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Tying and Consumer Harm

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ABSTRACT:
Brantley raises important issues of law, economics, and policy about tying arrangements. Under current legal principles, Brantley was on solid ground in distinguishing between anticompetitive ties and those that might harm consumer interests without impairing competition. As a matter of economics, the court was also right to reject the claim that the cable programmers forced consumers to pay for programs the customers didn't want. The hardest question is a policy one - whether antitrust law should ever condemn the exploitation of market power in ways that extract surplus from consumers but do not create or enlarge market power. I shall argue that Brantley got this last question right as well.

I. INTRODUCTION

In *Brantley* v. *NBC Universal, Inc.*,[1] the Ninth Circuit rejected a putative class action by cable television subscribers against cable television programmers because the subscribers' tying claims were unsupported by any theory of anticompetitive effects. Note that the court rejected the plaintiffs' case because of the absence of allegations of *anticompetitive* effects and not merely the absence of *exclusionary* effects. As the court recognized, tying can be anticompetitive without being exclusionary when it facilitates horizontal cartelization. The important principle of *Brantley* is that tying that allegedly harms consumer welfare, but without reducing the competitiveness of any market, is not cognizable under the antitrust laws.

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[1] 675 F.3d 1192 (9th Cir. 2012)

tive ties and those that might harm consumer interests without impairing competition. As a matter of economics, the court was also right to reject the claim that the cable programmers forced consumers to pay for programs the customers didn't want. The hardest question is a policy one - whether antitrust law should ever condemn the exploitation of market power in ways that extract surplus from consumers but do not create or enlarge market power. I shall argue that *Brantley* got this last question right as well.

II. THREE THEORIES OF CONSUMER HARM FROM TYING

Tying arrangements can harm consumer interests in three broad ways that could be relevant under the antitrust laws:[2] when they exclude competitors,[3] facilitate cartel arrangements,[4] or extract surplus from consumers.[5] The first theory - exclusion - is the one most commonly pursued in antitrust cases. It occurs when the tying firm leverages its market power in the tying market to diminish the competitiveness of the tied market by foreclosing the opportunity of rivals to obtain competitive traction in the tied market. The seller might do this in order to try and extract a second monopoly rent from the second market, although this theory raises the one monopoly profit theory and its detractions. Alternatively, the seller might obtain market power in the second market in order to circumvent rate regulators in the tying market or to erect barriers to entering the tying market. The *Brantley* plaintiffs initially pursued such a foreclosure theory, but then dropped it in their third amended complaint when discovery showed that the alleged tie hadn't excluded independent programmers from the programming market.[6]

Second, tying arrangements could be anticompetitive if agreed to collusively by vertically integrated competitors selling in both the tying and tied markets.[7] The *Brantley* plaintiffs made no such claim.[8]

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[2] *See generally* Daniel A. Crane & Graciella Miralles, T*oward a Unified Theory of Exclusionary Vertical Restraints*, 84 S. Cal. L. Rev. 605 (2011).
[3] Eastman Kodak Co. v. Image Tech. Servs., Inc., 504 U.S. 451, 481-85 (1992).
[4] *See* Christopher R. Leslie, *Tying Conspiracies*, 48 Wm. & Mary L. Rev. 2247 (2007).
[5] *See* Einer Elhauge, *Tying, Bundled Discounts, and the Death of the Single Monopoly Profit Theory*, 123 Harv. L. Rev. 397 (2009).
[6] 675 F.3d at 1196.
[7] Leslie, *supra* n.4.
[8] 675 F.3d at 1201.

This left a third possibility, that the programmers' tying or bundling harmed consumers without excluding rivals or enabling collusion. The *Brantley* plaintiffs alleged that the typical American consumer is only interested in watching 16-17 cable channels, and that "the average cable subscriber is forced to pay for 85 channels that he/she does not watch in order to obtain the approximately 16 channels he/she does watch."[9] The plaintiffs thus argued that the anti-competitive effect at issue was not due to the tying arrangement's exclusion of any rival from the market but from the direct exploitation of market power to force cable customers to buy more channels than they desired.

III. NON-ANTICOMPETITIVE TIES AND THE CONSUMER INTEREST

Lurking in the background of *Brantley* is a suspicion that dominant firms sometimes use their market power over one thing to force consumers to buy other things that they do not want. As noted, the *Brantley* plaintiffs alleged that they were being forced to purchase cable programs that they did not want: "Many small cable companies have testified that they are coerced by programmers into taking channels they do not want, and forced to resell them to consumers who similarly do not want certain channels."[10] Such claims resonate with Justice Stevens' statement in *Jefferson* Parish that "forcing" someone to buy a product he "did not want at all" is the core harm in a tying case.[11] Being forced to buy something you don't want sounds coercive and wrongful.

But at the heart of this claim lies a fundamental misconception. Contrary to popular belief, it is impossible for a seller to force a buyer to purchase something she *does* not want, unless the seller deceives the buyer about what she is buying or the buyer changes her mind after the purchase (in which case she hasn't really bought something she doesn't want but has bought something that she does want and then regrets her decision). Buyers will only pay for what they are willing to buy.

This proposition may seem intuitively wrong, because in many circumstances buyers may feel coerced to purchase something that they don't really want. But in every case where decep-

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9 *Brantley v. NBC Universal, Inc.*, No CV07-06191 CAS (VBKx), Third Amended Complaint at ¶ 21.

10 Third Amended Complaint at ¶ 44.

11 Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 12 (1984).

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tion is not at issue, the buyer is actually buying something she really does want and may find additional things thrown in for free. The contrary perception is an illusion.

Take, for instance, the extreme case of a seller holding a gun to the buyer's head and forcing her to cough up money for a product she has absolutely no interest in buying - the proverbial sale of sand to a Bedouin. To say that the Bedouin is forced to pay for sand isn't quite right. What she is really buying is her life - the sand is not any real part of the transaction. That the seller has wrongfully held a gun to her head obviously makes the transaction morally objectionable, but it does not diminish the fact that the buyer has secured something that she values more than her money - something that given the circumstances, she wanted to buy.

The same observation holds as to any circumstances where the seller wrongfully creates the buyer demand; for example, the miscreant who poisons the town well and then offers to sell the townspeople the antidote. The fact that the townspeople would not have wanted the antidote but for the criminal act does not diminish the fact that, faced with the illness, the townspeople are buying something they really do want.

The same observation applies in the far less extreme example of tying and bundling, which involves no criminal or otherwise unlawful threat. No matter how great its market power, the seller cannot force the customer to pay for something that she doesn't value. Suppose that the customer values Channel A at $3, Channel B at $1, and Channel C at $0. The seller can charge a price of up to $4 for an AB bundle. If it adds C to the bundle, it still cannot charge more than $4 for the bundle. The customer who pays $4 for the ABC bundle is only really buying A and B. If the seller throws in a hundred additional channels that the customer also doesn't value at all, the same follows. If the seller does not value the extra channels, she will not pay for or watch them. The seller can't exceed the buyer's reservation price. It can only extract payment for things that the buyer values.

Of course, sellers can sometimes charge buyers more than they prefer to pay for the things they do want. Indeed, sellers almost always charge buyers more than buyers want, since buyers would prefer to get everything they want for free. Buyers obviously can't get everything they want for free, since without payment there wouldn't be production or sales. In market economies, however, there is a general assumption that competition will drive prices down toward the cost of production, such that consumers reap all of the surplus of trade in exchanges with producers. Antitrust law arguably establishes marginal cost pricing as the normative baseline from which sellers cannot deviate through prohibited conduct.

So the real question as to non-anticompetitive ties is not whether customers are being forced to pay for something they don't want, but whether one of two other possible effects is occurring: (1) they are being forced to pay more than they should for the things they do want; or (2) they are forced to buy the things they do want from a disfavored seller. Let's examine the second circumstance before turning to the first.

On the other hand, there could be circumstances where the buyer has a preference for a rival's product and therefore suffers a loss in utility when forced to buy under a tying arrangement.

Effect (2) - buying something desired but from a disfavored seller - could be nothing more than an elaboration of (1) if the reason that buyers prefer not to buy from the tying seller is because they can buy the tied good less expensively elsewhere. In *International Salt*,[12] for example, the salt injection machine lessees all wanted to buy salt, without which the leased machines would have been quite useless, but may have wanted to buy from their salt requirements from other sellers in order to get a lower price. If the tying seller's salt was fungible with salt of the same grade sold by rivals - as the Supreme Court assumed was true - then the customer may simply have paid a higher price, at which point effect (2) collapses into effect (1).

On the other hand, there could be circumstances where the buyer has a preference for a rival's product and therefore suffers a loss in utility when forced to buy under a tying arrangement. If the buyer values a rival's good more than the tying seller's tied good, but her utility for the rival's good exceeds her utility for the tied good by less than the price of the rival's good, then she will decide to consume the tied good rather than make an additional purchase of the rival's good. At this point she may suffer a loss in utility as compared to being able to buy the tied and tying goods independently, even though she may have paid no more for the tied good than she would paid for the rival's good. In a world of low transactions costs the buyer might pay the seller to be relieved of the tie, but many different kinds of transactions costs could impede the bargain from that efficient solution.

The possibility that customers might lose some surplus because of the loss of a variety preference is an intriguing one, but it has no application to *Brantley*. The class alleged that they were being forced to pay for channels that they didn't want, not that they were being forced to give up channels they did want. Since, as already explained, the customers weren't actually being forced to pay for channels they didn't want, their claim only makes economic sense as a

[12] International Salt Co. v. U.S., 332 U.S. 392 (1947).

claim that they were being forced to pay *too much* for the channels that they did want.[13]

The mechanism by which this could have happened is well understood, having been explained long ago by George Stigler with reference to the block-booking cases.[14] Where different buyers have uneven and differentiated utility for a set of goods, the seller can increase the effective price for the goods by selling them in a package or block. Without knowing any customer's reservation price for any individual good in the block, the seller comes closer to customers' reservation price for all of the goods in the package. The seller thus uses tying to increase prices without harming the competitiveness of the market.

Should exploitation of this kind be covered by the antitrust laws? The normative case for illegality under the antitrust laws is weak, particularly given the draconian implications of the treble damages remedy.[15] Where tying arrangements do not diminish the competitive functioning of the market, but merely result in some possible extraction of consumer surplus, courts should not find liability, for two reasons.

First, the absence of an anticompetitive element means that the exploitation of market power through tying is conceptually no different from any other non-anticompetitive exploitation of market power that the antitrust laws do not cover. If a car buyer in a small rural town with a single car dealer has to pay 10 percent more than he would pay for the same car in a more competitive market, the dealer has exploited its market power to extract surplus from the consumer. If the dealer chooses to charge 10 percent less for the initial purchase price but requires the buyer to purchase his replacement tires from the dealer, thereby extracting a similar 10 percent premium over the life of the car, the economic effect on the consumer is identical. Why should it matter legally whether the exploitation of market power takes the form of a simple price premium on the car or a tying arrangement with the tires? The world is full of market power exploited by sellers. It is hard to find a principled reason to condemn one form and not another, unless the first form results in an enlargement of market power and the second does not.

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[13] The Third Amended Complaint in *Brantley* seems to recognize at points that the bundling at issue results in cable subscribers paying more for the shows they do want to watch rather than paying for shows that they don't want to watch. *See* Third Amended Complaint at ¶ 1 ("[T]he existing requirement that consumers purchase 50 or more expanded basic cable channels in the form of bundled tiers results in consumers paying inflated prices for the channels they do want to watch.").

[14] George J. Stigler, *United States v. Loew's Inc.: A Note on Block Booking*, 1963 Sup. Ct. Rev. 152.

[15] The case might be different in the patent misuse context, where the remedy is quite different.

Second, the level of adjudicatory complexity and the risks of false positives caution against allowing claims of non-anticompetitive ties. Complexity and false positives are intertwined here, because a court could not come to a robust judgment that the tying arrangement harmed consumer welfare without considering the many pro-competitive possibilities for such arrangements. As is well understood, tying arrangements can enhance consumer welfare in a number of ways: for example, by reducing production, distribution, or transactions costs; eliminating double marginalization; and permitting a seller to allocate its fixed costs to the customers with the least elastic demand which, in turn, allows it to increase output.

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While these same efficiency considerations, and hence concerns over complexity and false positives, are also present in cases involving allegedly anticompetitive ties, the interest in pursuing the claim is considerably higher. Firms that manipulate their present market power to obtain more power pose risks that firms that merely exploit their current power do not. Further, there is a principled basis for distinguishing legally between the exploitation of market power, which is ubiquitous and largely uncontrollable, and the deliberate enhancement of market power through exclusion or collusion, which is more contained and preventable.

IV. CONCLUSION

The *Brantley* court was correct to recognize that tying arrangements can have both exclusionary and collusive anticompetitive effects. Hence, foreclosure of rivals should not be a necessary condition for the illegality for tying arrangements in every case. The *Brantley* court was also correct in holding that some theory of anticompetitive effect from the tying arrangement - that is to say, some theory of how the tying arrangement reduced the market's competitiveness - should be required in every tying case. Pure exploitation theories of tying do not contain the necessary antitrust ingredients.