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Focus

Monopoly Money

By Carlton A. Varner

Bundled discounts, the practice of selling multiple products for a single price, are ubiquitous in America, ranging from Happy Meals at your local McDonald's to a single price for telephone, Internet and television service from your local cable or satellite provider.

Courts have struggled to develop an analytical model to determine when bundled discounts violate antitrust laws. They do not fit the tying paradigm because there is no conditioning; that is, a buyer can purchase the products in the bundle separately, albeit at higher individual prices. Likewise, unless the discount causes the seller's prices to be below the seller's incremental cost, bundled discounts do not constitute predatory pricing.

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9th Circuit Answer

The 9th Circuit addressed and resolved these issues in *Cascade Health Solutions v. Peace Health,* 2007 DJDAR 13732 (9th Cir. Sept. 4, 2007). It held that only when the discount at issue results in a price below the seller's incremental cost for the competitive product at issue do bundled discounts or rebates constitute exclusionary conduct under Section 2 of the Sherman Act.

In doing so, the 9th Circuit "declined to follow" a recent decision of the 3rd Circuit, *Le Page's Inc. v. 3M, 324 F.3d 141* (3rd Cir. 2003), which banned such discounts when offered by a monopolist, without regard to whether such discounts were below the seller's costs. This clear split in the circuits sets up the bundled-discount issue for resolution by the Supreme Court.

Cascade involved the pricing of hospital services in Lane County, Oregon. The defendant owned the largest hospital in the area and provided acute, secondary and tertiary care. The plaintiff owned a smaller hospital that provided only acute and secondary care. The defendant had 90 percent of the market for tertiary care, and 75 percent of the market for the other services.

The defendant offered insurers and preferred provider organizations in the area a 35 percent to 40 percent discount if they contracted exclusively with it for all three services. The defendant's offered discount was smaller if they also contracted with the plaintiff.

The plaintiff filed suit, and the court used the *Le Page's* rule to instruct the jury on the bundled-discount issue. The jury rejected the plaintiff's claims of monopolization, conspiracy to monopolize and exclusive dealing but awarded damages of $5.4 million each on attempted monopolization, price discrimination and tortious interference claims. The defendant's appeal centered on the conduct element of the attempt-to-monopolize claim, asserting that the District Court incorrectly instructed the jury about when bundled discounting can amount to anti-competitive conduct.

In a decision by Judge Ronald M. Gould, the 9th Circuit began by noting that bundled discounts are generally pro-competitive because buyers "get more for less" and sellers often achieve some cost savings. Here, however, where the plaintiff apparently showed it could provide primary and secondary care at a lower price than the defendant, bundling may have been anti-competitive, because it was used to exclude a less-diversified but more-efficient rival. The issue, according to the court, was how to draw the line between lawful and unlawful bundling in such cases.

'Le Page's' Lead

In *Le Page's*, the plaintiff was the market leader for private-label transparent tape. The defendant, 3M, had a monopoly on the manufacture of Scotch tape, manufactured some private-label tape and manufactured many other products, such as health care and automotive products. 3M's bundled-rebate structure offered progressively higher rebates when customers increased purchases across its multiple product lines. Le Page's could not match these discounts because it did not offer the same diverse product line. Thus, its market share and profitability declined. Le Page's filed suit, saying that the bundled-rebate program was an unlawful attempt by 3M to maintain its monopoly power over Scotch tape. The jury found in favor of Le Page's.

On appeal, 3M argued that its rebate structure was legal as a matter of law because it never priced below cost. 3M relied heavily on *Brooke Group v. Brown & Williamson*, 509 U.S. 209 (1993), which held that a predatory-pricing claim in a single-product case required below-cost pricing coupled with the likelihood of recoupment of its losses after the period of predation.

The 3rd Circuit rejected the analogy to *Brooke Group*, stating that it did not involve the bundling issue and should not apply to cases in which the defendant had monopoly power and thus could recoup its losses readily. Instead, it permitted the jury to find an antitrust violation when a bundled rebate is offered by a monopolist and thus forecloses portions of the market to a competitor that does not offer the full range of products.

Citing the recent report by the bipartisan Antitrust Modernization Commission, the court criticized the *Le Page's* rule as protecting a less-efficient competitor at the expense of consumer welfare.

The Supreme Court, according to the 9th Circuit, has emphasized repeatedly that antitrust law should protect competition, not

competitors. Absent the "clearest" showing that injury to the competitive process will result, courts should leave "unhampered" pricing practices that might benefit consumers. Because bundled discounts are price discounts, the 9th Circuit concluded that the exclusionary conduct of an attempt to monopolize claim is not satisfied unless the discount results in prices that are below an appropriate measure of cost.

Measuring Pricing

The court considered the various price/cost tests that could be used. The 9th Circuit rejected the defendant's suggested test - the discounted price of the entire bundle must be below the bundling firm's incremental cost to produce the entire bundle - as one that would allow discounts that harm competition to escape liability, because an equally efficient competitor could be excluded.

It also rejected a test from *Ortho Diagnostic Sys. Inc. v. Abbott Labs*, 920 F. Supp. 455 (S.D.N.Y. 1996). Under the Ortho test, an above-cost discount would be anti-competitive if the plaintiff proved that it was an equally efficient producer and was excluded only because the defendant sold in more product markets.

The downside to the *Ortho* test, however, is that it does not provide adequate guidance to sellers, because it looks to the costs of potential plaintiffs — to which a potential defendant considering a bundled discount would not have access. It also would, according to the 9th Circuit, require multiple suits to determine the legality of a single bundled discount.

The court adopted the "discount attribution" standard advocated by the Antitrust Modernization Commission. Under this approach, it wrote, "the full amount of the discounts given by the defendant on the bundle are allocated to the competitive product or products."

"If the resulting price of the competitive product or products is below the defendant's incremental cost to produce them, the trier of fact may find that the bundled discount is exclusionary for purposes of section 2," the court wrote.

This standard, said the court, makes the defendant's bundled discounts lawful unless the discounts have the potential to exclude a hypothetical equally efficient producer of the competitive product. The court concluded that the appropriate measure for incremental costs is average variable costs.

The court also addressed the plaintiff's price-discrimination and tortious-interference claims, as well as the plaintiff's appeal of the lower court's grant of summary judgment to the defendant on its tying claim under Section 1 of the Sherman Act. The price-discrimination claim was based on Oregon law patterned after the federal Robinson-Patman Act. Under *Brooke Group*, this federal price-discrimination law requires that in primary line cases (those between sellers), the plaintiff must show below-cost pricing and the likelihood of recoupment.

After finding that the Oregon Supreme Court likely would follow *Brooke Group*, the 9th Circuit vacated the jury verdict on the price-discrimination claim. It had the same defect as the attempt-to-monopolize claim: the failure of the jury instruction to address the below-cost issue. The verdict on the tortious interference, based as it was on antitrust violation, was also vacated.

In its tying claim, the plaintiff asserted that the tying product was the tertiary services and the tied products were the primary and secondary services. The lower court's grant of summary judgment was based on the absence of coercion, with the court finding that the defendant did not coerce the purchase of the tied products by offering a price discount.

The 9th Circuit rejected the plaintiff's assertion, based on *Heatransfer Corp. v. Volkswagenwork, A.G.*, 553 F.2d 964 (5th Cir. 1977), that, as a third party to the tying arrangements, it need not show coercion. It did, however, find a disputed factual issue regarding coercion, such that summary judgment was inappropriate.

Although higher prices to purchase the tied products separately do not, standing alone, create a fact issue on coercion, the fact that only a trivial portion — 14 percent — of the insurers purchased the services separately may indicate some degree of coercion. It also may indicate that the package discount is as effective as an outright refusal to sell the tying product — the tertiary services — separately. This fact, coupled with the market power of the defendant as the only provider of tertiary services in the relevant geographic area, was sufficient to create a factual issue for the 9th Circuit to vacate the summary judgment in favor of the defendant on the tying claim.

Although the Supreme Court denied certiorari in *Le Page's*, Cascade has created an environment in which the antitrust legality of bundled pricing likely will have to be addressed by the Supreme Court soon.

Carlton A. Varner is a partner of Sheppard Mullin Richter & Hampton in Los Angeles, where he specializes in antitrust counseling and litigation, as well as complex business litigation.