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ANTITRUST TRADE AND PRACTICE

Expert Analysis

Antitrust and Conditional Pricing Practices

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On June 23, 2014, the Antitrust Division of the Department of Justice and the Federal Trade Commission (FTC) held a joint workshop to discuss legal and policy issues surrounding conditional pricing practices and their implications for antitrust enforcement. The workshop was prompted by the recognition, at both agencies, that the economic complexities surrounding such practices are quite complex and that the legal framework for analyzing conditional pricing practices remains in flux.

Overview

Conditional pricing practices are commonly referred to as loyalty contracts and/or bundled discounts. Such practices are pervasive in our economy and can be found in many different forms, such as fast-food meal combos, season tickets, and frequent buyer cards. The fact that these types of practices are offered by a diverse group of sellers demonstrates how vital of a role they play in our economy.

The basic premise of these loyalty contracts is that the price a firm charges for its product will depend on the quantity of the products the customer purchases from the firm. These types of loyalty contracts can be based on a single product or on multiple products. With multi-product loyalty discounts, the price of one or more of the items sold by the firm will depend on the quantity of different products the customer purchases from the same firm. Some of these practices are simplistic in design, while others can be much more complex. For example, some loyalty contracts will also reference other rivals, such as discounts pegged to market share/volume requirements or discounts based on preferred retail display arrangements.

Loyalty contracts, at their core, often provide pro-competitive benefits because customers ultimately benefit from discounted pricing. The firms that offer these loyalty contracts can also experience significant economic efficiencies, such as reduced free riding by other rivals or reductions in contracting costs. However, many believe that such practices can also have anticompetitive effects. The workshop primarily focused on two main theories of competitive harm: first, dominant firms with monopoly power may use such loyalty contracts to exclude rivals from the marketplace; and second, firms may use loyalty contracts to "raise rivals' costs," which in essence 'softens' the vigor of competition that rivals can offer. Conditional pricing practices that reference rivals are viewed as especially suspect, as a dominant firm may use such practices to exert its market power in order to weaken a rival.

U.S. Legal Standard

The law with respect to conditional pricing practices remains somewhat in flux, with courts divided as to what type of legal test should be applied when facts are most probative. Courts have tended to look at these practices from an exclusionary framework and have fallen into one of two camps: either borrowing the price-cost test from *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp,*[1] and its progeny or applying a general rule of reason analysis. In *Brooke Group*, the U.S. Supreme Court applied the price-cost test in the context of a single product predatory pricing case, whereby the plaintiffs were required to prove that the defendants priced their products below their costs.

In *ZF Meritor, LLC v. Eaton Corp.*,[2] the U.S. Court of Appeals for the Third Circuit grappled with what framework to apply in analyzing a single-product loyalty contract. There, the district court found the terms of Eaton's long-term contracts with its customers amounted

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to a de facto exclusive dealing arrangement. Specifically, ZF Meritor and Eaton were the only two competitors in the market for heavy-duty truck transmissions, with Eaton having monopoly power in the relevant market. In response to a potential competitive threat posed by ZF Meritor's introduction of a new transmission model to the North American market, Eaton entered into long-term agreements with all four direct purchasers of heavy-duty truck transmissions.

The agreements all contained a provision for market share discounts in that each customer would receive conditional rebates only if they purchased a certain percentage of their needs from Eaton. Further, Eaton could terminate the agreement or recoup all contractual savings if the customers did not meet their market share targets. The agreements also mandated preferential treatment for Eaton by requiring purchasers to both include Eaton as their standard offering in their data books and to price Eaton's transmissions preferentially against its competitors'.

Eaton argued that the Third Circuit should adopt the price-cost test when analyzing these types of conditional rebates.[3] Based on this rationale, Eaton argued that it did not engage in anticompetitive conduct because it never priced its transmission below its costs. The Third Circuit held that the use of the price-cost test is appropriate when "price is the clearly predominant mechanism of exclusion."[4] But, the court declined to use the price-cost test, finding that Eaton engaged in additional non-price related exclusionary methods to foreclose ZF Meritor from the market; the court therefore opted to use a rule of reason analysis instead.

More recently, in *Eisai v. Sanofi-Aventis U.S.*,5 the District Court in New Jersey applied the standard established by *ZF Meritor* and used the price-cost test to dismiss an exclusive dealing claim. In this case, Eisai and Sanofi both marketed competing anticoagulant drug products. Eisai challenged the use of Sanofi's loyalty-discount contracts for its anticoagulant drug, Lovenox, claiming that such loyalty discounts violated antitrust laws. Specifically, these discounts were based on both the volume of Lovenox purchased by the customers, as well as a market-share calculation that determined what percentage of a customer's total need for a similar type of anticoagulant drug was satisfied by Lovenox. The court found that the price-cost test was appropriate for market share and volume rebate discounts if no additional non-pricing exclusionary tactics were utilized, and granted summary judgment to Sanofi on that basis.[6]

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With respect to multi-product loyalty discounts, there is currently a circuit split between the Third and Ninth circuits as to the use of the price-cost test. In *Cascade Health Solutions v. PeaceHealth*,[7] the U.S. Court of Appeals for the Ninth Circuit contemplated whether to adopt the Third Circuit's standard in *LePage's Inc. v. Minnesota Mining & Manufacturing Co*.[8] for assessing when bundled discounts may constitute exclusionary conduct. In *LePage's*, the Third Circuit had refused to apply *Brooke Group's* below cost pricing requirement to bundled discounting and opted instead for a rule of reason analysis.[9]

In *Cascade,* McKenzie-Williamette Hospital (aka Cascade) and PeaceHealth were the only two providers of hospital care in Lane County, Ore., and the relevant market was defined as "primary and secondary acute care hospital services in Lane County."[10] PeaceHealth was the dominant provider of primary and secondary care services and the only provider of tertiary services, while McKenzie provided only primary and secondary care services.[11] PeaceHealth offered insurers bundled discounts of 35 to 40 percent off reimbursement rates for tertiary services if they made PeaceHealth their sole preferred provider for all services.[12]

The Ninth Circuit rejected *LePage's* standard because (i) it assumed that all bundled discounts offered by a monopolist are anticompetitive with respect to its competitors who do not offer the same array of products; (ii) it protected less efficient competitors; and (iii) it offered no clear standards for businesses as to whether their bundled discounts would be permissible under antitrust laws.[13] Thus, the Ninth Circuit adopted the use of a price-cost test as safe harbor, and used the discount aggregation standard for conducting its price-cost analysis.[14]

Workshop

In their opening remarks at the workshop, both Assistant Attorney General William Baer and FTC Commissioner Maureen Ohlhausen reiterated the difficulty in analyzing conditional pricing practices and the need to develop an effective legal test that can accurately assess their competitive effects. Ohlhausen further specified that any competition rules used to establish the legality of such conditional pricing practices "should aspire to promote predictability, fairness, and transparency in the law," and that the "best way to accomplish these aims is to develop rules that are empirically grounded in economic efficiency while at the same time administrable by agencies and the courts."[15] With these overarching themes in mind, the workshop commenced in order to tackle some of these tough issues.

As the workshop continued throughout the day, one of the recurring themes that emerged was that there is no single overall general principle that conclusively encapsulates the likely competitive effects of such conditional pricing practices. More often than not, conditional pricing practices can be both exclusionary while also producing significant economic efficiencies. Whether such practices have an overall pro-competitive or anti-competitive effect depends on several factors, such as the specific type of mechanisms utilized by a firm, the particular industry, or unique dynamics of the marketplace. Given these significant complexities, many panelists preferred the use of a detailed, rule of reason analysis in order to capture the economic efficiencies that stem from such practices and to analyze their competitive effects in a more robust manner.

However, it was also recognized that the use of a detailed rule of reason analysis can leave much to be desired with respect to the administrability and predictability prongs in developing a legal framework for analyzing conditional pricing practices. In the absence of such predictability, many of the lawyers on the panel expressed concern as to how to advise their clients when formulating such loyalty contracts and what type of mechanisms are permissible. The panelists further raised concerns that this would lead to over-deterrence against the use of conditional pricing practices and that consumers may not receive pro-competitive benefits in the form of lower prices. Further, many of the panelists also voiced concern that such an open-ended analysis that leaves the ultimate decision to a jury would lead to an increase in frivolous litigation, instead preferring some type of structured rule of reason analysis that would allow a judge to dismiss unmeritorious cases. As mentioned, courts have faced similar dilemmas when analyzing conditional pricing practices, and in some cases, have adopted the price-cost test as a safe harbor.

Yet, many of the panelists seemed averse to the continued use of the price-cost test as a screen. Specifically, some panelists pointed out that the price-cost test was borrowed from a predatory pricing paradigm, in which the dominant firm hopes to drive out its competitor and then recoup its losses. Several panelists maintained that the price-cost test does not effectively capture the whole picture under different theories of anti-competitive harm. For example, a dominant firm can engage in exclusionary conduct without necessarily driving its rivals out of the market, but still be able to price above its marginal costs. Additionally, if the antitrust harm is based on a theory of raising rivals' costs or collusion, prices would almost always be above cost given that the alleged harm specifically stems from firms inflating their prices.

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Conversely, some panelists also posited situations where the price-cost test would yield false positives; for example, firms may price below cost in order to secure the bid of a lead customer, and such conduct would not necessarily have any exclusionary intent or effect. Thus, many panelists argued against the use of the price-cost test, claiming that the test's propensity to yield too many false positive and negatives leads to under-deterrence of anti-competitive behavior.

The price-cost test did, however, have its share of proponents. Many lawyers preferred the predictability of a bright-line rule that the price-cost test provided, which enabled them to counsel their clients more predictably with respect to loyalty contracts. In response, other panelists argued that the price-cost test was not as predictable or as easy to administer by courts as some have suggested, proposing instead other means for weeding out frivolous litigation, such as having a market share screen, only flagging pricing practices that reference rivals, or even implementing an "equally efficient rival" test. However, most panelists also agreed that there is a need for additional empirical studies in this area before implementing these alternative methods.

Looking Forward

The workshop confirmed many of the problematic issues associated with conditional pricing practices: that the economic complexities of such practices remain relatively unclear and that more theoretical and empirical work needs to be done in this area in order to substantiate the preferred way to distinguish between pro- and anti-competitive pricing practices. Similarly, although no clear consensus arose from the workshop as to the appropriate legal test for analyzing conditional practices, the panelists raised several plausible options beyond the current price-cost focus. The agencies will continue to accept public comments on the workshop until Sept. 22, 2014. After this point, the agencies may decide to issue guidance that should at least clarify what type of legal framework they will use to analyze conditional pricing practices. In the meantime, practitioners must continue to take into account the differing legal standards and economic theories when advising clients on conditional pricing practices, which at minimum will allow clients—especially those with arguable market power – to know what they are getting into when implementing conditional pricing programs.

1. 509 U.S. 209, 256-57 (1993).
2. 696 F.3d 254 (3d Cir. 2012).
3. See id. at 269.
4. See id. at 269, 275, 277.
5. No. 08-4168, 2014 WL 1343254 (D.N.J. March 28, 2014).
6. See id. at *29-30, *37.
7. 515 F.3d 883 (9th Cir. 2008).
8. 324 F.3d 141 (3d Cir. 2003).
9. See *LePage's*, 324 F.3d at 152.
10. See *Cascade*, 515 F.3d at 891.
11. See id.
12. See id. at 892.
13. See *Cascade*, 515 F.3d at 899-900.
14. See id. at 903, 906.
15. Transcript, FTC-DOJ Conditional Pricing Practices Workshop, at 4 (June 23, 2014), available at http://www.ftc.gov/system/files/documents/videos/conditional-pricing-practices-economic-analysis-legal-policy-implications-part-1/ftc-doj_conditional_pricing_practices_workshop_-_transcript_segment_1.pdf.