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Bundling has become antitrust law's "hot button." Push it and out pours a gusher of articles by learned scholars¹ and noted practitioners.² One ventures into the fray filled with trepidation. But venture one must because the backwash of the bundling cornucopia threatens to overwhelm the traditional analysis of exclusionary contractual practices which can constitute, or at least contribute to, antitrust violations under the Sherman Act. Were that to happen, it would be a doctrinal shipwreck of major proportions.

The term bundling is generally applied to the practice by a seller of charging less for a bundle of goods than for its components when sold separately. At least theoretically, when a near or actual monopolist bundles, competition can be harmed if rivals (either

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¹ See, e.g., HERBERT HOVENKAMP & ERIK HOVENKAMP, EXCLUSIONARY BUNDLED DISCOUNTS AND THE ANTITRUST MODERNIZATION COMMISSION (U. Iowa L. Stud. Res. Paper, No. 08-14, Jun. 2008), available at <http://ssrn.com/abstract=1126723>; John H. Kilper, *A Bundle of Trouble: An Analysis of How the Lower Courts Have Handled Bundled Discounts Since LePage's Inc. v. 3M*, 72 MO. L. REV. 203 (2008).

² See, e.g., Richard M. Steuer, *Bundles of Joy*, 22 ANTITRUST 25 (2008); Mark S. Popofsky, *Essay: Section 2, Safe Harbors, and The Rule of Reason*, GEO. MASON. L. REV. (forthcoming 2008).

alone or in concert with others) are unable to match the diversity or price of the bundles. In those circumstances, the dominant party may use bundled pricing to exclude (or limit the growth of) equally efficient competitors, thereby harming the competitive process. While bundling is ubiquitous, antitrust concerns often arise (as in *LePage's*) when the seller offers rebates to a buyer who, by aggregating its sales over a period of time such as one year, earns a rebate (functionally a discount).

While courts have addressed variants of bundled pricing since as early as 1978,³ the issues associated with it gained prominence only in 2004 when a divided U.S. Court of Appeals for the Third Circuit sitting en banc in *LePage's* found 3M's cross-product line bundling and rebate practices illegal under Section 2 of the Sherman Act. More recently, the U.S. Court of Appeals for the Ninth Circuit in *PeaceHealth* declined to follow the precedence set in *LePage's*, opting instead to endorse a modified form of the "safe harbor" screen recently proposed by the bipartisan Antitrust Modernization Commission ("AMC").⁴

However fascinating these current debates, they possess the potential for distorting the law's application to other practices potentially harmful to the competitive process. Both *LePage's* and, less obviously, *PeaceHealth* addressed price competition without more.⁵ That is to say, the cases involved complaints by competitors allegedly

³ See *SmithKline Corp. v. Eli Lilly & Co.*, 575 F.2d 1056 (3d Cir. 1978); and *Ortho Diagnostic Sys., Inc. v. Abbott Labs., Inc.*, 920 F. Supp. 455 (S.D.N.Y. 1996).

⁴ See ANTITRUST MODERNIZATION COMMISSION, REPORT & RECOMMENDATIONS 100 (2007) [hereinafter AMC Report], available at http://govinfo.library.unt.edu/amc/report_recommendation/amc_final_report.pdf.

⁵ In *PeaceHealth*, the issue was whether PeaceHealth, the largest hospital in Eugene, Oregon and the only provider of tertiary care services, engaged in unlawful attempted monopolization of the market for primary and secondary care when it offered two of the largest insurers in the area (albeit covering only 15

disadvantaged by a monopolist's offer of discounts spread over a bundle of products, including some which the rival did not and could not offer. In neither case did the plaintiff prove that the prices were below the defendant's costs regardless of how such costs were calculated (attributed or otherwise). What was not at issue, however, was whether formal contracts—whether they are ties, exclusives, or market share commitments—were illegal because they directly and substantially foreclosed competitors' opportunities without reference to price.

The crux of the problem is that the price versus contract distinction matters. Where price alone is the mechanism that compels a purchase and harms a rival, the lower prices presumptively benefit consumers and reflect production or distribution efficiencies—a presumption that should not be lightly disregarded when the risk of false positives (i.e., condemning that which is beneficial to consumers) is inevitably high. In such cases, a broad cost-based safe harbor makes sense based on, or as in *PeaceHealth* derived from, the predatory pricing rule announced in *Brooke Group*.⁶ That is true even if cost-based safe harbor constructs are more difficult to apply than many might assume, involving, as they do, issues such as economies of scope derived from joint product production and practical limitations on a plaintiff's ability realistically to switch a portion of the defendant's sales.

Different competitive concerns apply when exclusionary contractual devices—whether they are fully exclusive or not—are at issue. Although such contracts are not (or,

percent of private insureds) a discount on all three categories of service for the ensuing annual contract period if PeaceHealth were designated their sole preferred provider. The resulting contracts were terminable on short notice with virtually no switching costs.

⁶ *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993) [hereinafter *Brooke Group*].

in the case of ties, are not strictly) illegal per se, they are subject to a substantial foreclosure analysis where no safe harbor screen applies. Rather, to determine legality, courts must assess the effects of the contracts in their “real-world” setting in order to determine whether they violate, or contribute to a violation of, the Sherman Act. And so it has been since the seminal Supreme Court ruling in *Tampa Electric Co. v. Nashville Coal Co.*⁷ Precedence set by recent cases and the Antitrust Modernization Commission recommendations do not suggest otherwise.⁸ As Professor Steven C. Salop observed: “[T]he Brooke Group standard is not generally proposed as the liability standard for exclusionary conduct other than predatory pricing.”⁹

Predatory pricing in its various forms and exclusionary contractual practices differ in important respects.¹⁰ Cases involving exclusionary contracts do not involve the same risk of false positives as when the plaintiff complains about the defendant’s low prices. Unlike low prices, exclusionary contracts do not always benefit consumers in the short

⁷ *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320, 329 (1961).

⁸ The AMC Report states: “The recommended three part test is proposed here for challenges to bundled pricing practices and its purpose ... is to avoid deterring procompetitive price reduction. The Commission is not recommending application of this test outside the bundled pricing context, for example in tying or exclusive dealing cases.” (AMC Report, *supra* note 4, at 114, n.157). See also Jonathan M. Jacobson, *Exploring the Antitrust Modernization Commission’s Proposed Test for Bundled Pricing*, 21 ANTITRUST 23, 27 (Summer 2007) (where the practical effect of the bundled discount is to effectuate an exclusive dealing arrangement “normal ... exclusive dealing standards should apply”).

⁹ Steven C. Salop, *Exclusionary Conduct, Effect on Consumers, and the Flawed Profit-Sacrifice Standard*, 73 ANTITRUST L.J. 311, 319 (2006),

See also Willard K. Tom et al., *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 ANTITRUST L.J. 615, 637 (2000) (“The concern in exclusive dealing situations is not that prices are predatory, or, if not predatory, that their general level is low enough to cause a competitive problem. Rather, the concern is that the particular structure of the prices is designed in such a manner that it amounts to a *de facto* exclusivity requirement. This is an inquiry very different from predation.”).

¹⁰ See Salop (2006), *supra* note 9, at 314-18.

term, regardless of their long-term effect on competition.¹¹

Moreover, while exclusionary contracts may not necessarily prevent a new competitor from entering the market, they may well limit a smaller rival's reach and relegate it to low-volume, high-cost operations.¹² In doing so, they may limit the development of effective competition with the dominant firm.¹³ The cost to society is the potential for high monopoly prices insulated from market forces.

Certainly many exclusionary contracts are induced by price incentives which make such arrangements attractive to both parties. Indeed, the competitive efficiencies associated with such contracts subject them to antitrust analysis under the rule of reason where they can be measured against potential competitive harms. But a contracting party only agrees to an exclusive dealing contract when it perceives some financial benefit for itself—whatever the consequence for others in the marketplace. In other words, the fact that such contracts are voluntary does not mean that their effects on consumers and the competitive process are ipso facto benign.

Two recent government cases illustrate the significance of allegedly exclusionary contractual conduct irrespective of the prices charged by the seller. While both may be questioned on their particular facts, they illustrate the relevant analysis. The first is *Dentsply*, where the U.S. Department of Justice challenged a monopolist's policy of

¹¹ See, e.g., Susan A. Creighton, D. Bruch Hoffman, Thomas G. Krattenmaker & Ernest A Nagata, *Cheap Exclusion*, 72 ANTITRUST L.J. 975 (2005); EINER ELHAUGE & DAMIAN GERADIN, GLOBAL ANTITRUST LAW AND ECONOMICS 626 (2007); Jonathan M. Jacobson & Scott A. Sher, "No Economic Sense" Makes No Sense for Exclusive Dealing, 73 ANTITRUST L.J. 779 (2006).

¹² See *United States v. Dentsply Int'l Inc.*, 399 F.3d 181, 191 (3d Cir. 2005) [hereinafter *Dentsply*].

¹³ See, e.g., Illya Segal & Michael D. Whinston, *Naked Exclusion: Comment*, 90 AM. ECON. REV. 296 (2000); Philippe Aghion & Patrick Bolton, *Contracts as a Barrier to Entry*, 77 AM. ECON. REV. 388 (1987).

requiring its independent dealers to carry only its line of false teeth. Notwithstanding this policy, Dentsply allowed dealers who had previously sold competitors' products to continue doing so, and Dentsply's five largest dealers all continued to sell competing brands.¹⁴ While dental laboratories were the actual consumers of the artificial teeth, buying and selling through dealers provided significant benefits to both manufacturers and laboratories.¹⁵ The district court rejected the government's claims because direct sales to laboratories were a "viable" means of distribution. However, the U.S. Court of Appeals for the Third Circuit disagreed, stating: "[I]t is 'viable' only in the sense that it is 'possible,' not that it is practical or feasible in the market as it exists and functions."¹⁶ According to the Court: "The proper inquiry is not whether direct sales enable a competitor to 'survive' but rather whether direct selling 'poses a real threat' to defendant's monopoly."¹⁷

The U.S. Court of Appeals for the DC Circuit engaged in a similar analysis in *U.S. v. Microsoft*.¹⁸ Among other things, Microsoft entered into allegedly exclusionary agreements with Internet access providers (IAPs) such as AOL. Although AOL's agreement allowed it to supply rival Internet browsers to up to 15 percent of its subscribers, the Court analyzed it as an exclusive dealing arrangement.¹⁹ The Court concluded that the IAP agreements substantially foreclosed competition because IAPs

¹⁴ *Dentsply*, *supra* note 12, at 185.

¹⁵ *Id.* at 192-93.

¹⁶ *Id.* at 193; *see also id.* at 196 ("The mere existence of other avenues of distribution is insufficient without an assessment of their overall significance to the market.").

¹⁷ *Id.* at 193.

¹⁸ *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001) [hereinafter *U.S. v. Microsoft*].

¹⁹ *Id.* at 68.

were one of two major channels of browser distribution.²⁰ The Court also found that Microsoft's agreements with independent software vendors (ISVs) violated Section 2 of the Sherman Act even though they were a "relatively small channel," because they had a "substantial effect in preserving Microsoft's monopoly" given Microsoft's other anticompetitive conduct.²¹ Similarly, the Court found a Section 2 violation in Microsoft's agreement with Apple to make Internet Explorer the default browser on Apple's computers because, even though Apple was a relatively small manufacturer, the agreement helped protect Microsoft's browser monopoly.²² Finally, the Court condemned Microsoft's "first wave agreements" with ISVs because, "although not literally exclusive, the deals were exclusive in practice because they required developers to make Microsoft's [platform] the default in software they developed."²³ The Court did not attempt to quantify the foreclosure caused by these separate agreements, but noted that they "took place against a backdrop of foreclosure."²⁴

Allegedly exclusionary contracts are also at issue in the closely-watched *Masimo* litigation now being briefed in the U.S. Court of Appeals for the Ninth Circuit. There, a medical equipment supplier won a substantial jury verdict under Section 2 based, inter alia, on the claim that various contracts entered into by the defendant monopolist (Tyco) with large hospital purchasing organizations ("GPOs") as well as directly with member hospitals were exclusionary under traditional foreclosure standards. Tyco enjoyed the

²⁰ *Id.* at 71-72.

²¹ *Id.* at 72.

²² *Id.* at 73-74.

²³ *Id.* at 75 (discussing the district court's findings).

²⁴ *Id.*

built-in advantage of an installed equipment (monitor) base which required follow-on purchases of oximetry sensors (analogous to the razor blade) and laced the market with intersecting contracts, the combined effect of which was alleged to inhibit erosion of its monopoly position. On appeal, Tyco argued that nothing is truly involved other than consumer-friendly price discounts even if the discounts induced contracts containing the discount terms. The practices challenged as illegal include “sole source” agreements with multiple GPOs, market share agreements requiring hospital purchasers to buy a portion (90 percent) of their oximetry needs from Tyco, and bundled pricing (the latter were found illegal by the jury pre-*PeaceHealth*, but the trial court vacated that portion of the verdict which had been predicated on instructions framed on the basis of *LePage’s*). The case illustrates the potential significance courts may attach to contracts which bind end-user purchases where exclusion may be more readily found, as in *Masimo*, in contrast to those which operate only at the distributor level.²⁵

As the *Masimo* litigation illustrates, where one draws the line between price and contract can be severely contested even when actual contracts are involved. As previously noted in *PeaceHealth*, the “victor” in the price competition was awarded a one-year contract for exclusive preferred-provider status, but the agreement could be cancelled without meaningful switching costs on very short notice. The Ninth Circuit correctly viewed the issue as one involving straightforward price competition. Conversely, in *Minn. Mining and Mfg. Co. v. Appleton Papers Inc.*,²⁶ although the contracts at issue were technically “at will,” the trial court held that high switching costs

²⁵ See *Omega Envtl., Inc. v. Gilbarco, Inc.*, 127 F.3d 1157 (9th Cir. 1997).

²⁶ *Minn. Mining and Mfg. Co. v. Appleton Papers, Inc.*, 35 F. Supp. 2d 1138 (D. Minn. 1990).

presented a triable issue of fact concerning whether they created an effective “lock in” which was the functional equivalent of a long-term exclusionary contract. Post-*PeaceHealth*, one may venture that the Appleton “switching cost” analysis would still apply under the rubric of assessing the “practical effects” of a practice rather than a cost-based screen as was the case in *PeaceHealth*, although the clash between the two seems particularly vivid on those facts. Certainly switching costs were a vital part of the considerations which drove the outcome in *Dentsply*, even though the challenged restraint operated at the distributor rather than end-user level.

Put simply, contracts matter. Price discounts alone are a thin shield from competitor poaching. Only contracts can wall off buyers from a competitor and then only for the contract term, which is why short-term “exclusives” are viewed no differently than straight price competition. While a competitor can theoretically “buy out” an existing rival’s contract with a customer, it can only do so practically at term end otherwise it runs the risk of tort liability with its attendant indeterminate transaction costs, such as attorneys’ fees.²⁷

Some conclusions seem apparent even where end-user pricing is at issue: short-term or one-year rebate or discount practices without contractual commitment probably fall on the price side of the ledger, even though it may be more difficult in practice for a buyer to be induced to change its supplier as discounts or rebates mount toward the end of the program term. Even then, the practical ability of a buyer to switch its custom must be assessed and conceivably may trump a straight price-based analysis. *LePage’s*, which

²⁷ See *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F. 2d 227 (1st Cir. 1983).

involved no switching cost concerns, seems clearly wrong in condemning 3M's price bundling as illegal "de facto" exclusive dealing without having required an analysis of whether 3M's prices were below cost in the aggregate or on an attributed basis (as the dissent would have required). Accordingly, the Ninth Circuit in *PeaceHealth* was wise to part company with the Third Circuit while effectively limiting *Gilbarco* to its known habitat—namely, contracts with distributors where alternative means of accessing consumers are available. While the law continues to develop and *Masimo* may shed light on the subject, it seems clear at least that there should be no cost-based safe harbors for durable contractual undertakings which pose substantial risks of competitive harm, *Brooke Group* and its preterit progeny notwithstanding.