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Pricing Conduct Beyond The Safe Harbor

Law360, New York (July 29, 2010) -- In recent years, antitrust defendants and other monopoly firms navigating rough antitrust waters have sought refuge in what the defendants assert is a "safe harbor" established by the U.S. Supreme Court in the Brooke Group case.[1]

Relying on Brooke Group and its progeny,[2] monopoly firms have proffered arguments that any discount that does not reduce the price of the product below its marginal cost is per se legal, regardless of what form that discount takes.

The powerful rationale for this argument is that "because cutting prices in order to increase business often is the very essence of competition ... mistaken inferences ... are especially costly, because they chill the very conduct the antitrust laws are designed to protect."[3]

Monopoly firms have thus advocated for a complete shield from antitrust liability whenever they engage in aggressive but above-cost pricing conduct. Intel Corporation, a high-profile defendant in a recent antitrust action brought by its smaller rival AMD, made that very argument to the Delaware court in a failed attempt to short-circuit AMD's claims.[4]

The temptation to embrace this argument is understandable. Businesses benefit from the certainty afforded by a bright-line test. Businesses also benefit from offering deeper discounts and greater back-end rebates to those customers that are most essential to the firm's long-term success.

When offering these preferential discounts to certain loyal customers, businesses want an assurance that these discounts will pass antitrust scrutiny, and the Brooke Group test may offer that coveted protection to the price-cutting practice found to be above the appropriate measure of costs.

It is imprudent, however, to assume that the court will apply the Brooke Group test every time the disputed practice involves a price concession. Despite the popularity and the continued expansion of the Brooke Group price/cost analysis, most courts will be reluctant to hold that every above-cost pricing by a monopolist is per se legal under section 2 of the Sherman Act.[5]

While in the retail context, monopoly firms "will not incur liability as long as their retail prices are above cost,"[6] their price concessions to non-retail customers conditioned on the exclusion of a smaller rival still remain at a risk of not receiving a safe-harbor protection of the Brooke Group test, even if their prices are above costs.

Section 2 of the Sherman Act and the Brooke Group Test

Section 2 of the Sherman Act prohibits the acquisition or maintenance of monopoly power by means of exclusionary conduct.[7] While the acquisition of monopoly power is not by itself illegal,[8] a lawful monopolist can violate section 2 of the Sherman Act if the court finds it engaged in unreasonably exclusionary conduct to willfully maintain its monopoly power.[9]

"Exclusionary conduct" can take a variety of forms, one of which is predatory pricing at issue in the Brooke Group case. Other forms of exclusionary conduct that have been condemned under section 2 include tying arrangements, exclusive dealing agreements, and product bundling, among others.

The Brooke Group decision addresses one of the central tensions in the antitrust jurisprudence. Because low prices are so central to the goals of antitrust laws, the courts have been wary of limiting a monopolist's ability to offer reduced prices.[10]

In Brooke Group, the court articulated a two-part test for identifying those few aggressive discounting practices that run afoul of section 2 of the Sherman Act. Where a defendant (a) prices its products below an appropriate measure of its costs and (b) has an ability to recoup those costs after the predatory scheme is complete, an antitrust violation occurs.[11] Because plaintiff's failure to satisfy either prong of this test will negate section 2 liability, price predation claims are notoriously hard to win.[12]

The Brooke Group decision sparked a heated and long-lasting debate over its impact on the section 2 claims outside of predatory pricing context and that controversy continues today. Given the exceptional deference the courts afford to price competition, especially at the retail level where lower prices directly and immediately benefit the consumers, there can be little doubt that a monopoly firm will enjoy safe harbor for aggressively low retail pricing, so long as it is above the firm's appropriate measure of cost.[13]

In recent years, the Supreme Court further extended Brooke Group's safe harbor to other forms of price competition — "predatory bidding" and "price squeeze."

In the Weyerhaeuser case, the Supreme Court held that the "two-pronged Brooke Group test should apply to predatory-bidding claims" and the plaintiff must prove that "the predator's bidding on the buy side must have caused the cost of the relevant output to rise above the revenues generated in the sale of those outputs."[14] Plaintiff must also prove that "the defendant has a dangerous probability of recouping the losses incurred in bidding up input prices."[15]

Two years later, in the Linkline case, the Supreme Court held that the Brooke Group safe-harbor shielded the defendant that operated in both the wholesale and the retail markets from a "price squeeze" claim so long as its retail prices were not predatory.[16] It held that where "both the wholesale price and the retail price are independently lawful, there is no basis for imposing antitrust liability simply because a vertically integrated firm’s wholesale price happens to be greater than or equal to its retail price.”[17]

The Linkline decision has significantly strengthened safe-harbor for pricing conduct in cases where the defendant leverages its monopoly in one market to gain the competitive advantage in another market. Immediately following Linkline, the Ninth Circuit held that in a two-market monopoly leveraging case, the court must analyze each market separately and find no liability absent independent antitrust violations in each market.[18]

Despite this notable expansion of the Brooke Group’s safe harbor, these decisions do not address pricing conduct that is coupled with potentially exclusionary conditions, such as exclusivity for a certain term or purchase of a bundle of products as a precondition for earning the discount. That conduct is likely to be subjected to a different and less bright-line analysis.[19]

Conditional Discounts That May Fall Outside Brooke Group's Safe Harbor

While Linkline has reinforced the broad reach of the Brooke Group’s test, it does not extend Brooke Group’s safe-harbor to every exclusionary practice in which pricing or discounting is an element. In the vast majority of cases that involve more than naked price predation, courts continue to conduct an individualized inquiry into the facts of the case to determine whether the complained-of conduct was unlawfully exclusionary.

Discounts Conditioned on Exclusivity

Most exclusive dealing arrangements have a significant price component — a supplier offers its product at a reduced price in exchange for an agreement that a buyer would not buy that product from another supplier for a certain period of time.

Notwithstanding favorable pricing at the core of these agreements, the courts have not afforded safe-harbor protection to the exclusive deals involving above-cost pricing. The primary reason is that the evil associated with the exclusive deals is not the price, although an exclusive agreement could involve below-cost pricing, but the exclusivity condition itself. If the condition imposes a long term of exclusivity over a substantial portion of the market, the condition may reduce opportunities for the rival to grow and become a long-term check on the monpolist’s pricing.

If the term of exclusion is short or other potential sellers exist to whom the rival may offer its products, the exclusivity conditions may be seen as pro-competitive as they encourage a healthy bidding for the business that benefits consumers. But simply relying on the above-cost nature may not get you out of the rough waters in many courts.

Instead, courts may ignore the favorable language in Brooke Group regarding above-cost price-cutting and instead find a violation where the percentage of the market foreclosed is substantial and the term of exclusivity is longer than one year. Such an exclusive dealing case could be waged under Section 2 of the Sherman Act, Section 3 of the Clayton Act, and/or Section 1 of the Sherman Act.[20]

In analyzing the legality of the exclusive arrangements, the courts have focused on the duration and extent of market foreclosure, not limiting themselves to the quantitative cost/price analysis of the Brooke Group decision.

In a recent case involving a multiyear exclusive dealing arrangement, NicSand Inc. v. 3M Co., the Sixth Circuit considered whether the up-front cash payments that a supplier of automotive sandpaper, 3M, had paid to the retailers in exchange for that exclusivity were predatory.[21]

The court’s conclusion, however, that those payments were not predatory did not end the court’s analysis of the exclusive deals at issue. The court went on to analyze whether the multiyear term and the exclusive nature of the agreement unlawfully restrained competition in that market.[22]

Similarly, in the recent Ninth Circuit decision in Tyco, the court upheld “sole-source agreements” utilizing a traditional foreclosure analysis.[23] The court affirmed the district court’s finding of no antitrust violation but its analysis focused not on defendant’s discounted price relative to its costs but on whether the agreements in question foreclosed competition by forcing customers to purchase defendant’s products.[24]

These decisions show that courts will fall back on a Rule of Reason weighing of the pro-competitive benefits versus the anticompetitive effects rather than simply using a calculator to determine whether the defendant is pricing below cost.

Discounts Conditioned on Purchasing a Bundle of Products

Where a monopolist manufactures several product lines some of which are not manufactured by its competitors, conditioning price discounts on purchases of multiple product lines may violate Section 2 even if the discounted price is not strictly predatory under the Brooke Group test.

In LePage’s v. 3M,[25] defendant 3M offered discounts to certain customers conditioned on purchases spanning six of its product lines. If a customer failed to meet the target for any one product line, it would not receive its rebate.

The Third Circuit ruled that 3M’s discounts were anti-competitive because they "foreclose[d] portions of the market to a potential competitor who does not manufacture an equally diverse group of products and who therefore cannot make a comparable offer."[26]

The LePage's decision followed several earlier Third Circuit bundling cases, such as SmithKline Corp. v. Eli Lilly & Co.,[27] which held that the monopolist’s discounts conditioned on the purchase of its multiple products were unlawful.

The LePage's court famously rejected Brook Group price/cost test, judging it to be inapplicable to the section 2 bundling claims.[28] And while the LePage's decision has been widely criticized for its narrow interpretation of Brooke Group,[29] courts still do not apply the straight Brooke Group test to bundling cases.[30]

The greatest endorsement of the Brooke Group approach in a bundling context has come from the Ninth Circuit decision in Cascade Health Solutions v. Peacehealth, which applied a modified version of the cost/price test, called a "discount attribution" test.[31]

The court takes the full amount of the discounts given by the defendant on the bundle and allocates it to the competitive products for which the defendant competes with its rival. "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 § 2."[32]

The Peacehealth's attribution test has been criticized as deviating from the goals of Brooke Group by failing to replicate a company's price-setting decisions and distinguish between legitimate price-cutting to increase business and cutting prices to eliminate competition.[33]

Regardless of whether Peacehealth truly "removes the safe harbor" established in the Brooke Group as some critics contend,[34] the "discount attribution" offers a monopoly firm a significant measure of certainty in evaluating its pricing conduct for potential antitrust exposure.

Even if a firm does not perform a "discount attribution" test in a regular course of making pricing decisions, it can perform it as part of an antitrust audit to ensure that its pricing for a product bundle does not expose it to a potential Section 2 violation.

In sum, the recent Supreme Court decision in Linkline leaves no doubt that the Brooke Group's cost/price and recoupment test is alive and well and is likely to expand to other forms of aggressive price competition. There remain, however, various forms of pricing conduct that are not currently protected by the above-cost safe harbor.

Any pricing arrangement by a monopoly firm that conditions price discounts on the exclusion of a smaller rival from a substantial portion of the market for a lengthy term could be subject to much more holistic antitrust scrutiny beyond the cost/price and recoupment test.

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

[2] See, e.g., Pacific Bell Telephone Co. v. Linkline Communications Inc. __ U.S. ___, 129 S. Ct. 1109 (2009); Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., 549 U.S. 312, 319 (2007).

[3] Brooke Group, 509 U.S. at 226.

[4] The Delaware court in the AMD v. Intel case (In Re Intel Corporation Microprocessor Antitrust Litigation, MDL No. 05-1717-JJF) declined to consider that argument on procedural grounds, and the case settled a few months later with Intel agreeing to pay AMD $1.25 billion and cease a variety of business practices that were at the heart of AMD's complaint.

[5] Many legal scholars have supported that view. See, e.g., Steven C. Salop, Exclusionary Conduct, Effects on Consumers, and the Flawed Profit-Sacrifice Standard, 73 Antitrust L.J. 311, 315-18 (2006).

[6] Linkline Communications Inc., 129 S. Ct. at 1121.

[7] See 15 U.S.C. § 2.

[8] See United States v. Grinnell Corp, 384 U.S. 563, 571 (1966).

[9] Linkline, 120 S. Ct. at 1118.

[10] Brooke Group, 509 U.S. at 223.

[11] Brooke Group, 509 U.S. at 222-24.

[12] While the Brooke Group case involved a Robinson Patman claim, the Supreme Court has since made it clear that the Brooke Group's two-part test applies to a predatory pricing claim under the Sherman Act. See id. at 222; see also Linkline, 129 S. Ct. at 1120.

[13] It is important to note that convincing the court to apply the Brooke Group test to the firm's price-cutting conduct insures neither the vindication of that practice nor an easy sailing toward that outcome. In most cases, the complexity of applying the Brooke Group test to a specific set of facts will make it challenging to determine whether the price at issue is in fact above the appropriate measure of costs. In many cases, there will be a dispute about what actual price a monopolist charges its customers, and how to value non-monetary benefits monopolist afforded to its customers. There is also an open question of what is the "appropriate measure of costs," which was never fully resolved by the post-Brooke Group decisions.

[14] Weyerhaeuser, 459 U.S. at 324-25.

[15] Id. at 325.

[16] Likeline, 129 S. Ct. at 1122.

[17] Id.

[18] John Doe v. Abbott Laboratories,, 571 F. 3d 930, 931(9th Cir. 2009)

[19] See, e.g., M. Laurence Popofsky, Bundled Discounting: From LePage's to PeaceHealth, & Beyond, 9 Sedona Conf. J. 99, 101 (2008); see also Herbert Hovenkamp, HOVERNKAMP HORNBOOK ON FEDERAL ANTITRUST POLICY, THE LAW OF COMPETITION AND ITS PRACTICE (3RD ED. 2005), § 8.9 (discussing legal approaches to several "pricing practices that do not clearly fit within the traditional 'predatory pricing' definition").

[20] See 15 U.S.C. § 14 ("Section 3 of the Clayton Act"); Tampa Electric Co. v. Nashville Coal Co., 365 U.S. 320, 327 (1961); see also U.S. v. Microsoft, 253 F.3d 34 (D.C. Cir. 2001).

[21] 507 F. 3d 442, 452 (2007).

[22] Id. at 453-55.

[23] 592 F. 3d at 996-98.

[24] Id.; see also Palmyra Park Hospital Inc. v. Phoebe Putney Memorial Hospital, __ F.3d __, 2010 WL 1726653 at *9 (11th Cir. 2010), in which the Eleventh Circuit allowed plaintiff hospital to proceed with its claims against a competing hospital based on the allegations that defendant's "exclusivity arrangements force insurers who would otherwise prefer to deal with both [hospitals] to instead deal with only [defendant hospital]." The court did not analyze whether the price defendant offered in exchange for exclusivity was predatory.

[25] 324 F.3d 141 (3d Cir. 2003).

[26] Id. at 155. Many legal scholars agree that bundled discounts have the potential to exclude equally efficient rivals even if priced above cost. See, e.g., IIIA P. Areeda & H. Hovenkamp, ANTITRUST LAW §749 (2008); Thomas A. Lambert, "Evaluating Bundled Discounts," 89 Minn. L. Rev. 1688, June 2005.

[27] 575 F.2d 1056 (3d Cir. 1978).

[28] LePage's, 324 F.3d at 152.

[29] See, e.g., Herbert J. Hovenkamp, The Law of Exclusionary Pricing, 2 Competition Policy International 21, at 30, 32 (2006) (the LePage's decision wrongly "condemned bundled discounts without a showing that an equally efficient rival could not match the discounts"); Daniel A. Crane, Multi-product Discounting: A Myth of Nonprice Predation, 72 U. Chi. L. Rev 27, 43 (2005) (same).

[30] M. Laurence Popofsky, Bundled Discounting: From LePage's to PeaceHealth, & Beyond, 9 Sedona Conf. J. 99, 101 (2008) (the courts that have considered the appropriateness of applying the Brooke Group test to bundled discounting recognized the critical differences between price predation and bundled discounting and the need for different standards); see also N. Economides & I. Lianos, The Elusive Antitrust Standard on Bundling in Europe and in the United States at the Aftermath of the Microsoft Cases, 76 Antitrust Law Journal

483, 486-95 (2009) (discussing divergent antitrust standards applied to bundling practices); IIIA P. Areeda & H. Hovenkamp, ANTITRUST LAW §749 (2008) (Because "[p]ackage discounts bear some characteristics of both predatory pricing and tying, ... they are best analyzed by a model that draws a little from each area.")

[31] 515 F.3d 883 (9th Cir. 2008).

[32] Id. at 906.

[33] Jarod M. Bona, Loyalty Discounts and the FTC's Lawsuit Against Intel, THE JOURNAL OF THE ANTITRUST AND UNFAIR COMPETITION LAW SECTION OF THE STATE BAR, Spring 2010, at 17-18.

[34] Id. at 18.