Antitrust In Distribution – Tying, Bundling and Loyalty Discounts, Resale Pricing Restraints, Price Discrimination – Part I

The Editor interviews ***Alan J. Weinschel****, Partner;* ***Irving Scher****, Senior Counsel, and* ***Scott Martin****, Partner, Weil Gotshal & Manges LLP.*

Editor's Note: These interviews capture some of the high points of presentations of the interviewees at a seminar held on March 2 as part of an Antitrust Seminar Series sponsored by Weil Gotshal & Manges LLP.

Part II of these interviews will appear in our May issue.

Editor: Alan, please describe the elements of a *per se* "tying" violation under the Sherman Act.

Weinschel: The first element is that there must be two separate products. The second element is proof that there was a forced sale, i.e., the sale of one product is conditioned on the purchaser also taking the second product. The third element is "sufficient economic power" in the tying product to accomplish the tie successfully. This was involved in the recent *Independent Ink* decision (*Illinois Toolworks v. Independent Ink,* 547 U.S.___ (2006)), which held that one cannot presume market power solely from the fact that the tying product is patented. Finally, there needs to be a substantial effect on competition in the tied product. The latter element was also referred to in the *Independent Ink* decision, where Justice Stevens seemed to say that substantial effect was required in *all* tying cases.

Editor: What is the difference between "tying" and "bundling?"

Weinschel: Bundling is not tying because forcing is absent. In "bundling" there are two or more products and there are inducements to take the whole bundle, or more than one product. The inducement is usually a discount that only applies when multiple products are purchased. The two products are available separately so there is no compulsion to buy product B along with product A. Bundling law has evolved differently from tying law even though some economists look at the two in a similar fashion.

Editor: In what circumstances would bundling be illegal?

Weinschel: These are hard cases because they deal with the difference between "hard competition" and "exclusion." Violations have been found where there is significant market power in one of the products in the bundle and competition is prevented (not just made difficult) with respect to one or more other products. An example is *SmithKline Corp. v. Eli Lilly & Co.,* 575 F.2d 1056 (3rd Cir. 1978). Lilly had two leading antibiotics that were patented and unique. Lilly also sold hospitals other antibiotics for which there were substitutes. Lilly offered a discounted bundle that included the two unique Lilly antibiotics and other Lilly antibiotics. There were very strong economic incentives to take the bundle and earn the discounts. SmithKline, which sold a competing antibiotic, argued that the discount structure penalized hospitals for dealing with SmithKline and showed that it could not remain profitable in the long run in products that competed with the bundled product. The Third Circuit held that Lilly violated Section 2 of the Sherman Act in attempting to extend and entrenching its monopoly in antibiotics.

Another case that comes to mind, also from the Third Circuit, is the more recent *LePage's Inc. v. 3M*, 324 F.2d 141 (3rd Cir. 2003). There, 3M, with admitted monopoly power in the brand name market, was faced with competition by LePage's, a seller of private label tape. 3M offered discounts to customers buying a broad bundle of its products. LePage's lost significant sales to 3M and won a jury verdict. The majority seemed comfortable that the evidence in the record was enough to support a verdict that 3M had gone too far even though there was no allegation that 3M sold below cost. The majority seemed troubled by the fact that 3M tailored its discounts to target LePage's major customers. Analytically, this shouldn't be determinative, but it is one of those facts that could lead to a conclusion that a company had gone too far and had acted in an "exclusionary" manner. The dissent (including now-Justice Alito) was not so comfortable, because of the absence of proof that 3M sold below cost or that LePage's was unable to meet 3M's competition.

Editor: What are some of the characteristics of the cases where bundling has not been found illegal?

Weinschel: A leading case cited for the proposition that bundling is legal if competition can still occur is *Ortho Diagnostic Sys., Inc. v. Abbott Labs, Inc.,* 920 F.Supp. 455 (S.D.N.Y. 1996). Judge Kaplan concluded in a scholarly opinion that a bundle did not violate the Sherman Act in the absence of pricing that prevented sales by an equally efficient competitor and in the absence of proof that there was no viable economic alternative to the bundle for purchasers.

Another case that came to a similar conclusion was *Virgin Atlantic Airways Ltd. v. British Airways PLC*, 257 F.2d 256 (3rd Cir. 2001). Virgin sued British Airways for offering volume discounts to travel agents and some corporate customers. Some were on specific routes where BA faced competition from Virgin. Virgin alleged that BA lowered the prices on the competitive routes and allegedly subsidized those lower prices with monopoly profits on the noncompetitive routes. The court threw out the case distinguishing *SmithKline* because there was no proof that British Airways' pricing was below cost or that consumers were harmed. The Second Circuit also followed Supreme Court precedent and rejected the theory of "monopoly leverage" – gaining an advantage in one market through a dominant position in another – as a cause of action under the Sherman Act. *See Spectrum Sports, Inc., v. McQuillan*, *506 U.S. 447 (1993); see also, Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, 540 U.S, 398 (2004)*

Editor: What about loyalty discounts?

Weinschel: Loyalty discounts are inducements to customers to buy more and thereby earn a lower price. Even if the seller has a substantial market share, and even if the discounts are below cost, it must be shown that the net effect of the discount program is to exclude competition and that the seller would be able to recoup its losses through monopoly pricing after all competition has been eliminated. It is a very difficult case for the plaintiff. The antitrust laws are designed to encourage sellers to lower prices and take sales away from competitors

An example here is *Concord Boat Corp. v. Brunswick Corp.,* 207 F.2d 1039 (8th Cir. 2000). This case is often discussed as a bundling case but in reality it is about loyalty or market share discounts. Brunswick sold marine engines. Plaintiffs were boat manufacturer-customers of Brunswick. Brunswick offered market share discounts of 3% to boat builders and dealers buying 70 percent of their engine requirements from Brunswick, as well as other inducements to increase purchases. The evidence was that Brunswick did not sell below cost. There was also a failure of proof that the programs themselves compelled customers to buy from Brunswick. There was also testimony on the difficulty other engine manufacturers faced in the marketplace and a general lack of evidentiary connection between the discounts and rivals' lost sales. Given these circumstances, there was no antitrust violation.

Editor: I understand that the EC treaty bans loyalty discounts.

Weinschel: The EC takes a different approach. The EC has taken the position that a dominant seller that gains a competitive edge by using loyalty discounts or bundled discounts can thereby "abuse" its dominant position. The EC believes it is necessary to protect smaller competitors (even if they are less efficient) in order to protect the competitive process. It is similar to the offense of "monopoly leveraging," which has been rejected here. The EC appear to equate harm to a competitor as equal to harm to competition. This is quite inconsistent with U.S, antitrust principles.

Editor: Irv, how does Section 1 of the Sherman Act affect the ability of suppliers to influence prices charged by resellers?

Scher: Under Section 1 of the Sherman Act and similar state laws, an agreement must exist for the law to apply. If a supplier has acted independently, it is not subject to Section 1. While the law is easy to state, what happens in real life is not so simple. This can result in litigation with an uncertain outcome. The issue usually is whether the facts show: (1) an agreement with a retailer or distributor that it will not sell below a stated price, or (2) only a pricing recommendation, followed by acquiescence without an express agreement. (There is an exception generally permitting agreements as to resale price *ceilings* or requiring customers to pass-through specified promotional funds provided by the supplier.)

In sum, a supplier can suggest that a customer not resell an item below a stated price or price range. However, if a jury (or judge in a bench trial) concludes that discussions led to an oral agreement by the customer not to resell below the specified price or price range, it is *per se* unlawful – there is no defense available. Thus, the supplier must leave its customers free to sell below suggested prices, although it can try to persuade them – short of agreement – to resell at those prices. Most of the case law involves "persuasion" efforts. If it results in an agreement rather than mere independent acquiescence, there is a violation under Section 1 of the Sherman Act.

Editor: So, avoiding an agreement is key. How do problems arise?

Scher: Law suits in this area typically involve a supplier that has suggested resale prices applicable to retailers. Then, while one retailer in a mall, for example, follows the suggested resale prices, another retailer may sell below those prices from time to time, or even continually. The other retailer complains and demands that the supplier terminate the transgressor.

The law since the United States Supreme Court decision in *Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752 (1984), is that a supplier that does no more than terminate the discounter after receiving the complaint from the other retailer has not violated the law because there has not been an agreement – the only action having been a pricing complaint followed by independent supplier action responsive to that complaint. However, actual events usually go beyond that kind of simple situation. And, given the use of email today, it has become easier for a plaintiff to show the existence of an agreement than previously was the case.

For example, upon receiving a complaint about lower prices being charged by a non-acquiescing competitor, a supplier may ask a sales person to check it out. The sales person approaches the transgressor and may say that unless it stops discounting it will be terminated. The sales person may then email headquarters to inform her superiors that the transgressor will no longer cut prices – which can be a "hot" document that a plaintiff's counsel can use to show an *agreement* to comply, which is *per se* unlawful. These problems are more readily avoided by sellers of "designer" products selling only to prestige retailers, or other suppliers with very limited distribution. If a supplier limits its customer base in that manner, there may be somewhat less to be concerned about. *Mr. Scher's interview will be continued in Part II, which will also include Scott Martin's interview.*

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