BUNDLED REBATES: A TEMPORARY BLIP ON THE ANTITRUST RADAR

BY: COLIN R. KASS *

Is private antitrust litigation becoming a dead letter? It seems as though the few doors that remain open are rapidly closing, leaving only the most hard-core offenses – like horizontal price-fixing – and the occasional patent misuse or abuse claim subject to serious scrutiny. That trend will likely continue.

In the last few years, the antitrust plaintiffs' bar has suffered a series of stinging blows at the High Court. Not once since 1995 has the Supreme Court sided with the plaintiffs in a major antitrust case. This unprecedented string of defeats continued through the last term, where the Court erected more roadblocks to plaintiffs' recovery in antitrust cases. Two more plaintiff-friendly decisions from the Courts of Appeal are now on deck for possible reversal this term. All of these cases demonstrate the Court's continued vigilance against using the Sherman Act as tool through which juries substitute their emotionally-driven judgment for free-market outcomes.

But this alone does not spell the end of private antitrust lawsuits. Despite High Court set-backs, lower courts remain more hospitably inclined. With recent judgments rendered against the likes of Microsoft, U.S. Tobacco, Visa/MasterCard, and 3M – all affirmed by the Courts of Appeals – the plaintiffs' bar can hardly complain about a lack of targets, now that many markets have been reduced to two or three players after the rush of "strategic mergers" in the 1990's.

In fact, right now is perhaps the most plaintiff-friendly time to bring a monopolization claim. A prime example of this plaintiff-friendly attitude is the Third Circuit's decision in *3M v. LePage's*, which purports to illegalize both "program pricing" (*i.e.*, prices or rebates that apply across multiple products) and individually-negotiated volume discounts. *LePage's Inc. v. 3M*, 324 F.3d 141 (3rd Cir. 2003). In *LePage*'s, the Third Circuit decided *en banc* (with now-Justice Alito dissenting) that 3M – the well-known maker of Post-it® Notes and Scotch® Tape – violated Section 2 of the Sherman Act.

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It did so by creating an innovative discount program where big box retailers would earn discounts by exceeding 3M's target threshold in each of six different six product categories. Miss just one target, and the retailer would lose discounts across all categories. Retailers, who were unwilling to risk the loss of these discounts, refused to mix and match competitors by using 3M for some categories, like Post-It® notes, and others, like LePage's, for transparent tape. Since LePage's could not economically reimburse retailers for its lost discounts on both tape (which it produced) and also Post-It Notes (which it did not), LePage's sales rapidly declined. In addition, 3M also individually negotiated volume discounts with the large retailers, which supposedly incentivized them to purchase exclusively from 3M. Collectively, these "bundled rebates" and "*de facto* exclusives" threatened LePage's viability, prompting it to successfully seek protection from the federal courts.

But *LePage*'s reverberations goes far beyond the $68 million treble damages awarded in that case. By putting at risk the long-standing pricing practices of virtually every consumer goods manufacturer, *LePage's* succeeded in driving fear through the hearts of large firms everywhere. Now, almost every effort to compete for business by offering unique discount packages or "programs" can be challenged as an unlawful "bundle" or a "*de facto* exclusive." This gives fringe firms lacking economies of scale or an attractive product an alternative forum: Rather than compete in the market place, they can compete in the courtroom.

But is it really so easy to prevail? For now, with the law so in flux, it very well may be. The Supreme Court has expressly decided not to close the door on these claims just yet. When 3M sought certiorari, the Supreme Court asked for the Solicitor General's views and then followed his request that the Court stay its hand while the lower courts feel their way through the morass of big firm pricing practices. *See* Brief for United States as Amicus Curiae, 2004 WL 1205191 (May 28, 2004) (urging the "the Court [to] deny the petition for a writ of certiorari and allow the lower courts an opportunity to refine and clarify the application of Section 2" since the "the applicability of the *Brooke Group* approach to this business practice would benefit from further judicial and scholarly analysis"). The result is a mix-mash of lower court decisions – now too numerous to cite here – reaching conflicting results.

But in the end, it will be economics that once again drives a stake through a new-found proliferation of questionable antitrust claims and closes the Pandora's box that *LePage's* opened. This is despite a pervasive "big is bad" mentality that drove the result in *LePage's* and understandably wins juries' hearts to this day. For what could be wrong with holding a dominant firm liable when it "punishes" and "retaliates" by withdrawing huge rebates from customers who do not bend to its will (by refusing to purchasing exclusively from the monopolist)?

The problem is that what constitutes "punitive" and "retaliatory" conduct is in the eyes of the beholder. Competitors know "punitive" conduct when they see it: It is anything that causes them to lose a sale, lower a price, or reduce their margins. Customers know it: It is anything that forces them to pay more than their "target" price. Juries know it: It is anything memorialized in inflammatory ails. The "Big, Bad" Monopolist knows it too: It is any conduct that makes no economic sense. (And certainly anything that helps it make a buck, makes economic sense).

But judges cannot so easily condemn conduct that others may characterize as "unfair." Nor can they approve – or condemn – conduct just because the monopolist benefits from it. Courts need clear standards that govern ***when*** inflammatory, retaliatory, or punitive conduct crosses the line and actually ***harms*** competition.

What should be clear is that harm to competitors is not enough. Firms might be as justly rewarded for harming a competitor as sanctioned for it. The antitrust laws love it when a firm – large or small – is "harmed" by having to lower its prices just to maintain its share of the market. This

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is the essence competition, not the antithesis of it. Similarly, a big firm that competes for – and wins – exclusivity does so by paying for it, which is just another way of saying that it lowered prices for increased sales. What is wrong with that?

Paying money to exclude rivals, or conditioning rebates and discounts on "screw[ing] your competitor," as Microsoft was accused of doing, are – as the *Le Page's* court characterizes them – agreements with "strings attached," to be sure. But as Judge Easterbrook, one of the nation's leading antitrust jurists, explained, "competition for the contract is a vital form of rivalry, and often the most powerful one, which the antitrust laws encourage rather than suppress." *Menasha Corp. v. News America Marketing In-Store, Inc.*, 354 F.3d 661 (7th Cir. 2004) (Easterbrook, J.).

> ***Two key questions govern: (i) does the financial incentive exceed the firm's incremental profits; and (ii) do these agreements restrict rivals' elasticity of supply.***

But this is not a pro-defense article, seeking to convince all readers that monopolists should be left alone to price how they please. Rather, there are clear, objective, and unmistakable ***economic*** tests for determining when a monopolist's price concessions, volume discounts, or bundled rebates cross the line.

These tests can be reduced to following two necessary and sufficient conditions for holding a monopolist liable for "attaching strings" to favorable prices: (i) Does the financial incentive used to garner additional business exceed the firm's profits on that business; ***and*** (ii) do these agreements drive rivals from the market (or otherwise restrict the elasticity of its rivals' supply)? These two tests – the "profitable incremental volume" test and the "recoupment" test – constitute a modified form of the Supreme Court's *Brooke Group* test for predatory pricing. But it has been altered to focus on bundling and exclusive dealing by ensuring the ***proper*** allocation of financial incentives to the products where the alleged foreclosure occurred.

How do we know whether these are the right two questions and that there are no others? Let's take the first question. Suppose a monopolist tells its customer that "if you purchase products from my competitor for even 1 of 100 SKUs (or products), I will withdraw every cent of promotional support you receive." Punitive? Certainly. Disproportionate? Probably. Retaliatory? Maybe. But anticompetitive? Not necessarily.

YOU SIMPLY HAVE TO DO THE MATH! What if the lost profits on that one SKU dwarfs any promotional payment the monopolist withdraws? Suppose, for example, the lost SKU carried a invoice price of $100 and a variable cost of $50, yielding $50 profit for each unit. Economists – not generally known for agreeing on anything – will uniformly say that, in a perfectly competitive environment, a producer should be willing to rebate up to $50 per unit off the invoice price in order to secure the business. So, if this SKU is a big seller – say 100,000 units a year – no one would argue that a monopolist should be permitted to ***increase*** its promotional funding by $5 million – the difference between the price of the product and the variable cost – in order to get this business.

Nor should it matter whether this $5 million comes in the form of a $5 per unit price reduction, a fixed rebate of $5 million for all of the products (*i.e.*, exclusivity), or a promotional support payment to be allocated across all 100 SKUs (*i.e.*, a bundled rebate). *LePage's* would suggest that the latter two types of offers – where the monopolist is paying for exclusivity or providing "bundled rebates" – are anticompetitive. But economically, all of these offers are the same and the law should treat them as such.

Similarly, just as there is no harm to competition from offering to increase promotional payments by $5 million to obtain this one SKU, there should be no concern about withdrawing $5 million if that SKU is lost. While it is easy to characterize a withdrawal of funds as "punitive" or "retaliatory," it is the same, mirror-image financial incentive as an increase. It makes no difference whether the $5 million is offered on top of some pre-existing amount if new business is added or whether the $5 million is deducted from some pre-existing amount when that piece of business is withdrawn. In either case, the seller is making the same offer: "I'll pay $5 million to guarantee the sale of this one SKU. Deal or no deal?"

If the customer takes the deal, then it essentially gets that product at cost. If it does not, the customer has obviously decided that the rival's offer is better than the monopolist's. Either way, it is the optimal competitive result. And far from discouraging competition, this kind of so-called "strings attached" offer is the very mechanism by which prices are forced down to competitive levels. Indeed, regardless of form, such an offer not only makes economic sense for the monopolist, but an "equally efficient producer" could – and would – match the offer. Because a low-cost niche competitor could beat the behemoth despite the "bundle," competition would be well served if courts stayed out of the competitive struggle.

Only when the financial incentive is so large that it exceeds the monopolist's incremental profits can it conceivably cross the line into anticompetitive territory. If, for example, instead of offering $5 million in promotional payments, a monopolist offered $10 million (again, to secure 100,000 additional units invoiced at $100 each), then the monopolist would be effectively giving this product away for free. A smaller, but equally efficient rival would not be able to match that offer. And putting aside externalities, the only reason the monopolist would have for "hurting itself" (by selling this specific product below cost) would be to prevent future competition from the rival, something antitrust law clearly forbids.

This "Profitable Incremental Volume" Test takes us most of the way home. But it doesn't get us there entirely. Simply offering a financial incentive that exceeds the value of the incremental business is not enough to show harm to competition. Just as in any predatory pricing scheme, consumers benefit in the short term through lower prices. Customers are only hurt if, in the next negotiating season, they face fewer choices and have to pay higher prices that outweigh the benefits of the prior deal. But this can only occur when rivals exit the market, allowing the monopolist to recoup its investment in below-cost pricing.

If smaller, but more nimble, rivals can find ways to succeed in the face of price bundling and de facto exclusives, they will continue to exert a strong competitive constraint on the market. Indeed, what could be better than perpetually forcing monopolists to price at their costs? And even if a rival's future is dim, it is still constrains the monopolist. For no monopolist can remain one for long if it doesn't beat competitive offers. Only when the rival is wiped from the face of the earth (and the earth then salted to prevent its future re-emergence) can the monopolist sit back and relax. Thus, courts should only discourage these "strings attached" offers if the smaller rival can prove that the monopolist's low-ball (*i.e.*, below cost) offers threaten to put it out of business (or otherwise restrict rivals' long-run elasticity of supply). This is the second necessary and sufficient condition for finding a monopolist guilty of abuse. The requirement itself stems from *Brooke Group* and was present in *LePage*'s.

By following this simple two-step process, courts can be confident in their ability objectively separate plaintiffs who were "blacklisted" from the market by predatory, economically irrational conduct from lazy, competitively impotent, but more litigious ones that struck out in the marketplace. ■

ENDNOTES

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