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I INTRODUCTION

The antitrust law of bundled discounts is unsettled. *LePage's*[1] broadly condemned bundled discounts instituted by a dominant firm where it appeared that the discounts served no economic purpose other than to place rival, single-product suppliers at a competitive disadvantage. In contrast, *PeaceHealth*[2] more recently proposed a less restrictive standard, requiring for antitrust liability that the firm's attributed price, allocating all discounts on the entire bundle of products to the rival's product, be less than the firm's costs of producing that product.

A major shortcoming in both of these decisions, and in antitrust analysis more generally, is the failure to understand the competitive role served by bundled discounts. This absence of a pro-competitive rationale has fundamentally influenced the terms of the debate and antitrust litigation. Without an understanding of the pro-competitive economic forces that may lead firms to use bundled discounts, competition does not appear to be

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[1] LePage's Inc. v. 3M Co., 324 F. 3d 141 (3d Cir. 2003) [hereinafter *LePage's*].

[2] Cascade Health Solutions v. PeaceHealth, 502 F. 3d 895 (9th Cir. 2007).

occurring “on the merits.”[3] This leaves bundled discounts unnecessarily vulnerable to challenge on monopolization/attempted monopolization grounds. The Antitrust Modernization Commission’s attempt to develop reasonable safe harbor screens,[4] including the attributed price less than cost requirement adopted by the *PeaceHealth* court, was an effort to control such challenges to pricing arrangements generally considered part of the normal competitive process, even if we do not know exactly what purpose they serve.

The goal of this article is to begin to fill this gap in our economic understanding by outlining the possible efficiencies associated with bundled discounts. In undertaking this economic analysis, this article focuses on cases of bundled discount arrangements that have the potential effect of limiting competitors’ access to the market by controlling distribution. This may occur, for example, when bundled discounts have the effect of limiting a rival tape supplier’s access to retail distribution (the claim in *LePage’s*) or when bundled discounts similarly restrict a rival hospital’s ability to serve consumers (the claim in *PeaceHealth*).

The use of bundled discounts to obtain preferred distribution at the expense of rivals is different from bundling cases where multiple goods are sold together as a single package, either as a way to reduce transaction costs,[5] as a way to use a complementary

[3] “Competition on the merits” was the term used by the U.S. Court of Appeals for the DC Circuit in describing the absence of a pro-competitive justification for Microsoft’s exclusive browser distribution contracts, where “competition on the merits” was defined in terms of, “for example, greater efficiency or enhanced consumer appeal.” United States v. Microsoft Corp., 253 F.3d 34 at 59 (D.C. Cir. 2001) (en banc).

[4] ANTITRUST MODERNIZATION COMMISSION, REPORT AND RECOMMENDATIONS (2007).

[5] *See* David S. Evans & Michael Salinger, *Why Do Firms Bundle and Tie? Evidence from Competitive Markets and Implications for Tying Law*, 22 YALE J. REG. 37 (2005).

consumable to meter demand for a durable good,[6] or as a way to implicitly price discriminate between buyers who have different relative valuations of the components of the package.[7] While pro-competitive business justifications exist in the economic literature for these cases of packaged bundling, a business justification for bundled discounts as a way to obtain preferred distribution, as occurred in *LePage's* and *PeaceHealth*, does not now exist.[8]

II. THE ECONOMIC EFFICIENCIES OF BUNDLED DISCOUNT ARRANGEMENTS

In analyzing the potential economic efficiencies of bundled discount arrangements, it is useful to break the economic analysis into two distinct questions corresponding to the two aspects of the bundled discount contract:

1. what the firm is buying from the distributor, and
2. how the firm is paying the distributor for what it is buying.

With regard to the first aspect of the contract, the firm is buying preferred distribution for its products relative to rival products; with regard to the second aspect of the contract, the firm is paying for preferred distribution with price discounts for other products on which the firm possesses market power. The economic question is whether there is a pro-competitive justification either for the preferred distribution the firm is purchasing or for the form of payment the firm is making for preferred distribution.

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[6] For example, Illinois Tool Works v. Independent Ink, 547 U.S. 28 (2006).

[7] George J. Stigler, *United States v. Loew's: A Note on Block Booking*, 1963 SUP. CT. REV. 152.

[8] The pro-competitive justification offered by 3M for its bundled discounts in *LePage's* was the consumer desire for single invoices and single shipments. However, this could have been accomplished by 3M without the use of bundled pricing. *LePage's*, *supra* note 1, at 164.

A. The Purchase of Preferred Distribution

A pro-competitive justification for the purchase of preferred distribution is not obvious. Although price discounts related to the total quantity purchased by a distributor may be cost-justified, there does not appear to be an economic justification for price discounts based on the relative share of the distributor's sales devoted to the firm's products. One may reasonably ask why price discounts to a distributor would be based on who else the distributor buys from.

The preferred distribution contractual arrangements in *LePage's* and *PeaceHealth* are analytically similar to loyalty rebates and market share discount contracts. These types of contracts all provide distributors with an incentive to increase their sales share of a chosen supplier's products at the expense of rival products. A pro-competitive justification for such preferred distribution contracts, therefore, may appear to be related to the pro-competitive justifications for exclusive dealing contracts, with exclusive dealing merely interpreted as an extreme form (100 percent) of preferred distribution.[9]

However, the usual pro-competitive justifications for exclusive dealing do not seem to fit the preferred distribution contracts at issue in *LePage's*, *PeaceHealth*, or other bundled discount restricted distribution cases. All of the accepted justifications for exclusive dealing rely implicitly or explicitly on contracting problems (contract specification, monitoring or enforcement of distributor performance) that are mitigated

[9] Market share discount contracts are described as partial exclusive dealing contracts in Willard K. Tom, David A. Balto & Neil W. Averitt, *Anticompetitive Aspects of Market-Share Discounts and Other Incentive to Exclusive Dealing*, 67 ANTITRUST L.J. 615 (2000).

by exclusivity.[10] Such contract enforcement problems do not exist in our preferred distribution cases, where all that is being contracted for is a greater share of the distributor's sales.

Rather than relying on a variant of the standard justifications for exclusive dealing, the preferred distribution element of bundled discount contracts can be explained as a normal aspect of competition for distribution in the common case when distributors have loyal consumers.[11] Distributors with loyal consumers have the ability to shift a share of their sales to a chosen manufacturer, and in fact such share-shifting is what manufacturers are competing for with price discounts and upfront payments when they contract for preferred distribution. Inter-distributor competition then can be expected to largely pass these payments for preferred distribution on to consumers in lower retail prices, which further reinforces consumer loyalty.

For example, manufacturers of office supply products may compete for preferred distribution at Staples and Office Depot by offering price discounts and upfront payments. Staples and Office Depot then compete for consumers (who are concerned about the overall package of prices, variety, and service they receive from the retailer) by passing on the payments they receive for preferred distribution in lower retail prices. Retailers, therefore, can be thought of as acting as agents for their consumers when they negotiate with suppliers, possibly trading off reduced product variety for larger price

[10] For a list of commonly accepted economic justifications for exclusive dealing, *see* Jonathan M. Jacobson, *Exclusive Dealing, "Foreclosure", and Consumer Harm*, 70 ANTITRUST L.J. 311, 357-60 (2002).

[11] The following is a summary of the analysis presented in Benjamin Klein & Kevin M. Murphy, *Exclusive Dealing Intensifies Competition for Distribution*, 75 ANTITRUST L.J. (forthcoming 2008).

reductions in circumstances where consumers as a group prefer a single supplier at a lower price.

This analysis is similar to the competitive share-shifting negotiations by pharmacy benefit managers (PBMs), who offer pharmaceutical manufacturers a preferred position on their formularies in return for wholesale drug price discounts. It similarly explains why hospitals, such as PeaceHealth, will offer insurers price reductions in return for a preferred provider designation. By reducing the co-pay, either of the preferred drug or the preferred hospital, the insurer is able to shift share to a designated supplier, and in return receives favorable prices to the ultimate benefit of consumers.

B. Payment for Preferred Distribution with Bundled Price Discounts

Recognizing that contracting for preferred distribution is likely to be part of the competitive process, we turn now to the second question of whether there are any efficiencies of paying for preferred distribution with bundled price discounts. *LePage's* and *PeaceHealth* involved payment for preferred distribution with a price discount on one product, call it product A, where the firm possessed market power, contingent on the distributor's commitment to purchase a preferred amount of another product, product B, where the firm faced competition. In *LePage's*, product A was 3M's Scotch-brand transparent tape and product B was private label transparent tape. 3M provided retailer discounts on Scotch tape (and other 3M products) contingent on the retailer's purchase of 3M private label tape. Similarly, in *PeaceHealth*, product A was tertiary hospital services (such as cardiovascular surgery and intensive neonatal care on which PeaceHealth had market shares greater than 90 percent) and PeaceHealth provided insurers with discounts on these services contingent on the insurer's designation of PeaceHealth as the preferred provider of product B, primary and secondary hospital services (less complex services such as setting a broken bone or performing a tonsillectomy, for which PeaceHealth had a lower market share and faced greater competition).

Independent of whether there is a pro-competitive rationale for a firm's purchase of a significant share of a distributor's sales of a product, there does not appear to be a pro-competitive reason why 3M or PeaceHealth purchased their preferred sales share with this type of bundled discount, to the claimed disadvantage of rival suppliers of the competitive product (suppliers of private label tape or of primary and secondary hospital services). (It is important to recognize, however, that if fully attributed price remains above cost, rival suppliers can offer sufficiently low prices on their single products to obtain distribution.)

This second aspect of bundled discount arrangements often may be an efficient way for a firm to pay for preferred distribution. As described by Barry Nalebuff,[12] it does not cost a firm as much to purchase preferred distribution of B with a price discount on A when there is a greater price-marginal cost gap on A than on B. In these circumstances it is more profitable for the firm to move down its demand curves by discounting A rather than B because the firm earns greater profits on increased sales of A than on increased sales of B. Consequently, bundled discounts can increase manufacturer profit, and by reducing a monopoly distortion also increase consumer welfare.

[12] Barry Nalebuff, *Bundling As An Entry Barrier*, 119 Q.J. ECON. 159 (2004).

The PeaceHealth court used this result to conclude that, contrary to the predatory pricing framework of *Brooke Group*[13] and the Antitrust Modernization Commission's proposed second safe harbor, recoupment was not a reasonable screen in bundled discount cases since the efficiencies of bundled pricing imply that firms need not bear any short-term costs when implementing bundled discounts. But this analysis also implies that bundled discounts need not be motivated by anticompetitive intent or have any anticompetitive effect; bundled discounts in these circumstances may be an element of the normal competitive process with beneficial effects for consumers.

III. CONCLUSION

The antitrust policy implications of this economic analysis of bundled discount contractual arrangements are complex and case-specific. But the important general policy implication is that, given the possibility of pro-competitive efficiencies associated with bundled discount contracts, there must be a more systematic demonstration of significant anticompetitive effects, perhaps by requiring a minimum foreclosure of distribution, rather than merely relying on the claim that competition is not occurring "on the merits."

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