



**VIEWPOINT:**

**Bundled Discounts and the Antitrust Modernization Commission**

**Aaron M. Panner**

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## Bundled Discounts and the Antitrust Modernization Commission

By

Aaron M. Panner<sup>1</sup>

The Report of the Antitrust Modernization Commission<sup>2</sup> (“AMC”) devotes relatively little space to antitrust common law – the judge-made doctrine that governs unreasonable restraints of trade under Section 1 and monopolization under Section 2 of the Sherman Act. That lack of emphasis – particularly with regard to standards under Section 1 – reflects in part a consensus that the project of doctrinal reform that began with *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*,<sup>3</sup> and *Continental T.V., Inc. v. GTE Sylvania, Inc.*,<sup>4</sup> has made substantial progress. The principle that antitrust law should protect the competitive process as the best way to ensure consumer welfare (*Brunswick*) and the recognition that the law must take account of possible pro-competitive justifications of restraints and thus avoid unjustified rules of *per se* illegality (*Sylvania*) – once matters for debate in the legal community – are now essentially unchallenged.<sup>5</sup> The antitrust analysis originally associated with the Chicago School has carried the day in the courts and especially in the Supreme Court which has swept away a series of antitrust rules that could not be squared with what is now not-so-new learning.<sup>6</sup> As Commissioner Jacobson noted, the AMC could have taken on additional issues of substantive antitrust law – for example, as he noted, the *per se* rule against tying (best honored, it is widely recognized, in the breach) has “long outlived its usefulness.”<sup>7</sup> The AMC’s decision not to do so does not, however, reflect any modesty about today’s “received wisdom.”<sup>8</sup> Rather, it likely reflects a confidence that the law is headed in the right direction and that the doctrinal issues that the AMC did not address will be resolved by courts applying sound antitrust principles.

In light of that, it is notable that the AMC *did* choose to address both general standards governing exclusionary conduct under Section 2 and, more particularly, the Third Circuit’s controversial decision in *LePage’s v. 3M*,<sup>9</sup> which condemned bundled rebates. In the last few years there has been substantial attention to adoption of sound

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<sup>1</sup> Aaron M. Panner is a Partner with the law firm of Kellogg, Huber, Hansen, Todd, Evans & Figel, P.L.L.C., and an eCCP Advisor.

<sup>2</sup> Antitrust Modernization Commission, *Report and Recommendations* (April 2007) (“AMC Report”).

<sup>3</sup> 429 U.S. 477 (1977).

<sup>4</sup> 433 U.S. 36 (1977).

<sup>5</sup> See AMC Report at 34-36.

<sup>6</sup> The Court has rejected expansive antitrust rules in cases like *Weyerhaeuser, Illinois Tool, Dagher, Trinko, State Oil Co. v. Kahn, NYNEX v. Discon*. The *per se* rule against minimum resale price maintenance – the only remaining vertical restraint that was condemned irrespective of actual market effects and the most venerable – was overturned in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, over Justice Breyer’s vigorous dissent.

<sup>7</sup> AMC Report, Statement of Commission Jacobson, at 413.

<sup>8</sup> Cf. *id.* at 414.

<sup>9</sup> 324 F.3d 141 (3d Cir. 2003) (en banc).

rules to guide analysis of single-firm conduct, and a concerted effort to replace the vacuous formulas of *Grinnell*<sup>10</sup> and the confusion of *Aspen Skiing*<sup>11</sup> with something more functional. That has led the Department of Justice and astute (if occasionally Casaubon-like) commentators to seek a unifying principle that can distinguish pro-competitive conduct from exclusionary conduct. The AMC reviewed those efforts, but – not surprisingly for a group operating largely by consensus – it did not adopt any of them. Instead, the AMC prefaced its discussion of proposed standards with the caveat that “[m]any commentators are skeptical that any one legal standard should be used to evaluate the wide variety of different types of conduct that may be challenged under Section 2.”<sup>12</sup> The purpose of addressing exclusionary conduct standards was not, for the most part, to suggest what the standard or standards should be either in general or for particular patterns of conduct. (The two exceptions were for bundled rebates/discounts – discussed below – and for refusals to deal with rivals, for which the AMC suggested a qualified rule of *per se* legality.) Instead, the AMC emphasized principles to guide the *structure* of legal rules under Section 2. Recommendation No. 12 reads:

In general, standards for applying Section 2 of the Sherman Act’s broad proscription against anticompetitive conduct should be [1] clear and predictable in application, [2] administrable, and [3] designed to minimize overdeterrence and underdeterrence, both of which impair consumer welfare.<sup>13</sup>

There is nothing surprising about these recommendations – what the AMC said about Section 2 might be said about any system of legal rules. That the AMC felt the need to articulate these principles in the Section 2 context reflects the difficulty of establishing such rules in the Section 2 context. In the first place, what conduct should be “deterred” in the first place is quite often controversial.<sup>14</sup> “[T]he welfare effects of unilateral practices are inherently difficult to assess.”<sup>15</sup>

[V]igorous competition may look very similar to acts that *undermine* competition and support monopoly power. The resulting danger is that courts will prohibit, or the antitrust authorities will prosecute, acts that *appear* to be anticompetitive but that really are the opposite. The difficulty is that effective competition by a firm is always tough on its rivals.<sup>16</sup>

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<sup>10</sup> United States v. Grinnell Corp., 384 U.S. 563 (1966).

<sup>11</sup> Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585 (1985).

<sup>12</sup> AMC Report at 91.

<sup>13</sup> See AMC Report at 11.

<sup>14</sup> There is general agreement that “naked exclusion” – use of force or fraud to cripple rivals or would-be rivals to establish or preserve monopoly – should be condemned, as it has no pro-competitive benefit and can harm consumers.

<sup>15</sup> David S. Evans & A. Jorge Padilla, *Designing Antitrust Rules for Assessing Unilateral Practices: A Neo-Chicago Approach*, 72 U. Chi. L. Rev. 73, 73 (2005).

<sup>16</sup> William J. Baumol & Alan S. Blinder, *Economics: Principles and Policy* 425-26 (8th ed. 2000) (paragraph break omitted).

Beyond the substantive difficulty of identifying conduct that should be condemned, there is the problem of formulating the rule in a manner that lawyers can understand and explain to their clients. As then-Judge Breyer noted:

unlike economics, law is an administrative system the effects of which depend upon the content of rules and precedents only as they are applied by judges and juries in courts and by lawyers advising their clients. Rules that seek to embody every economic complexity and qualification may well, through the vagaries of administration, prove counter-productive, undercutting the very economic ends they seek to serve.<sup>17</sup>

Any lawyer who has tried to formulate a recommendation for clients with regard to whether particular conduct is permitted, and in what circumstances is familiar with the problem.

Its general task defined, the AMC sought to formulate a rule governing bundled discounts. First, the AMC criticized *LePage's* for its failure to “assess whether 3M’s bundled discounts constituted competition on the merits” – by which the AMC apparently meant that the Court did not “require *LePage's* to prove it could make tape as efficiently as 3M” or that 3M’s conduct would have the effect of excluding such a competitor.<sup>18</sup> The decision was “too vague” and therefore “likely to chill welfare-enhancing bundled discounts or rebates.”<sup>19</sup>

Next, the AMC considered possible “safe harbors” for bundled discounts, focusing on tests that – like the Supreme Court’s test in *Brooke Group*,<sup>20</sup> would consider both the relationship between the defendant’s prices and costs and the potential for recoupment – *i.e.*, the likelihood that the defendant’s conduct would have the effect of entrenching the defendant’s market power. With regard to the relationship between price and costs, the AMC considered two major proposals: one that would, like *Brooke Group*, focus on the overall relationship between price and cost and provide a safe harbor for above-cost pricing; the second that would evaluate the effect of bundled discounts on a hypothetical efficient producer of a competitive product that is part of the bundle.

In the end, the AMC recommended the latter approach and the following three-part standard:

Courts should adopt a three-part test to determine whether bundled discounts or rebates violate Section 2 of the Sherman Act. To prove a violation of Section 2, a plaintiff should be required to show each one of the following elements (as well as other elements of a Section 2 claim):  
(1) after allocating all discounts and rebates attributable to the entire

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<sup>17</sup> *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 234 (1st Cir. 1983).

<sup>18</sup> AMC Report at 97.

<sup>19</sup> *Id.*

<sup>20</sup> *Brooke Group v. Brown & Williamson Tobacco*, 509 U.S. 209 (1993).

bundle of products to the competitive product, the defendant sold the competitive product below its incremental cost for the competitive product;<sup>[21]</sup> (2) the defendant is likely to recoup these short-term losses; and (3) the bundled discount or rebate program has had or is likely to have an adverse effect on competition.<sup>22</sup>

The AMC asserted that the first element of the test would “establish that bundled discounts should be subject to scrutiny under Section only if they could exclude a hypothetical equally efficient competitor.”<sup>23</sup>

For present purposes, I leave aside the question whether the initial criterion that the AMC adopted – that is, exclusion of an equally efficient competitor – is the correct one in this context. I also leave aside suggestions – which have considerable force – that all discounting should be per se lawful because of the definite benefit for consumers and the highly speculative nature of any possible subsequent harm. Instead, the question I consider is whether the AMC’s proposed standard meets its own criteria of being clear and predictable in application and administrable and whether it avoids overdeterrence (or underdeterrence) of the supposedly undesirable discounting behavior.

The standard seems to fail that test. To see why, consider the following simple example of a three-product bundle. The defendant faces no competition for the first product A, slight competition for the second product B, and the market for the third product C is reasonable competitive. If purchased separately, each costs 10 dollars with an incremental cost of 7 with no scope economies. If A and B are purchased together the price is 18; if all three are purchased the price is 26. Does the bundled rebate flunk the first hurdle? On the one hand, it could be argued that it does: the overall “discount” is 4 dollars; at 6 dollars C is priced below cost. On the other hand, it could be argued that it does not, because the *additional* discount (compared to a package of A and B) is only 2, which leave price above incremental cost. Or, one might argue that some portion of the discount should be allocated to B, because there is *some* competition for that product. Or, one might argue that how the discount should be allocated should depend on actual consumption patterns. In any event, the standard, as articulated by the AMC, simply does not explain how the test is to be applied.

Moreover, the standard does not make sense on its own terms. The AMC requires that the defendant be “likely to recoup . . . short-term losses,” but the standard does not require that there *be* any losses – to the contrary, presumably the discounts that are of interest are those that involve pricing that is *above* overall cost. Again using the example of a hypothetical three-product bundle, suppose now that the defendant is a monopolist in products A and B, and that the only alternative to purchasing all products separately is to

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<sup>21</sup> Presumably, incremental cost of the competitive product takes any economies associated with joint provision of the competitive product into account, though it would not appear to allocate any joint costs to the competitive product.

<sup>22</sup> *Id.* at 99.

<sup>23</sup> *Id.* at 100.

buy the bundle of A, B, and C, at a price of 23. Assume for present purposes that this pricing pattern clearly flunks the AMC's price-cost test, because, if the discount of 7 is applied to product C, it is well below cost. What, then, does it mean for the defendant to "recoup . . . losses" from this pattern of discounts? The AMC may have meant that the competitor could recoup the difference between the price of the "competitive product," reduced by "all discounts and rebates," and its incremental cost – that is, it would have to recoup the "loss" of 4 from each sale of the bundle. If that is indeed what the AMC meant, then if there were sale of 10,000 units at the discounted price before the hypothetical efficient competitor in C were driven from the market, the defendant would have to be likely to "recoup" a "loss" of 40,000. But what would "recoupment" consist of? Presumably, the pricing power that matters is in Product C, but if Product C is still available in a three-product bundle at a price of 29 is there *any* recoupment (arguably not, since the defendant is still discounting below the stand-alone price) or is there recoupment of 2 (since the discount, attributed to Product C, still leaves its price 2 above its incremental cost)? Again, the AMC does not say.

There seem to be additional difficulties. The test is almost certainly not administrable. The test assumes clear distinctions between products that are competitive and those that are not and an ability accurately to measure "discounts." But in most cases, market power for particular products rests on a continuum, and identifying discounts and rebates is difficult. As the previous examples suggest, in any multi-product bundle – particularly when consumers may purchase various products in the bundle – identifying the "undiscounted" price may be controversial. Without an ability to identify that undiscounted price, one cannot measure the discount. And this says nothing about the notorious difficulty of accurately determining incremental cost of the competitive product, particularly given the difficulties of identifying and allocating joint costs for goods in a bundle. In short, it seems unlikely that the usual process of civil litigation would uncover sufficient information to provide sure answers to the question that the standard poses, or that a lay jury would be able to distinguish between conflicting expert opinions on the subject.

In light of the foregoing problems, the test that the AMC proposes – if widely adopted – would almost certainly deter discounting that would not be condemned if perfect information were available and the test were accurately applied. Precisely because of the uncertainty in the standards and the complexity of the data, expert economists may disagree about the appropriate measures of price and cost, and – presented with a small company claiming to have been "victimized" by the aggressive pricing practices of a dominant competitor – a jury may frequently err in favor of imposing liability. Given that risk, a potential defendant may predictably pull its competitive punches by discounting less aggressively than it otherwise would – leaving prices higher and perhaps protecting inefficient competitors.<sup>24</sup>

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<sup>24</sup> The third element of the test – which requires an actual or likely "adverse effect on competition" – certainly adds no clarity and makes the test no more predictable or administrable. Nor would it be likely to mitigate overdeterrence, as it seems unlikely that a fact-finder would find, in a suit by a failed competitor, that the first two elements were satisfied but that there had been no effect on competition.

The AMC's response to all of this might well be that the problem is complicated but real, and that, based on commentary by a variety of leading antitrust scholars and economists, the standard was the best compromise and superior in material respects to the non-standard of *LePage's*. Nevertheless, disappointed competitors will have a natural inclination to attempt to exploit this test, precisely to deter aggressive discounting by rivals. In so doing, they are likely to attempt to use the AMC's test as a template. In particular cases, courts will continue to be presented with the question whether the AMC's test is sufficiently protective of desirable discounting behavior, and defendants – and plaintiffs – will continue to be pressed to define applicable standards in a way that is most consistent with the underlying pro-consumer goals of antitrust law. The AMC's analysis and overall approach provides valuable insights, but it would be unfortunate if the standard that it has proposed truncated a process of law-formation that still has a long way to go.

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