harm to competition. A significant consideration in this regard is whether rivals remain and are likely to remain in the market. Rivals' continued presence in the market casts serious doubt on the existence of anticompetitive effects—consumers continue to benefit from the bundled discounting as well as rivals' presence.<sup>129</sup> Accordingly, the Department believes that if rivals have not exited the market as a result of the bundled discounting and if exit is not reasonably imminent, courts should be especially demanding as to the showing of harm to competition.

Further, the Department believes that, when actual or probable harm to competition is shown, bundled discounting by a monopolist that falls outside the discount-allocation safe harbor should be illegal only when (1) it has no procompetitive benefits, or (2) if there are procompetitive benefits, the discount produces harms substantially disproportionate to those benefits. This standard requires plaintiffs to show that the anticompetitive harms of a monopolist's bundled discounting substantially outweigh its procompetitive benefits in those instances in which there are both anticompetitive effects and non-exclusionary explanations for the conduct. The Department does not believe that a trivial benefit should outweigh substantial anticompetitive effects.

**The Department believes that, when actual or probable harm to competition is shown, bundled discounting by a monopolist that falls outside the discount-allocation safe harbor should be illegal only when (1) it has no procompetitive benefits, or (2) if there are procompetitive benefits, the discount produces harms substantially disproportionate to those benefits.**

#### D. Conclusion

A monopolist's bundled discounts or rebates may, in certain circumstances, produce anticompetitive effects. At the same time, however, overly broad prohibitions against bundled discounting may inhibit pricing practices that benefit consumers. Clear and administrable standards are needed to enable firms to know in advance if bundled discounting may subject them to antitrust liability.

The Department believes that the development of clear, administrable standards for analyzing bundled discounts would be furthered by use of an appropriate price-cost safe harbor. The particular price-cost safe harbor that should be used depends on whether bundle-to-bundle competition is reasonably possible. If it is, the potential competitive harm of bundled discounting mirrors that caused by predatory pricing, so the appropriate price-cost safe harbor should look to whether the discounted price of the entire bundle exceeds an appropriate measure of cost of all the products constituting the bundle. For pricing outside this safe harbor, a plaintiff should have to show harm to competition sufficient to establish a likelihood of recoupment.

Where bundle-to-bundle competition is not reasonably possible, the potential competitive harm more closely resembles the harm that can arise from tying. Such harm may occur where the bundled discounting would cause customers to purchase the monopolist's bundle instead of buying only the monopoly product from the monopolist and purchasing the competitive product from an equally efficient competitor. The discount-allocation safe

<sup>129</sup> It is possible that a plaintiff will lose sufficient sales due to bundled discounting so that even though it remains in the market, it could be a significantly less vigorous competitor. Those allegations are easy to make but deserve careful scrutiny. For example, although plaintiff's average costs almost certainly will rise if it loses sales due to bundled discounting, its marginal costs may not significantly increase and thus its competitive significance may not be diminished even though it is operating at a reduced scale. Cf. Nov. 29 Hr'g Tr., *supra* note 2, at 179 (Tom) (suggesting "looking for the rival's marginal cost to be raised in such a way that the perpetrator can raise prices"). Moreover, other rivals may still be able to compete vigorously in the market.

harbor is an appropriate screen for determining whether those consequences are possible. The discount-allocation safe harbor compares an appropriate measure of defendant's cost for the competitive product (or products) in a bundle to the imputed price of that product (or products), which is the price after allocating all discounts and rebates attributable to the entire bundle to the competitive product (or products).

If the conduct falls outside the discount-allocation safe harbor, further analysis is required. Failure to come within the safe harbor should not create a presumption of anticompetitive effects. Where bundle-to-bundle competition is not reasonably possible, bundled discounting should only be condemned with an adequate showing of actual or probable harm to competition. A significant factor in this regard is whether rivals remain or are likely to remain in the market and, if so, whether the bundling significantly increases their marginal costs. Further, the Department believes that a proven procompetitive explanation for such a bundled discount should defeat a section 2 challenge to the bundled discount unless the anticompetitive harms are substantially disproportionate to the benefits.

## II. Single-Product Loyalty Discounts

### A. Introduction

In some instances, a seller may offer discounts (or rebates) on all units of a single product conditioned upon the level of purchases.<sup>130</sup> These are sometimes called "all-units" or "first-dollar" discounts, because they apply to all of the customer's purchases, rather than just the units beyond the level of purchases required to obtain them.<sup>131</sup> The

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<sup>130</sup> The offering of discounts or rebates contingent upon a buyer's purchase of two or more different products—or bundled discounting—is addressed in part I of this chapter.

<sup>131</sup> The applicability of the discount to *all units* distinguishes the situation from various pricing schedules that consumers frequently face. For example, a record club might offer "buy two albums at full price, and get all additional albums at 50% off." In that situation, the discounts do not go back to the first units.

discounts may be conditioned, for example, on the quantity of product purchased (e.g., a twenty percent discount on all units bought this year with the purchase of eighty units) or on the percentage of needs purchased (e.g., a twenty percent discount on all units with the purchase of eighty percent of buyer's total annual needs). The discounting seller may offer such discounts to all customers<sup>132</sup> or to a single customer.<sup>133</sup> This report uses the term "single-product loyalty discounts" to refer to these kinds of discounts and focuses on situations where the firm engaging in the practice has monopoly power (or the prospect thereof) over the product in question.<sup>134</sup>

Even when offered by firms with monopoly power, or by firms that have the prospect of achieving such power, single-product loyalty discounts can benefit consumers by reducing prices and increasing output beyond what the monopolist would otherwise have charged or produced, leading to more efficient resource allocation. A manufacturer may use these discounts to induce a retailer to provide brand-specific merchandising or otherwise increase its selling efforts.<sup>135</sup> Such discounts

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Similarly, a sandwich shop may charge \$5 for a sandwich and give customers a frequent-buyer card that offers a free sandwich after the card has been stamped ten times. Under this type of loyalty-reward program, a customer pays \$5 each for sandwiches 1-10, nothing for sandwich 11, and then \$5 again for sandwich 12. This chapter does not address such practices.

<sup>132</sup> See, e.g., *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000).

<sup>133</sup> See, e.g., *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227 (1st Cir. 1983) (Breyer, J.).

<sup>134</sup> One panelist suggested that single-product loyalty discounts, unlike exclusive-dealing contracts, "are not found in nature" and occur only with "firms which have substantial positions in the market." May 8 Hr'g Tr., *supra* note 52, at 82 (Creighton). Another panelist questioned whether there is evidence to support the assertion "that unlike bundling and exclusive dealing which we find everywhere, loyalty discounts are somehow a practice that we only find with firms with very large market shares." *Id.* at 84 (Muris).

<sup>135</sup> See David E. Mills, *Market Share Discounts* (Aug. 8, 2008) (unpublished working paper), available at <http://www.virginia.edu/economics/papers/mills/>

may also reduce costs of production by, for example, reducing a manufacturer's sales fluctuations. More generally, "non-linear pricing" (pricing that deviates from charging a constant price per unit) "can reflect real economic savings that are difficult to measure . . . or simply may be [a] way[] that firms choose to compete for the most desirable customers."<sup>136</sup> As with other types of discounts, loyalty discounts offered by firms with monopoly power may arise as part of the normal competitive process and need not have any exclusionary effect.<sup>137</sup>

However, as with predatory pricing, single-product loyalty discounts may be anticompetitive in certain circumstances, such as where the resulting price of all units sold to a customer is below an appropriate measure of cost. Further, commentators and panelists generally agree that even where a single-product loyalty discount is above cost when measured against all units, such a discount may in theory produce anticompetitive effects, especially if customers "must carry a certain percentage of the leading firm's products"<sup>138</sup> and the discount is structured to induce purchasers to buy all or nearly all needs beyond that "uncontestable" percentage from the leading firm.<sup>139</sup> Some noted that "if the

financial benefits of a market-share discount are effectively concentrated on the decision whether to buy a relatively small number of marginal units, even prices that technically are 'above cost' on average effectively may be below cost as to those marginal units."<sup>140</sup> These discounts may effectively foreclose such a large portion of available business that competitors cannot achieve efficient scale, thereby enabling the dominant firm to acquire or maintain monopoly power.<sup>141</sup>

Although there is general agreement that a monopolist's above cost (on all units) single-product loyalty discounts can be anticompetitive, there is no consensus on how likely that is. Further, there are questions as to how a court or enforcer should go about determining whether a particular single-product loyalty discount is anticompetitive, as well as how a business deciding whether to offer such a discount can know at the time whether the discount might later be deemed illegal. One question is whether the focus should be on whether the dominant firm is covering the cost of producing all units sold to a customer or on covering the cost of the additional sales induced by the discount. Another question is at

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Market%20Share%20Discounts.pdf.

<sup>136</sup> Dennis W. Carlton, *A General Analysis of Exclusionary Conduct and Refusal to Deal – Why Aspen and Kodak Are Misguided*, 68 ANTITRUST L.J. 659, 664 (2001).

<sup>137</sup> See, e.g., Sreya Kolay et al., *All-Units Discounts in Retail Contracts*, 13 J. ECON. & MGMT. STRATEGY 429 (2004); Patrick Greenlee & David Reitman, *Competing with Loyalty Discounts* (Jan. 7, 2006) (unpublished working paper), available at <http://www.wcas.northwestern.edu/csio/Conferences/Papers2006/GreenleeandReitmanpaper.pdf>.

<sup>138</sup> Feb. 13 Hr'g Tr., *supra* note 52, at 106 (Stern) (stating that it may be appropriate to distinguish this situation from situations in which "suppliers can essentially compete to supply the entire demand of the customer").

<sup>139</sup> See Willard K. Tom et al., *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 ANTITRUST L.J. 615, 627 (2000) (arguing that discounts can be used to achieve total or partial exclusivity where a "dominant firm is so well

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established among ultimate consumers that its customers . . . have a base, inelastic demand for the firm's products").

<sup>140</sup> *Id.* at 636; see also Nov. 29 Hr'g Tr., *supra* note 2, at 199 (Tom) (questioning whether it is preferable to "look at the incremental sales that were induced by the loyalty program and look at the revenues from those incremental sales and compare it to incremental cost" or "apply a Brooke Group test" comparing "all of the sales, all of the revenues" to "all of the costs for all of the sales"); Robert H. Lande, *Should Predatory Pricing Rules Immunize Exclusionary Discounts?*, 2006 UTAH L. REV. 863, 870-74, 877-80 (providing hypothetical examples of all-unit discounts resulting in below-cost pricing on marginal units).

<sup>141</sup> See May 8 Hr'g Tr., *supra* note 52, at 82-83 (Creighton); Nov. 29 Hr'g Tr., *supra* note 2, at 79-84 (Nalebuff); *id.* at 84 (Sibley); *id.* at 99-100 (Lambert); Tom et al., *supra* note 139, at 633-34; see also AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b, at 248 (recognizing that there may be situations where an above-cost single-product discount "increases the dominant firm's sales so much that it denies rivals economies of scale because they cannot get their own output high enough").

what level are the quantities of sales induced by the practice likely to have significant anticompetitive effect.

These issues, as well as concerns common to all types of single-firm conduct, including the need to develop administrable rules that appropriately balance the risk of false positives and false negatives, are reflected in the relatively limited case law and commentary on single-product loyalty discounts and in the views expressed by panelists. This chapter discusses these cases and perspectives and presents the Department's current thinking on how single-product loyalty discounts should be analyzed.

### B. Background

As with bundled discounting, no single-product loyalty discount antitrust case has yet reached the Supreme Court. The three appellate decisions addressing this practice emphasize the importance of factual evidence of an anticompetitive effect (rather than simply of an effect on a competitor) and the substantial judicial concern about deterring beneficial price cuts.

The earliest case, *Barry Wright Corp. v. ITT Grinnell Corp.*,<sup>142</sup> involved the market for snubbers, which are safety devices used in nuclear power plants. Pacific Scientific had most of the market for snubbers (over eighty percent).<sup>143</sup> Grinnell, which accounted for about half of snubber purchases, had been trying to help plaintiff Barry Wright become an alternative source of supply.<sup>144</sup> Pacific Scientific then offered Grinnell a large discount if it would agree to purchase large quantities of snubbers, and Grinnell agreed. The specified amounts constituted most, but not all, of Grinnell's anticipated purchases over a two-year period.<sup>145</sup> Barry Wright subsequently abandoned its attempt to enter the market and sued, alleging that the discount violated section 2.<sup>146</sup>

<sup>142</sup> 724 F.2d 227 (1st Cir. 1983) (Breyer, J.).

<sup>143</sup> *Id.* at 229.

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.* at 229–30.

Both the district court and the court of appeals rejected the claim. In the First Circuit opinion, then-Judge Breyer explained that, under conventional price-cost tests for predatory pricing, Pacific's discount was not predatory because the resulting price was above any relevant measure of Pacific's cost.<sup>147</sup> The theoretical possibility that such prices could harm competition did not justify the risk of deterring procompetitive price cutting by entertaining that possibility in litigation. As the court cautioned:

[U]nlike economics, law is an administrative system the effects of which depend upon the content of rules and precedents only as they are applied by judges and juries in courts and by lawyers advising their clients. Rules that seek to embody every economic complexity and qualification may well, through the vagaries of administration, prove counterproductive, undercutting the very economic ends they seek to serve. . . . [W]e must be concerned lest a rule . . . that authorizes a search for a particular type of undesirable pricing behavior end up by discouraging legitimate price competition.<sup>148</sup>

The court thus concluded "that the Sherman Act does not make unlawful prices that exceed both incremental and average costs."<sup>149</sup>

In *Concord Boat Corp. v. Brunswick Corp.*,<sup>150</sup> several boat builders challenged Brunswick's discount program on stern-drive engines. Brunswick manufactured and sold the engines for recreational boats and had a large market share (about seventy-five percent).<sup>151</sup> Brunswick (like its competitors) offered market-share discounts. Boat builders who agreed to buy a certain percentage of their engine requirements from Brunswick for a certain period received a

<sup>147</sup> *Id.* at 233.

<sup>148</sup> *Id.* at 234.

<sup>149</sup> *Id.* at 236. Even if price exceeding both incremental and average costs was not determinative, then-Judge Breyer noted that there was evidence that the discount enabled Pacific to operate more efficiently, because it led to a firm order that allowed Pacific to utilize its excess snubber capacity. *Id.*

<sup>150</sup> 207 F.3d 1039 (8th Cir. 2000).

<sup>151</sup> *Id.* at 1044.

discount off the list price for *all* engines purchased.<sup>152</sup> Because some of the boat builders' customers apparently preferred Brunswick engines, the boat builders arguably had to purchase a significant percentage of their engine needs from Brunswick; nevertheless, the discounts might well have led them to purchase higher quantities from Brunswick than they otherwise would have. There was, however, evidence that at least two customers who previously had purchased more than eighty percent of their engines from Brunswick switched to a competitor for more than seventy percent of their purchases.<sup>153</sup>

In concluding that plaintiffs had not offered sufficient evidence for a jury to determine that Brunswick's market-share discounts were anticompetitive, the Eighth Circuit emphasized that Brunswick's discounted prices were above cost.<sup>154</sup> The court also found that Brunswick's discounts were not exclusive-dealing agreements (buyers could purchase forty percent of requirements from other sellers while still receiving loyalty discounts from Brunswick) and other engine sellers could—and did—compete with Brunswick by offering better discounts.<sup>155</sup> While Brunswick offered testimony that the discounts served procompetitive purposes beyond simply lowering prices (for example, by increasing the predictability of demand and thus lowering manufacturing costs),<sup>156</sup> the court of appeals relied simply on "Brunswick's business justification . . . that it was trying to sell its product."<sup>157</sup>

*Virgin Atlantic Airways Ltd. v. British Airways PLC*<sup>158</sup> also involved an unsuccessful challenge to a first-dollar discount program. British

Airways (BA) offered incentive programs that provided travel agencies with commissions, and corporate customers with discounts, for meeting specified thresholds for sales of BA tickets. The discounts applied to all sales, not just those beyond the target threshold.<sup>159</sup> Virgin claimed that the result was below-cost pricing on certain transatlantic routes where it and BA competed.<sup>160</sup>

Both the district court and the court of appeals concluded that Virgin failed to show below-cost pricing.<sup>161</sup> Virgin's expert had assumed that the incentive agreements had generated additional flights to carry increased passenger load and compared the incremental costs of those flights with the revenues they generated.<sup>162</sup> The courts, however, were not sufficiently persuaded that the assumption reflected reality and concluded that "the issue of whether British Airways is selling below-cost tickets to the marginal passengers on the five routes at issue in this case is a fact-rooted question as to which Virgin has not submitted direct evidence."<sup>163</sup>

Although plaintiff lost each of these three appellate cases, private litigants continue to challenge single-product loyalty discounts. In *Masimo Corp. v. Tyco Health Care Group, L.P.*,<sup>164</sup> the district court sustained the jury's verdict that market-share discounts and sole-source arrangements violated the antitrust laws and ordered a new trial on damages.<sup>165</sup> Tyco had offered hospitals increased discounts on the purchase of pulse oximetry sensors in exchange for commitments to buy a greater percentage of their oximetry needs from Tyco. A typical offer involved 40 percent off all sensors if the hospital bought 90 percent or more of its

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<sup>152</sup> *Id.*

<sup>153</sup> *Id.* at 1059.

<sup>154</sup> See *id.* (Brunswick's above-cost prices left ample room for new competitors to enter the market and lure customers away with superior discounts); *id.* at 1062 (questioning the district court's rejection of Brunswick's contention that above-cost discounts are per se lawful).

<sup>155</sup> *Id.* at 1062–63.

<sup>156</sup> *Id.* at 1047.

<sup>157</sup> *Id.* at 1062.

<sup>158</sup> 69 F. Supp. 2d 571 (S.D.N.Y. 1999), *aff'd*, 257 F.3d 256 (2d Cir. 2001).

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<sup>159</sup> *Id.* at 574.

<sup>160</sup> *Id.* at 576.

<sup>161</sup> 257 F.3d at 269; 69 F. Supp. 2d at 580.

<sup>162</sup> 69 F. Supp. 2d at 575–77.

<sup>163</sup> *Id.* at 580.

<sup>164</sup> No. CV 02-4770 MRP, 2006 WL 1236666 (C.D. Cal. Mar. 22, 2006).

<sup>165</sup> *Id.* at \*\*11, 15. The court, however, vacated the jury's findings of liability based on bundled discounts and co-marketing arrangements. *Id.* at \*14.

requirements from Tyco, and a 16 to 18 percent discount if less than 90 percent.<sup>166</sup> Masimo argued that the possible loss of Tyco's maximum discounts on all of a hospital's sensor purchases functioned as a penalty, forcing hospitals to deal exclusively with Tyco.<sup>167</sup> The court held that the jury reasonably could have concluded that the market-share discounts "were designed to and did maintain monopoly power" in violation of section 2<sup>168</sup> and constituted illegal exclusive dealing in violation of section 1 and section 3 of the Clayton Act.<sup>169</sup> The court did not analyze or discuss whether Tyco's prices were above any relevant measure of its costs.

In *J.B.D.L. Corp. v. Wyeth-Ayerst Laboratories, Inc.*,<sup>170</sup> another district court case, the court granted summary judgment for defendant Wyeth on section 1 and section 2 claims alleging exclusive dealing and anticompetitive loyalty rebates on Wyeth's sales of Premarin, a "conjugated estrogen" product and the largest selling product for estrogen replacement therapy.<sup>171</sup> The key allegation was that Wyeth's contracts with pharmacy benefit managers (PBMs) effectively foreclosed competition from Cenestin, a conjugated estrogen product the FDA approved in 1999 for short-term use.<sup>172</sup> Wyeth's contracts with PCS Health Services, a PBM, and with some other PBMs, placed Premarin in their Core Formulary and provided that all rebates paid under the contracts were contingent on Premarin's being listed as the Core Formulary's "exclusive

conjugated estrogen" (the sole CE clause).<sup>173</sup>

Conceding monopoly power for purposes of its summary judgment motion, Wyeth argued that its PBM contracts were not actionable under section 2 by direct-purchaser plaintiffs absent predatory pricing, and that its prices were not predatory in the "classic sense of below-cost pricing to squeeze out a competitor."<sup>174</sup> The court concluded that

absent explicit, controlling appellate authority that Wyeth's conduct in executing [the PBM] contracts, a practice that is widespread throughout the larger and unique pharmaceutical market in the U.S., runs afoul of the guiding principles of Section 2 liability, this Court believes that the approach adopted by the Eighth Circuit in *Concord Boat* is correct. Wyeth's pricing behavior "plus" – in this case the "plus" factor being the "sole CE" contract clause – did not violate Section 2 of the Sherman Act.<sup>175</sup>

In the absence of a Supreme Court decision in a single-product loyalty discount case, it is difficult to discern the precise legal standard that a particular court will apply. Nonetheless, most of the handful of lower court decisions analyzing these discounts have applied some type of price-cost test.

### C. Analysis

Compared to the voluminous legal and economic commentary analyzing bundled discounting (and other unilateral conduct, such as predatory pricing and tying), there has been relatively little commentary regarding single-product loyalty discounts. Those who have commented on this subject generally agree that these discounts are most often procompetitive: for example, a manufacturer may use these discounts to induce services from distributors or retailers<sup>176</sup> or "to compete

<sup>166</sup> *Id.* at \*\*4-5.

<sup>167</sup> *Id.*

<sup>168</sup> *Id.* at \*11.

<sup>169</sup> *Id.* at \*\*5-6 ("The jury was free to conclude that Tyco's Market Share Discounts, in practical effect, offered hospitals their best discount only if they dealt with Tyco exclusively. . . . Although the Market Share Discount agreements appear to have been terminable on short notice on their face, the jury could reasonably have concluded that in practice they were not.").

<sup>170</sup> Nos. 1:01-CV-704, 1:03-CV-781, 2005 WL 1396940 (S.D. Ohio June 13, 2005), *aff'd on other grounds*, 485 F.3d 880 (6th Cir. 2007).

<sup>171</sup> *Id.* at \*1.

<sup>172</sup> *Id.* at \*\*1-2.

<sup>173</sup> *Id.* at \*\*3-4.

<sup>174</sup> *Id.* at \*11.

<sup>175</sup> *Id.* at \*17. The court granted summary judgment for Wyeth on the section 1 exclusive-dealing claim, finding that plaintiffs could not establish the necessary substantial foreclosure of competition. *Id.* at \*\*10-11.

<sup>176</sup> *See Mills, supra* note 135, at 26.

for the most desirable customers.”<sup>177</sup> There is also agreement that, as with standard predatory pricing, these discounts can be anticompetitive where they bring the total price on all units sold to a customer below an appropriate measure of cost and there is the likelihood of recoupment.

**While commentators agree that single-product loyalty discounts are most often procompetitive, they also agree that these discounts can be anticompetitive where they bring the total price on all units sold below an appropriate measure of cost and there is a likelihood of recoupment.**

Some panelists and commentators have further posited that single-product loyalty discounts that are above cost when measured against all units sold to a customer can be anticompetitive where a monopolist’s customers “must carry a certain percentage of the leading firm’s products”<sup>178</sup> and the discount is structured so as to induce purchasers to buy all or nearly all needs beyond that uncontestable percentage from the monopolist.<sup>179</sup>

**Some panelists and commentators believe that single-product loyalty discounts, under certain circumstances, can be anticompetitive, even where the resulting price on all units sold is above an appropriate measure of cost.**

Commentators’ analyses of above-cost (on all units) single-product loyalty discounts depend on their view of the likelihood of these discounts harming competition and the feasibility of addressing that harm with an administrable test that does not chill desirable,

<sup>177</sup> Carlton, *supra* note 136, at 664.

<sup>178</sup> See Feb. 13 Hr’g Tr., *supra* note 52, at 106 (Stern); see also Nov. 29 Hr’g Tr., *supra* note 2, at 79 (Nalebuff) (describing *Concord Boat* as a case in which defendant “had a monopoly for some share of the market based on installed base”).

<sup>179</sup> See *supra* text accompanying notes 138–39.

procompetitive discounting. For example, based on concerns regarding administrability and chilling procompetitive conduct, Professor Hovenkamp would apply “antitrust’s ordinary predatory pricing rule” to all single-product loyalty discounts, finding the discount “lawful if the price [on all units sold] after all discounts are taken into account exceeds the defendant’s marginal cost or average variable cost.”<sup>180</sup>

As discussed below, other commentators believe that the Hovenkamp test would result in an unacceptable level of false negatives in situations where rivals cannot compete with the monopolist for all or almost all sales. Some of these commentators have suggested that single-product loyalty discounts should perhaps be analyzed in the same manner as bundled discounts are analyzed in situations where bundle-to-bundle competition is not possible. For example, they suggest applying the total discount on all sales to the sales in the contestable portion of the market to determine if the discount falls outside the price-cost safe harbor and, if it does fall outside the safe harbor, determining if anticompetitive foreclosure effects result.<sup>181</sup> Others recommend an approach that would evaluate “market share discounts structured to produce total or partial exclusivity . . . according to the same economic principles that govern exclusive dealing.”<sup>182</sup>

### 1. Predatory-Pricing Analysis

Professor Hovenkamp would apply “antitrust’s ordinary predatory pricing rule” to all single-product loyalty discounts, comparing the price (after all discounts are taken into account) to the cost of all units sold to a customer.<sup>183</sup> While conceding that there may be

<sup>180</sup> AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b, at 245.

<sup>181</sup> See, e.g., Lande, *supra* note 140, at 878, 880 (suggesting that Professor Hovenkamp’s attribution test for bundled discounts “easily could be used to evaluate the discounts involving just the marginal, contested units for one product, a virtually identical situation,” but suggesting that a rule banning all “all-units” discounts would be a preferable way of handling single-product loyalty discounts).

<sup>182</sup> Tom et al., *supra* note 139, at 615.

<sup>183</sup> AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b, at

circumstances in which an above-cost (when measured against all units sold to a customer) loyalty discount might be anticompetitive as a result of denying rivals economies of scale,<sup>184</sup> courts and juries could not, in his view, apply such theories without creating an intolerable risk of chilling procompetitive behavior.<sup>185</sup> The principle that “[d]iscounting is presumptively procompetitive and should be condemned only in the presence of significant market power and proven anticompetitive effects”<sup>186</sup> guides Professor Hovenkamp’s analysis.<sup>187</sup>

A number of panelists supported Professor Hovenkamp’s approach, primarily based on concerns about administrability and risks of chilling desirable discounting behavior. Thus, one panelist, while not disputing that single-product loyalty discounts could theoretically have anticompetitive effects where they deny rivals the opportunity to achieve efficient scale, stated that sufficient information about economies of scale is “almost impossible” to come by. He supported Professor Hovenkamp’s approach, concluding:

I can’t think as a lawyer of a way to design a rule that doesn’t have a chilling effect if we are having to focus on what is minimum efficient scale and what amount of a discount is permissible before you usurp so much business that you prevent someone from achieving minimum efficient scale. I think that is too hard to administer.<sup>188</sup>

Other panelists also supported employing predatory-pricing rules in analyzing single-product loyalty discounts.<sup>189</sup> One

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<sup>184</sup> See *id.* ¶ 749b, at 248.

<sup>185</sup> See *id.* ¶ 749b, at 245, 248–50.

<sup>186</sup> *Id.* ¶ 749b, at 245.

<sup>187</sup> *Id.* ¶ 749b.

<sup>188</sup> Nov. 29 Hr’g Tr., *supra* note 2, at 99–100 (Lambert); see also *id.* at 60–65 (Kattan) (supporting Professor Hovenkamp’s approach and stressing the need for pricing rules that are administrable and enable firms to base pricing decisions on an objective measure).

<sup>189</sup> See, e.g., May 8 Hr’g Tr., *supra* note 52, at 81–82 (Rule) (stating that he is “not aware of any good case that’s ever been pointed to where a loyalty discount has really had an anticompetitive effect” and that applying

panelist stressed the need for discipline in litigation in supporting a predatory-pricing approach to single-product loyalty discounts,<sup>190</sup> concluding that “whatever the appropriate measure of cost is, if that cost is recouped on the overall sale to a client, then the discount that created the overall sale should be legal.”<sup>191</sup> Another panelist stressed the need for administrable tests that firms can apply on the basis of information that is available to them. In particular, responding to panelists who expressed concern about loyalty discounts in situations in which a large percentage of each buyer’s needs is met by the monopolist and effectively not contestable, he suggested that it would be “incredibly complicated” to determine what portion of sales was not contestable (inframarginal) and what portion was contestable (marginal).<sup>192</sup>

However, some panelists were critical of the predatory-pricing approach. As described below, a number of panelists and commentators expressed concern that this approach would fail to identify instances of anticompetitive foreclosure.

In addition, one critic of the predatory-pricing approach suggests that Professor Hovenkamp’s conclusions rest on plausible but unproven assumptions about the relative importance of procompetitive and anticompetitive effects of single-product loyalty discounts.<sup>193</sup> For example, he asks whether the assertion that most discounting practices are procompetitive is “still true when these discounts are given by monopolists, by monopolists for the first time facing the prospect of significant new entry, or by would-be monopolists that are targeting rivals?

a *Brooke Group* test will dispose of virtually all cases); Feb. 13 Hr’g Tr., *supra* note 52, at 156–57 (Sewell) (Hovenkamp approach is “a clear and sensible rule”); Sherman Act Section 2 Joint Hearing: International Issues Hr’g Tr. 116, Sept. 12, 2006 (Bloom) (suggesting using price above average avoidable cost as a safe harbor).

<sup>190</sup> Nov. 29 Hr’g Tr., *supra* note 2, at 196 (Crane).

<sup>191</sup> *Id.* at 198.

<sup>192</sup> *Id.* at 83 (Kattan).

<sup>193</sup> Lande, *supra* note 140, at 863–64.

Where is the empirical evidence that discounts in these situations usually are procompetitive?"<sup>194</sup>

That commentator also suggests that single-product loyalty discounts can be "sham discounts" and discusses a hypothetical in which a monopolist faced with new entry essentially threatens customers with a higher price unless they meet the threshold needed to obtain a "discount" that merely allows them to continue paying what they have been.<sup>195</sup> He concludes that it is premature to devise and adopt a comprehensive test that antitrust analysis could be saddled with for decades; these discounts "should, for now, be evaluated under the rule of reason."<sup>196</sup> The most that he believes should be considered at this point are a few "modest presumptions of legality or illegality."<sup>197</sup>

## 2. Foreclosure Analysis

A number of panelists and commentators expressed concern that using a predatory-pricing test to analyze single-product loyalty discounts would fail to identify certain instances in which these discounts might result in harmful foreclosure. They have suggested that single-product loyalty discounts can be anticompetitive where customers must buy a certain percentage of their needs from the monopolist and the discount is structured so as to induce them to buy all or nearly all needs beyond that uncontestable percentage from the monopolist as well.<sup>198</sup> Accordingly, some panelists suggested treating a situation in which rivals can "essentially compete to supply the entire demand of the customer or the entire demand in the marketplace" differently than a situation in which "the customer must carry a certain percentage of the leading firm's products."<sup>199</sup>

**Some panelists and commentators have suggested that single-product loyalty discounts can be anticompetitive where customers must buy a certain percentage of their needs from the monopolist and the discount is structured so as to induce them to buy all or nearly all needs beyond that uncontestable percentage from the monopolist as well.**

In accordance with this approach, some panelists viewed single-product loyalty discounts as more analogous to bundled discounts, where bundle-to-bundle competition is not possible, than to predatory pricing.<sup>200</sup> In particular, one panelist suggested that focusing on whether the overall price for all units exceeded an appropriate measure of cost was inconsistent with a test for bundled discounts that would attribute the entire discount across multiple products to the competitive product. He suggested that it might be more appropriate to look at the sales "that were induced by the loyalty program and look at the revenues from those . . . sales" and compare them to the cost of the program, rather than to "apply a Brooke Group test that says you take all of the sales, all of the revenues and compare it to all of the costs for all of the sales."<sup>201</sup>

Another panelist suggested that an overall

<sup>200</sup> See Nov. 29 Hr'g Tr., *supra* note 2, at 195 (Ordovery) (resisting distinguishing single-product discounts from bundled discounts because "[i]f you believe in the competitive equilibrium model, every good is a single different thing"); *id.* at 197 (Tom) ("[I]t can be very difficult to distinguish single product from multiproduct situations as a theoretical matter."); see also Lande, *supra* note 140, at 878 (arguing that Professor Hovenkamp's attribution test for bundled discounts "easily could be used to evaluate the discounts involving just the marginal, contested units for one product, a virtually identical situation").

<sup>201</sup> Nov. 29 Hr'g Tr., *supra* note 2, at 199 (Tom); see *id.* at 197 (suggesting that a Brooke Group test would be warranted only if based on conclusions regarding "administrability and cost of false positives and false negatives . . . because there are certainly plenty of possibility proofs that show that you can have anticompetitive effects in this situation even with overall price exceeding overall cost").

<sup>194</sup> *Id.* at 865.

<sup>195</sup> See *id.* at 870-74.

<sup>196</sup> *Id.* at 882-83.

<sup>197</sup> *Id.* at 876.

<sup>198</sup> See *supra* text accompanying notes 138-39.

<sup>199</sup> Feb. 13 Hr'g Tr., *supra* note 52, at 106 (Stern); see also Nov. 29 Hr'g Tr., *supra* note 2, at 79-80 (Nalebuff).

price for all units exceeding cost should not necessarily be conclusive of legality, but should result in a “burden-shifting exercise” whereby a plaintiff could attempt to show “discontinuities or jumps in the loyalty schedule and [that] they have potentially serious competitive effects.”<sup>202</sup> He suggested that a ban on negative marginal pricing—instances in which the buyer pays less overall when its purchases include the additional increment—would be preferable to a ban on pricing below cost, because it would be relatively easy to implement, though it would not detect all exclusionary pricing.<sup>203</sup>

Other panelists and commentators suggested that “loyalty discounts can be an issue under Section 2 if they’re really equivalent to exclusive dealing.”<sup>204</sup> These commentators argue that “market-share discounts structured to produce total or partial exclusivity should be judged according to the same economic principles that govern exclusive dealing” and should be condemned under existing case law “if they produce anticompetitive effects without counterbalancing procompetitive effects.”<sup>205</sup> They view the relevant issue as being “the structure and effects of the price scheme” and thus contend that “complex pricing structures, designed to create incentives toward exclusive dealing, are not per se legal merely because each element in the structure is above the seller’s cost.”<sup>206</sup>

A statement in the Department’s 1994 Competitive Impact Statement in the *Microsoft* licensing case reflected similar concerns:

While the Department recognizes that

<sup>202</sup> *Id.* at 194 (Ordovery).

<sup>203</sup> See Ordovery & Shaffer, *supra* note 3, at 20.

<sup>204</sup> Feb. 13 Hr’g Tr., *supra* note 52, at 105 (Sheller) (distinguishing discounts conditioned on buying one-hundred percent of needs from those conditioned on sixty to seventy percent); see also *id.* at 201 (Wark) (suggesting that loyalty discounts should be analyzed in a predatory-pricing context unless “you can equate the loyalty program with making it exclusive, then maybe you have to analyze it in an exclusive dealing context”).

<sup>205</sup> Tom et al., *supra* note 139, at 615.

<sup>206</sup> *Id.* at 636–37.

volume discount pricing can be and normally is pro-competitive, volume discounts also can be structured by a seller with monopoly power (such as Microsoft) in such a way that buyers, who must purchase some substantial quantity from the monopolist, effectively are coerced by the *structure* of the discount schedule (as opposed to the level of the price) to buy all or substantially all of the supplies they need from the monopolist. Where such a result occurs, the Department believes that the volume discount structure would unlawfully foreclose competing suppliers from the marketplace—in this case, competing operating systems—and thus may be challenged.<sup>207</sup>

Similarly, a number of panelists expressed concern about the potential use of single-product loyalty discounts to deny a monopolist’s rivals the scale necessary to enter or remain in a market.<sup>208</sup> One panelist stated that “it is a question about whether or not in a particular case they can be used to keep rivals from gaining efficient scale” and queried whether “there are markets in which achieving sufficient scale is critical and the purpose of the loyalty discount is really to foreclose that.”<sup>209</sup> Another panelist suggested there could be problems with these discounts because it may not always be realistic for a rival to replace one hundred percent of the monopolist’s sales to a customer, and in such circumstances the discounts may prevent a rival from achieving a reasonable scale.<sup>210</sup> Some conclude that a rule

<sup>207</sup> Competitive Impact Statement at 18, United States v. Microsoft Corp., 56 F.3d 1448 (D.C. Cir. 1995) (Nos. 95-5037, 95-5039), available at <http://www.usdoj.gov/atr/cases/f0000/0045.pdf> (noting that, while the Department considered relief limiting the manner in which Microsoft could structure discounts, it would not require such relief because it did not have evidence that Microsoft had in fact structured volume discounts to achieve anticompetitive ends) (emphasis in original).

<sup>208</sup> See May 8 Hr’g Tr., *supra* note 52, at 82–83 (Creighton); Nov. 29 Hr’g Tr., *supra* note 2, at 79–84 (Nalebuff); *id.* at 99–100 (Lambert); *id.* at 194–96 (Ordovery); *id.* at 196–97 (Tom).

<sup>209</sup> May 8 Hr’g Tr., *supra* note 52, at 82–83 (Creighton).

<sup>210</sup> See Nov. 29 Hr’g Tr., *supra* note 2, at 79–80

of reason assessment might condemn discounts that effectively lock up such a large portion of available business that competitors cannot achieve substantial scale economies that significantly reduce their marginal costs or have sales volumes sufficient to make investments in quality improvements possible.<sup>211</sup>

Professor Carlton has acknowledged that non-linear pricing could achieve the same ends as exclusive dealing but has suggested that antitrust intervention “should be used rarely and apply only to extreme pricing conditions.”<sup>212</sup> He observed that volume discounts and special deals for big buyers are ubiquitous, and that “[a]ttacking such common competitive behavior would likely create much turmoil and chill competition.”<sup>213</sup> While not suggesting a specific test to apply to conduct that induces partial or total exclusivity, Professor Carlton cautioned: “If antitrust does pursue contracts that create de facto exclusivity, it would be wise to limit attention to those contracts with extreme pricing terms like those of the Microsoft [1995 consent decree] type, where it is unambiguous that incremental price is below marginal cost for many buyers.”<sup>214</sup>

Similarly, while recognizing that in extreme cases single-product discount schemes might bear some resemblance to exclusive dealing, Professor Hovenkamp stressed two important differences. First, such discounts will be less exclusionary than exclusive-dealing contracts where a buyer is able to earn the discount

without purchasing everything from the seller. Second, unlike exclusive-dealing arrangements, there is no contract, dealership, or franchise involved in most loyalty-discount programs, so the penalty for not meeting the percentage or quantity threshold is simply the loss of the discount and not a breach of contract suit or termination of a franchise.<sup>215</sup> Moreover, because the buyer is not facing loss of its dealership or franchise, “an equally efficient rival should be able to steal the sale as long as the fully discounted price is above cost.”<sup>216</sup>

Professor Hovenkamp also suggests that one of the problems with the theory that single-product loyalty discounts might deprive rivals of efficient scale is that the seller could, instead of offering a structured discount, simply offer the lower price on all purchases, and that this would take even more sales away from rivals.<sup>217</sup> However, it is not clear that simply offering the lower price on all units would necessarily take more sales away from rivals, particularly if buyers were committed to the monopoly seller for some level of purchases.<sup>218</sup>

<sup>215</sup> AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b1, at 247–48.

<sup>216</sup> Herbert Hovenkamp, *The Law of Exclusionary Pricing*, COMPETITION POL’Y INT’L, Spring 2006, at 21, 28; see also May 8 Hr’g Tr., *supra* note 52, at 80 (Pitofsky) (suggesting that loyalty discounts present less of a problem than exclusive dealing because they tend to be only partially exclusive and therefore exclude less, and the customer can switch at any time, losing only its discount).

<sup>217</sup> AREEDA & HOVENKAMP, *supra* note 7, ¶ 749b1, at 249.

<sup>218</sup> For example, assume a customer who is a retailer expects to sell 100 widgets, believes that it must carry 80 of the monopolist’s widgets, and is currently paying \$10 per widget. A new entrant appears, offering widgets to the customer for \$7. On these assumptions, if the monopolist keeps the price at \$10 but offers to charge \$8 per widget if the customer buys 100, the customer will choose to buy all 100 widgets from the monopolist – since it must buy 80 and will pay the same total (\$800) whether it buys 80 or 100, it is essentially getting the last 20 widgets free. If the monopolist instead had simply lowered the price to \$8, the customer would have continued to purchase 80 widgets from the monopolist and bought 20 from the new entrant.

(Nalebuff).

<sup>211</sup> See Tom et al., *supra* note 139, at 622–23.

<sup>212</sup> Carlton, *supra* note 136, at 664.

<sup>213</sup> *Id.*

<sup>214</sup> *Id.* at 665 (footnote omitted). The 1995 Microsoft consent decree forbade Microsoft from using “per processor” contracts, under which an Original Equipment Manufacturer (OEM) paid Microsoft a royalty based on the total number of computers it sold, regardless of the number of such computers containing Microsoft operating systems. The Department’s Competitive Impact Statement stated: “In effect, the royalty payment to Microsoft when no Microsoft product is being used acts as a penalty, or tax, on the OEM’s use of a competing PC operating system.” Competitive Impact Statement, *supra* note 207, at 5.

One panelist asserted that it would be difficult in any given case to determine what constitutes “efficient scale” and that any rule addressing this potential problem would be too difficult to administer.<sup>219</sup> Another panelist contended that it would be “incredibly complicated” to determine in specific cases what part of the market, if any, is uncontested.<sup>220</sup> However, another panelist suggested that it may be possible to “calculate which units have negative prices associated with them” (so that the buyer pays less overall when its purchases include the additional increment needed to obtain the discount) and “what level of entry you would need to achieve if you were a new entrant and wanted to cover costs.”<sup>221</sup>

Some panelists suggested that, although single-product loyalty discounts theoretically can be structured to induce some degree of foreclosure, analysis of these discounts under section 2 should focus on their actual or likely competitive effects. For example, one panelist stated that although “[t]here are many instances in which, if you allocate the discount . . . to a handful of sales in order to make the discount look like it is below cost, you will be talking about a volume of sales too small to have an impact on competition.”<sup>222</sup> Accordingly, he suggested that by looking “at competitive effects, you often can allay the concerns about loyalty discounts.”<sup>223</sup> Another panelist suggested focusing on “the

exclusionary impact”<sup>224</sup> and expressed doubt as to whether there has ever been a loyalty-discount program found to have produced actual anticompetitive effects.<sup>225</sup> A written comment submitted for the hearings regarding single-product loyalty discounts also stressed focusing on competitive effects: “Inadequate attention to demonstrable competitive effects could create law that preserves inefficient competitors while sacrificing competition.”<sup>226</sup>

#### D. Conclusion

The Department believes that the standard predatory-pricing approach to single-product loyalty discounts has a number of advantages. Compared to other possible approaches described above, a predatory-pricing rule would be relatively easy for courts and enforcers to administer and would provide businesses with the clarity necessary to conform their conduct to the law using information available to them. Further, this approach has a relatively low risk of chilling desirable, procompetitive price competition that immediately benefits consumers. The Department likely would apply a standard predatory-pricing test in analyzing most single-product loyalty discounts. However, in light of views from panelists and others suggesting that above-cost single-product loyalty discounts can be structured to have anticompetitive effects under certain circumstances, and the relatively limited case law and commentary on these types of discounts, the Department believes that further assessment of the real-world impact of these discounts is necessary before concluding that standard predatory-pricing analysis is appropriate in all cases.

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<sup>219</sup> Nov. 29 Hr’g Tr., *supra* note 2, at 99–100 (Lambert).

<sup>220</sup> *Id.* at 83 (Kattan).

<sup>221</sup> *Id.* at 84 (Sibley). One panelist whose company is plaintiff in ongoing litigation argued more broadly that “a retrospective discount or rebate . . . is usually, when deployed by a monopolist, not a rebate or discount at all. It’s a price coupled with the threat of a price increase.” Sherman Act Section 2 Joint Hearing: Business Testimony Hr’g Tr. 176–77, Jan. 30, 2007 (McCoy). However, another panelist whose company is defendant in that litigation argued that “really the way to look at loyalty discounts is these are incentives to buy. These are not punishments for failure to buy.” Feb. 13 Hr’g Tr., *supra* note 52, at 201 (Sewell).

<sup>222</sup> May 8 Hr’g Tr., *supra* note 52, at 83 (Melamed).

<sup>223</sup> *Id.* at 83–84.

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<sup>224</sup> *Id.* at 81–82 (Rule).

<sup>225</sup> *Id.* at 82.

<sup>226</sup> International Chamber of Commerce, Single-Firm Conduct as Related to Competition 3 (Jan. 11, 2006) (hearing submission).

**The Department believes that the standard predatory-pricing approach to single-product loyalty discounts has a number of advantages, including its administrability, clarity, and reduced risk of chilling procompetitive price competition. The Department likely would apply this approach in most cases, but thinks further assessment is necessary before concluding that it is appropriate in all cases.**

The Department believes that the competitive effects of any single-product loyalty-discount program should be evaluated carefully before it is condemned under section 2. Situations in which above-cost (on all units) single-product loyalty discounts result in significant foreclosure effects appear to be rare. Theoretical anticompetitive effects appear possible only where some significant portion of the market is uncontestable due to factors external to the parties, most likely end-user demand. The Department believes that an approach requiring courts to determine whether a portion of a market is uncontestable and to quantify that portion, as well as to analyze whether a discount deprived plaintiff of efficient scale, would be difficult to administer. More importantly, such an approach would not provide much clarity to firms deciding whether to offer discounts and likely would chill desirable price competition.

The Department emphasizes that, in any situation in which a foreclosure-based approach is used, plaintiff should be required to demonstrate that the discount forecloses a significant amount of the market and harms competition. Further, as with bundled discounting, plaintiff's (and any other rivals') ability to remain in the market should be a significant factor in assessing competitive harm. When harm to competition is implausible, courts should uphold the discount. Also, as with bundled discounting, where plaintiff demonstrates actual or probable harm to competition, a single-product loyalty discount should be illegal only when (1) it has no procompetitive benefits, or (2) if there are procompetitive

benefits, the discount produces harms substantially disproportionate to those benefits. The Department does not believe that a trivial benefit should outweigh substantial anticompetitive effects.

**The Department emphasizes that, in any situation in which a foreclosure-based approach is used, plaintiff should be required to demonstrate that the discount forecloses a significant amount of the market and harms competition.**