

Loyalty Discounts and Bundled Pricing— Lawful Incentives or Exclusionary Conduct?



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Our Program

- Overview of U.S. law
- Key issues in litigation
- Open policy questions
- Discussion

Law Governing Loyalty Discounts and Bundled Pricing—Introduction

- Topic addresses various forms of financial incentives designed to encourage customer loyalty
- Most discounts and rebates are legal and even encouraged by the antitrust laws
- Almost all of the potential problems arise when the company offering the discount or rebate has market/monopoly power in one or more of the affected product markets
- Focus on federal law
- Price discrimination issues

Loyalty Discounts—Legal Framework

- Focus is on Section 2 of the Sherman Act [15 U.S.C. § 2] (monopolization and attempted monopolization)
- Also possible claims under Section 1 of the Sherman Act [15 U.S.C. § 1] (unreasonable restraints of trade) and Section 3 of the Clayton Act [15 U.S.C. § 14] (exclusive dealing/pricing conditioned upon exclusivity)

Loyalty Discounts—Legal Framework

- **No clear rules**
- **Tension between two legal standards:**
 - Predatory pricing (*Brooke Group*)
 - Below cost (price-cost test)
 - Recoupment
 - Principal concern: avoiding “false positives”
 - Difficult standard for plaintiffs
 - Exclusive dealing/exclusionary agreements (*Tampa Electric, Microsoft, Dentsply*)
 - Substantial foreclosure
 - More fluid analysis of effects
- **Structure of the loyalty program can affect which body of law will apply**

Loyalty Discounts—Applicable Law

- **Discounts conditioned on exclusivity**
 - Treated as the legal equivalent of actual exclusive dealing agreements
 - See the language of Clayton Act Section 3
- **Volume discounts**
 - Legal if above cost (*Brooke Group*)
 - Not aware of any case finding liability for volume discounts that did not have another condition attached (e.g., a market share requirement)
 - But recent focus on “first dollar” discounts and “contestable share” analysis

Loyalty Discounts—Applicable Law

- **Market share discounts**

- Obligate the customer to buy a certain percentage of its total needs from the seller to receive a discount or rebate (e.g., 20% discount for buying 90% or more from seller)
- Highlight the tension between relatively permissive pricing rules and rules applicable to exclusionary agreements/exclusive dealing

Loyalty Discounts—Applicable Law

- ***Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000)**
 - 1% discount for 60% of purchases; 2% for 70%; 3% for 80%
 - No long term market share commitment
 - Court disagreed with defendant that market share discounts were per se legal if above cost
 - Applied substantial foreclosure analysis
 - Concluded that discounts did not have the same practical effect as exclusive dealing
 - Pricing not coercive; no “golden handcuffs”
 - Customers switched between Brunswick and competitors depending on price and quality
 - Therefore legal because above cost
 - Decision does not necessarily stand for the proposition that above-cost market share discounts are legal

Loyalty Discounts—Applicable Law

- ***Masimo Corp. v. Tyco Health Care Group*, 350 F. App'x 95 (9th Cir. 2009)**
 - 9th Circuit upheld judgment in Masimo's favor finding market share agreements violated Sherman Act Sections 1 and 2 and Clayton Act Section 3
 - Unpublished opinion; very little analysis
 - Market share discounts operated in conjunction with sole source agreements
 - 40% off list for 90% market share commitment
 - Installed base issue
- **No liability for market share discounts on similar facts in *Allied Orthopedic Appliances v. Tyco Health Care Group*, 592 F.3d 991 (9th Cir. 2010)**
 - But the court did apply substantial foreclosure analysis rather than assume discounts legal because above cost

Loyalty Discounts—Applicable Law

- **Where do we stand on market share discounts?**
 - Lack of clear guidance in case law
 - No clear government guidelines or policies
 - Withdrawn DOJ Section 2 report agreed that above-cost discounts could be exclusionary, but came down in favor of applying *Brooke Group* pending further study of how likely it is that market share discounts harm consumers
 - FTC action against Intel under Section 5 of the FTC Act
 - Modified price-cost test for market share discounts?
 - Contestable share analysis; similar to 9th Circuit test for bundled pricing
 - European Commission Article 102 guidelines adopted in 2009; decision against Intel
 - Concept is that the discounts can exclude competitors who cannot practically replace all of the larger firm's sales to a given customer (e.g., due to capacity constraints or brand preferences)
 - Perspective depends on whether you see market share discounts as presumptively procompetitive price reductions or as exclusionary on their face

Bundled Discounts

- **Any form of loyalty discount that covers more than one product line**
- **Could be structured as a pure price offer or incorporate a volume or market share requirement**
 - E.g., Buyer gets a 5% discount on all products if it buys 90% of its needs on 3 different product lines from the defendant
- **Bundled discounts are different from single product discounts because they can exclude equally efficient sellers solely because they do not sell the same range of products**

Bundled Discounts—Illustration

- Firm A makes shampoo and conditioner; monopoly power in shampoo; consumers need both products
- Firm B makes shampoo only, equally efficient
- Costs: shampoo \$12 (A & B); conditioner \$7 (A)
- Firm A sells shampoo alone for \$15 and conditioner for \$10, but offers bundled price for both of \$20—above combined cost
- To compete with the bundled discount, Firm B would need to sell its shampoo for \$10—below its costs

Bundled Discounts—Applicable Law

- ***SmithKline v. Eli Lilly*, 575 F.2d 1056 (3d Cir. 1978)**
 - Discount on bundle of 3 antibiotics, 2 of which were sold only by Lilly
 - Liability without price-cost analysis
- ***Ortho Diagnostic Systems v. Abbott Labs.*, 920 F. Supp. 455 (S.D.N.Y. 1996)**
 - Attribution analysis, plaintiff must be equally efficient
 - Summary judgment for defendant because plaintiff could match discount and still make a profit

Bundled Discounts—Applicable Law

- ***LePage's v. 3M*, 324 F.3d 141 (3d Cir. 2003)**
 - Concerned competition in the transparent tape market. 3M offered large retailers bundled discounts covering multiple product lines.
 - Jury instruction: 3M liable if its conduct “had the effect of preventing or excluding competition” or “impaired the opportunities of rivals” (taken from *Aspen Skiing*)
 - No attempt to prove below-cost pricing on any basis; LePage’s concededly less efficient
 - Original panel reversed the judgment below
 - En banc court disagreed and affirmed liability under Section 2

Bundled Discounts—Applicable Law

- **LePage’s en banc opinion**
 - *Brooke Group* inapplicable because 3M was a conceded monopolist
 - 3M violated Section 2 by harming the only other competitor in the market
 - Not clear exactly which conduct violated the law
 - Suggested that LePage’s could not match the discounts, although that was never tested objectively
- **Cert. petition denied**
 - SG said the issues needed to be analyzed further before being addressed by the Court
 - But the decision “provided few useful landmarks on how Section 2 should apply as a general matter in future cases” and “failed to explain . . . what precisely rendered 3M’s conduct unlawful”
- **Some district court decisions in other circuits critical of LePage’s; others followed the Third Circuit**

Bundled Discounts—Applicable Law

- **Antitrust Modernization Commission Report (2007)**
 - Criticized *LePage's*
 - Proposed discount attribution test:
 - Allocate all discounts to the competitive product(s) and then determine if the defendant sold below its costs
 - Recoupment
 - Likely to have an adverse effect on competition
 - Attribution test functions as a safe harbor

Bundled Discounts—Applicable Law

- ***Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883 (9th Cir. 2008)**
 - McKenzie hospital offered only general acute care; PeaceHealth, a much larger hospital, also offered specialized tertiary care
 - PeaceHealth offered insurers discounts on tertiary care if they agreed to use it exclusively for primary care
 - Section 2 verdict for plaintiff following instruction modeled on *LePage's*
 - On appeal, amici took three different positions: (1) pure *Brooke Group* rule; (2) attribution test; (3) rule of reason

Bundled Discounts—Applicable Law

- **The Ninth Circuit chose the middle approach:**
 - Rejected *LePage's* and held that Supreme Court precedents required a price-cost test
 - But simple *Brooke Group* test wouldn't address the unique aspects of bundled pricing
 - Test:
 - Full amount of discounts allocated to price of competitive product. Discount can provide the basis for liability if adjusted price is below defendant's costs (using average variable costs)
 - No showing of recoupment required
 - No separate requirement of showing harm to competition, although the court appeared to assume that pricing not falling within the safe harbor would be analyzed under the rule of reason

Bundled Pricing—Applicable Law

- **Attribution analysis now viewed as mainstream, but the law is unsettled**
 - *LePage's* remains good law in the Third Circuit
 - Commentators from both sides criticize the attribution analysis
 - Attribution analysis has many problems in application
- **Lack of clarity about how bundled pricing relates to tying law**
 - *PeaceHealth* did not decide whether a plaintiff can show coercion for purposes of a tying claim by showing that the discounts “failed” the price-cost attribution test

Bundled Pricing—Applicable Law

- **Uncertainty about whether the attribution test should be applied mechanically or adjusted according to the facts**
 - *Meijer v. Abbott Labs.*, 544 F. Supp. 2d 995 (N.D. Cal. 2008)
 - EU guidelines: long run average incremental cost (includes product specific fixed costs)
 - Result is different for each customer depending on the mix of products they buy
 - Result also varies for each potential plaintiff depending on the products they make

Litigation Considerations—Market Share Discounts

- **Defendants**

- Argue predatory pricing standard (*Brooke Group*)
 - Apply discounts across all sales; price > cost?
 - Discounts ≠ exclusivity
 - Remedies for breach ≠; discounts optional; <100% ≠ exclusive
 - Predation standard applies to all pricing claims
 - Discounts pro-competitive
 - Lower price; volume assurance to supplier (esp. high fixed, low marginal costs); fairness to smaller customers

Litigation Considerations—Market Share Discounts

- **Plaintiffs**

- Argue for rule of reason/foreclosure analysis
 - Like exclusive dealing analysis (*Tampa Electric, Microsoft, Dentsply*)
 - Is foreclosure substantial / competitively significant?
 - 1 approach: (Δ 's market share) x loyalty % = foreclosure
 - > 30%-40%? > 50%-60%?
 - 100% not required; actionable level for monopolist may be lower
- Price/cost screen can yield false negatives (e.g., monopolist raises prices, then offers M.S. “discount”)

Litigation Considerations—Market Share Discounts

- **Is there a middle ground?**
 - EU: contestable / uncontestable market segments
 - Apply whole discount to contestable share, determine if price > cost
 - Problems: is there an uncontestable share, and how to determine its size?
 - Technological, customer preference, contractual term lock-ins?

Litigation Considerations—Market Share Discounts

- **Cost metrics**

- Marginal cost (“MC”)
- Average Variable Cost (“AVC”)
- Average Avoidable Cost (“AAC”)
- Long Run Average Incremental Cost (“LRAIC”)

Litigation Considerations—Bundled Pricing

- **Defendants**

- Ninth Circuit: *PeaceHealth* attribution standard. Issues incl.: (i) competitors selling different bundles, (ii) customers buying different bundles
- Third Circuit: Δ may be saddled with foreclosure analysis
- Outside Ninth, Third Circuits: may argue for *Brooke Group*-type standard (bundled price > AVC?)

Litigation Considerations—Bundled Pricing

- **Plaintiffs**

- Third Circuit very attractive if jurisdiction/venue (rule of reason/foreclosure analysis) Open q. outside Ninth Circuit
- How to prove foreclosure?
 - Price/cost test – a possibility
 - Exclusive dealing-type analysis – foreclosure of rivals
 - #/% customers who take the discounted bundle, % customer demand remaining
 - Tying claim? (per se rule) – unclear application
 - Separate products, Δ market power (tying product), coercion

Open Issues

- **Relationship between exclusive dealing law and loyalty discounts**
 - How to distinguish between price competition and agreements subject to substantial foreclosure analysis?
 - Does contractual commitment matter?
- **Relationship between tying law and bundled discounts**
- **Use of contestable share analysis for single product loyalty discounts**
- **Measure of costs for *PeaceHealth* attribution analysis**
- **Does attribution analysis offer more predictability than rule of reason analysis based on effects in the market?**
- **Concern about false positives**
- **Section 5 of the FTC Act**