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Bundled Pricing and Loyalty Discounts: Navigating the Confusing Antitrust Standards

Avoiding Anticompetitive Conduct When Implementing Marketing and Pricing Strategies

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Today's faculty features:

James J. Long, Shareholder, **Briggs & Morgan**, Minneapolis

Michael B. Miller, Partner, **Morrison & Foerster**, New York

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BUNDLED PRICING AND LOYALTY DISCOUNTS: NAVIGATING THE CONFUSING ANTITRUST STANDARDS

June 24, 2014

James J. Long
JLong@Briggs.com

Michael B. Miller
MBMiller@mofo.com

Defining Bundled Discounts and Examining *LePage's v. 3M*

Jim Long

June 24, 2014

Bundled Discounts Defined

Discounts across 2 or more relevant product markets

Rebates are provided to an account across product lines based upon qualifying purchases (a percentage of requirements, volume or growth) in multiple groups of different products.

Contrast With Loyalty Discounts

Defined:

Discounts tied to purchase of percentage of buyer's requirements of one product.

Bundled Discount Example:

M sells products in 3 relevant markets: A, B, C

OFFER: If purchaser buys 90% of its requirements in all three markets, M will provide a 10% rebate on all of P's purchases

So if P purchases $200,000 of A, $200,000 of B, and $200,000 of C (90% of its requirements for each product), then it will receive a rebate of $60,000 (10% of $600,000)

Primary Statutory Liability

- Section 2 of The Sherman Act:

  Monopolization

  * existence of monopoly

  * acquisition or maintenance of monopoly through exclusionary conduct

  Attempt to Monopolize

  * specific intent

  * predatory conduct

  * dangerous probability of monopolization

  Issue is under what circumstances can bundling be considered exclusionary or predatory conduct?

Other Statutory Liability

- Section 1 of The Sherman Act
- Section 3 of the Clayton Act
- Section 5 of the FTC Act

Related Theories But Not Bundled Discounts

- Predatory Pricing: Sale of one product below cost with a dangerous probability of recoupment

  Brooke Group v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993)

- Tying: The agreement to sell one product ("tying" product) on condition buyer purchase second product ("tied" product)
- Loyalty Discounts: Increased discounts on one product conditioned on customer purchasing a certain quantity or percent of requirements
- Exclusive Dealing: Require buyer to purchase exclusively (or predominantly) from supplier.

LePage's v. 3M, 324 F.3d 141 (3d Cir. 2003) *cert. denied*, 542 U.S. 953 (2004)

3M offered rebates conditioned on customers (such as Staples) purchasing their requirements in six diverse product lines:

Home Care
Home Improvement
Health Care
Stationery (including transparent tape)
Retail Auto
Leisure Time

Multi-tiered rebate structure: higher rebates when customers purchased products in a number of product lines.

3M's Defense: It never priced its transparent tape below cost.

"above-cost pricing cannot give rise to an antitrust offense as a matter of law, since it is the very conduct that the antitrust laws wish to promote …" 3M Appellate Brief at 30 citing *Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

Third Circuit rejects this argument:

- Does not read *Brooke Group* to apply to Section 2 exclusionary conduct other than predatory pricing.
- "Nothing in any of the Supreme Court's opinions in the decade since the *Brooke Group* decision suggested that the opinion overturned decades of Supreme Court precedent that evaluated a monopolist's liability under Section 2 by examining its exclusionary, i.e., predatory conduct." 324 F.3d at 153.

Key Facts

- Transparent Tape – 3M admitted monopolist with over 90% share
- Plaintiff LePage's only real competitor in transparent tape – entered market and got large share of private label tape
- 3M then offered bundled rebates
- LePage's did not compete in other markets – arguably did not have ability to bundle
- Huge "Penalty" for Purchasing LePage's tape: $264,000 Sam's Club, $450,000 Kmart, $310,000 American Stores

Key To Opinion Is Foreclosure to Market

- Third Circuit held:

  "The principle anticompetitive effect of bundled rebates as offered by 3M is that when offered by a monopolist they may foreclose portions of the market to a potential competitor which does not manufacture an equally diverse group of products and who therefore cannot make a comparable offer." 324 F.3d at 155.

  "In some cases, these magnified rebates to a particular customer were as much as half of LePage's entire prior tape sales to that customer." 324 F.3d at 157.

"3M's bundled rebate programs caused distributors to displace LePage's entirely, or in some cases, drastically reduce purchases from LePage's." 324 F.3d at 161.

"The jury could have reasonably found that 3M's exclusionary conduct cut LePage's off from key retail pipelines necessary to permit it to compete profitably." 324 F.3d at 160.

* Decision does not require below cost pricing

Bundled Discounts Only An Issue If Seller Has Some Market Power

- Market power = the power to restrict supply and increase price

- Judged by: share of the relevant market and whether significant barriers to entry exist

Supreme Court refused to take Cert <u>BUT</u>

- Government Amicus Brief:
  - bundled rebates "are widespread and are likely, in many cases, to be procompetitive."
  - "it would be desirable to provide the business community, consumers, and the lower courts with additional guidance on the application of Section 2 to bundled rebates."
  - "the court of appeals' failure to identify the specific factors that made 3M's bundled discount anticompetitive may lead to challenges to pro competitive programs and prospectively chill the adoption of such programs."

- Dissent in *LePage's* criticized decision for not requiring LePage's to show it was an equally efficient producer as 3M.
- *LePage's* made bundled rebate plans difficult to counsel on:
  - If Seller has market power in any affected product market and offered bundled rebate plans
  - No real parameters or limits to circumstances could face liability
  - At the time it was unclear whether *LePage's* would be followed

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Bundled Discounts: *Battling Exclusion Standards (Cascade Health v. Peace Health)*

June 24, 2014

Michael B. Miller

Cascade Health Solutions v. PeaceHealth

- McKenzie-Williamette Hospital and PeaceHealth were the only two providers of hospital care in Lane County, Oregon.
- McKenzie operated one hospital that offered only primary and secondary acute care services – these are "common medical services like setting a broken bone and performing a tonsillectomy." 515 F.3d at 891.
- PeaceHealth operated three hospitals and offered primary and secondary care (just like McKenzie), but also offered "tertiary care," which was defined as "more complex services like invasive cardiovascular surgery and intensive neonatal care." *Id.*

More Facts

- In Lane County, PeaceHealth controlled 90% of the market for cardiovascular services; 93% of the market for tertiary cardiovascular services and roughly 75% of the market for primary and secondary care services.
- Plaintiff suffered financial losses and as a result merged with another company so that it could add tertiary services.

What are the Questions?

- Are costs relevant? If so, what costs count?
- Do the bundled rebates need to actually exclude a competitor or potential competitor?
- If such rebates need to exclude a competitor, should that competitor or potential competitor need to be “equally efficient” and if so what does that mean?
- Do the bundled products need to include products from two separate product markets or can the bundle involve two products in the same market?
- Does it matter if the competitors produce the same package of products?
- Any safe harbors that create procompetitive presumptions?
- What’s the role of market power?

The Result Below

- McKenzie sues, bringing claims for (i) monopolization, (ii) attempted monopolization, and (iii) other antitrust claims
- McKenzie's central allegation:
  - PeaceHealth offered insurers a price discount of 35% to 40% on tertiary services, IF the insurers also agreed to make PeaceHealth their sole preferred provider for all hospital services — primary, secondary, and tertiary.
  - Thus, the BUNDLE – (i) primary and secondary with (ii) tertiary
- McKenzie claimed that it was excluded from preferred provider plans and as a result patients in Lane County had to pay substantially more out-of-pocket expenses for inpatient services obtained from them than from PeaceHealth.
- After jury trial: PeaceHealth liable for attempted monopolization, total trebled damages award of $16.2 million.

The Appeal

- PeaceHealth appealed and argued, among other things, that the district court erred in permitting a jury instruction that "[b]undled price discounts may be anti-competitive if they are offered by a monopolist and substantially foreclose portions of the market to a competitor who does not provide an equally diverse group of services and who therefore cannot make a comparable offer."
- PeaceHealth argued that this instruction was incorrect as a matter of law because it did not ask the jury to consider whether the defendant priced below cost.
- Central issue for the Ninth Circuit was whether to follow *LePage's* (nope) or the so-called "full *Brooke Group"* approach (in which bundled pricing would be lawful absent proof that total price of all bundled products was less than the incremental cost of those products (nope).

The Ninth Circuit Adopts the Discount Attribution Test – Starts with Commercial Reality

- Commercial reality is the starting point for the Ninth Circuit opinion: "[b]undled discounts are pervasive," "a fundamental option for both buyers and sellers," and offer pro-competitive benefits. *Id.* at 894-95.
  - "Bundled discounts generally benefit buyers because the discounts allow the buyer to get more for less." *Id.* at 895.
  - "Bundling can also result in savings to the seller because it usually costs a firm less to sell multiple products to one customer at the same time than it does to sell the products individually." *Id.*
- But some more commercial reality too: "[I]t is possible, at least in theory, for a firm to use a bundled discount to exclude an equally or more efficient competitor and thereby reduce consumer welfare in the long run." *Id.* at 896.

The Ninth Circuit's Discount Attribution Test

- After reviewing the relevant Supreme Court case law in detail, the Ninth Circuit concluded that precedent shows:

> *"a measured concern to leave unhampered pricing practices that might benefit consumers, absent the clearest showing that an injury to the competitive process will result."*

- The Panel recognized that bundled discounts could pose an anticompetitive threat by "excluding less diversified but more efficient Producers" but criticized the decision in *LePage's* because (a) it could protect a less efficient competitor at the expense of consumer welfare; and (b) it offers no clear standards to assess a potential bundled rebate.

More on the Discount Attribution Test

- The question is whether "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."
- *Plaintiff must also show "antitrust injury" – an actual or probably adverse effect on competition. (Where have we heard this before?)*
- "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 the purpose of § 2. This two-part standard makes the defendant's bundled discounts legal unless the discounts have the potential to exclude a *hypothetical* equally efficient producer of the competitive product." That's the idea anyway.
- *No recoupment requirement?* No.

Contrasting Other Cases

- The Court rejected the below cost standard suggested in *Ortho Diagnostic Sys., Inc. v. Abbott Labs., Inc.*, 920 F. Supp. 455 (S.D.N.Y. 1996).
  - In *Ortho*, the Southern District concluded a plaintiff must prove either that (a) the monopolist priced below its average variable cost or (b) it is at least as efficient a producer of the competitive product as the defendant but the defendant's pricing makes it unprofitable for the plaintiff.
  - The Ninth Circuit found this standard inadequate because under it above cost prices are not per se legal. *PeaceHealth*, 515 F.3d at 905.
  - The Ninth Circuit also found this standard problematic because it does not provide adequate guidance to sellers since they do not have access to information about any plaintiff's costs. *Id.*

More On the *Ortho* Standard

The Ninth Circuit further noted that the Ortho standard could lead to multiple lawsuits with inconsistent outcomes.

- Multiple competitors may have different costs.
- The same program could thus be legal as to some competitors but illegal as to others.

What Must Be Established

- The “discount attribution” theory (incorporating a key component of the standard proposed by the Antitrust Modernization Commission).

> *“To prove that a bundled discount was exclusionary or predatory for purposes of a monopolization or attempted monopolization claim under §2 of the Sherman Act, the plaintiff must establish that, after allocating the discount given by the defendant on the entire bundle of products to the competitive product or products, the defendant sold the competitive product or products below its average variable cost of producing them.”*

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Loyalty Discounts:

Concord Boat v. Brunswick

Jim Long

June 24, 2014

Loyalty Discounts

Defined:

Discounts tied to purchase of percentage of buyer's requirements of one product.

Legitimate Purpose

Incentivize Increased Sales

Avoid Robinson-Patman Act issues

- Functional Availability
- Avoids problem of volume discounts
- Any buyer can qualify

Concord Boat Corp. v. Brunswick Corp., 207 F.3d 1039 (8th Cir. 2000)

- Brunswick had 75% share of marine stern drive engine market
- Brunswick sold to boat builders
- Brunswick offered share loyalty discounts
  - 3% discount 80% requirements
  - 2% discount 70% requirements
  - 1% discount 60% requirements
- Several other marine manufacturers also offered loyalty discounts

- Could earn additional 1-2% discount if committed for 2 to 3 years
- Attempted to increase market share requirement to 95%, but boat builders did not accept
- No claim prices were below some measure of cost

Boat Builders Sue

- Allege loyalty discounts monopolized market: violated Section 7 of Clayton Act and Sections 1 and 2 of The Sherman Act.
- Jury finds for boat builders that Brunswick violated all three statutes.
- Awarded actual damages of $44 million. Court trebled and awarded $9 million in attorney's fees and costs.

8th Circuit Decision
Section 1 Claim

- Finds "undisputed … not exclusive contracts"
- Analyzes as defacto exclusive dealing contract
- Factors for Defacto Exclusive Dealing:
  - Extent to which competitor has been foreclosed in a substantial share of the relevant market
  - Duration of any exclusive arrangements
  - Height of entry barriers

Court found:

(1) Programs did not require boat builders commit for any specified period of time

(2) Purchasers free to walk away from discounts at any time – some did switch

(3) Did not show significant barriers to entry

Section 2 Claim

- Court cites *Brooke Group* for general rule that above cost discounts not anticompetitive.
- *Brunswick* argued that since resulting prices not below cost, discounts were *per se* lawful.
- Trial Court had cited *LePages* (trial court), *SmithKline* and *Ortho* to request this argument.
- 8th Circuit distinguished three cases as "all involve bundling or tying" which require two markets.

8th Circuit holds:

(1) "cutting prices is the very essence of competition"

(2) competitors also cut prices – confirms

(3) not exclusive dealing contracts – not required to purchase 100% requirements

(4) buyers free to walk away

Reverses Trial Court

Brunswick Counseling "Rule"

- If not exclusive or "defacto exclusive dealing" conduct
- If purchasers free to walk away
- If resulting prices not below cost

Then should not be significant antitrust risk.

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Bundled Discounts: *Battling Exclusion Standards (Some Different Perspectives)*

June 24, 2014

Michael B. Miller

What About Non-Price Exclusion?

- So far, been talking about discounts, rebates, and price-based exclusion
- But what's the test when the exclusionary conduct focuses on non-price factors?
  - Some sort of "price-cost test?
  - Broad "Rule of Reason" standards
  - Something else
- *ZF Meritor, LLC v. Eaton Corporation* – THE THIRD CIRCUIT
  - *(After 200 pages)*

ZF Meritor v. Eaton

- Eaton
  - Leading Supplier of heavy-duty truck transmissions in North America
  - Exclusive dealing arrangements with the main direct purchasers of those transmissions
- Question in the Case, According to the Third Circuit – Are Plaintiffs' claims judged by the price-cost test (*Brooke Group*) or the Rule of Reason
  - Price-cost test: plaintiff must prove that the prices are "below cost"
  - Rule of Reason test: "probable effect to substantially lessen competition in the relevant market"

Rule of Reason Applies

- Price-cost test: Only applies "when price is the clearly predominant mechanism of exclusion:"
- Eaton used not prices, but the full scope of its long term agreements
  - Prices didn't drive out competition
  - The contracts in question as a whole foreclosed the opportunity to compete
- Question then became – did Eaton's agreements foreclose a substantial share of the market
  - According to the Third Circuit, the answer was "yes"

Rule of Reason Analysis

- "Where, as here, a dominant supplier enters into de facto exclusive dealing arrangements with every customer in the market, other firms may be driven out not because they cannot compete on a price basis, but because they are never given an opportunity to compete, despite their ability to offer products with significant customer demand."
- Purchase requirements imposed by Eaton were basically total exclusivity
- No producer could afford to lose Eaton as a supplier
- Eaton wrapped up 85% of the market in 2003, according to the Third Circuit
  - By 2005, that went down to 4%

The Counseling Muddle

- Judge Greenberg in dissent:

"I do not know how corporate counsel presented with a firm's business plan...if it is a dominant supplier that seeks to expand sales through a discount program...will be able to advise the management," except to "to take a chance in the courtroom casino"

The Europeans Have Spoken

- *Intel Corp. v. European Commission*, Case T-28609 (12 June 2014)
- The Case
  - Advanced Micro Defenses (AMD) filed a formal complaint with the Commission in October 2000
  - Investigation launched by the EC in May 2004
  - AMD files a complaint with the German Cartel Office in July 2006
  - EC files a statement of objections in July 2007
  - EC issues a Decision in May 2009
    - Decision: Intel committed an infringement by "implementing a strategy aimed at foreclosing AMD from the market for "x86 microprocessors"
    - Intel gave four OEMs rebates conditioned on those OEMs purchasing all or almost all of the x86 microprocessors from Intel
    - Fine of 1.06 billion EUROS.

Translate this into American

- 143 First of all, it should be recalled that a finding that an exclusivity rebate is illegal does not necessitate an examination of the circumstances of the case (see paragraphs 80 to 93 above). The Commission is not therefore required to demonstrate the foreclosure capability of exclusivity rebates on a case-by-case basis.
- 144 Next, it follows from the case-law that, even in the case of rebates falling within the third category, for which an examination of the circumstances of the case is necessary, it is not essential to carry out an AEC test. Thus, in *Michelin I*, paragraph 74 above (paragraphs 81 to 86), the Court of Justice relied on the loyalty mechanism of the rebates at issue, without requiring proof, by means of a quantitative test, that competitors had been forced to sell at a loss in order to be able to compensate the rebates falling within the third category granted by the undertaking in a dominant position.
- 145 Moreover, it follows from Case C-549/10 P *Tomra*, paragraph 73 above (paragraphs 73 and 74), that, in order to find anti-competitive effects, it is not necessary that a rebate system force an as-efficient competitor to charge ‘negative’ prices, that is to say prices lower than the cost price. In order to establish a potential anti-competitive effect, it is sufficient to demonstrate the existence of a loyalty mechanism (see, to that effect, Case C-549/10 P *Tomra*, paragraph 73 above, paragraph 79).

More Translation Required

- 146 It follows that, even if an assessment of the circumstances of the case were necessary to demonstrate the potential anti-competitive effects of the exclusivity rebates, it would still not be necessary to demonstrate those effects by means of an AEC test.

- 147 Moreover, the applicant's argument that the AEC test is the only evidence that the Commission presented in the contested decision in order to demonstrate the foreclosure capability of the rebates at issue has no factual basis (see paragraphs 173 to 175 below).

- 148 With respect to the applicant's argument that it would have demonstrated by means of an AEC test carried out properly that the rebates at issue did not have a foreclosure capability, the Court makes the following observations.

- 149 First of all, it should be borne in mind that a foreclosure effect occurs not only where access to the market is made impossible for competitors. Indeed, it is sufficient that that access be made more difficult (see paragraph 88 above).

A Few Additional Thoughts

- *PeaceHealth* seemed to rely on business realities, but left open the possibility that the discount attribution test may not apply outside of the "bundled pricing" label, for example in tying or exclusive dealing cases.
  - *See also Masimo Corp. v. Tyco Health Care Group*, 2009 WL 3451725, at *1 (9th Cir. Oct. 28, 2009)
- Should be able to calculate the attributed discount, even approximately – can handle the legal risk.
- Even if a particular bundled discount fails the discount attribution test, still could survive unless there is actual "antitrust injury" (harm to competition) – but how much do you want to rely on this prong?

Some Additional Guidance?

- If applying the “discount attribution" rule is not practical (e.g. , when cost measures are not available), continue to follow these guidelines when offering a bundle that includes multiple products, and particularly when competing against smaller rivals:
- Price each element of the bundle above the incremental (average variable cost) of the service, and make a good faith effort to comply with the “discount attribution" rule
- Do not price the bundle in such a way that the only viable economic option for the customer is to buy the bundle
- Be sure the customer understands it can purchase each element of the bundle separately if it wishes
- If you have questions about the advisability of offering a bundled discount in a particular context, contact Legal

Best Practices and Thorny Issues For Bundled and/or Loyalty Discounts

Discussion

Risk Factors

- What market share/market structure is required to create significant exposure to a bundling claim? To a loyalty discount claim?
  - Are there any safe harbors?

Risk Factors

- What level of foreclosure of competitors is required for significant exposure?

Risk Factors

- What level of purchase requirements (50% of a purchaser's requirements/90% of a purchaser's requirements) creates significant exposure?
  - Risk of an "all or nothing" plan.
  - At what percent level will a purchase requirement percent be viewed as "*defacto*" exclusive dealing?

Mitigating Factors

- Is a relevant (or dispositive) factor in the analysis whether other competitors have the same or similar abilities to bundle?
  - Does the analysis in the vacated opinion in *Southeast Missouri Hospital v. C. R. Bard, Inc.*, 616 F.3d 888, 893 (8th Cir. 2010) vacated Oct. 19, 2010, have any viability?

Mitigating Factors

- Does a quasi "meeting competition" defense apply?

  - If other competitors are bundling may a competitor respond with its own bundled discount plan?

  - If other competitors offer loyalty discounts?

Mitigating Factors

- If customers request bundled discounts or loyalty discounts, does that reduce or eliminate exposure?
  - Is the purpose behind offering the bundled discount and/or loyalty discount plan relevant to the analysis?

Does It Matter What Circuit You Are In?

How Important Are The Labels?

Is Pricing Above Cost a Safe Harbor for Loyalty Discounts?

Is There A Test Analogous To the Discount Attribution Test For Loyalty Discounts?

What are practical ways to limit exposure when instituting a bundled discount plan?

What are practical ways to limit exposure when instituting a loyalty discount plan?

- 5 Questions to Ask When a Bundled Discount Plan Walks in the Door?

- 5 Questions to Ask When a Loyalty Discount Plan Walks in the Door?

Foreclosure:

Is That The Basis Of The Analysis For Both?