Nos. 05-35627, 05-35640, 05-36153, 05-36202

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

CASCADE HEALTH SOLUTIONS FKA
McKENZIE-WILLAMETTE HOSPITAL,

Plaintiff-Appellees,

v.

PEACEHEALTH,

Defendant-Appellant.

Appeal from the United States District Court
for the District of Oregon
Case No. CV-02-06032-HA

BRIEF OF PACIFIC BELL TELEPHONE COMPANY (D/B/A AT&T CALIFORNIA) AND VISA U.S.A. INC. AS AMICI CURIAE SUPPORTING REVERSAL

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SFI-563704v1

CORPORATE DISCLOSURE STATEMENT

Amicus curiae Pacific Bell Telephone Company, doing business as "AT&T California," is a wholly owned subsidiary of AT&T Teleholdings, Inc., which is a wholly owned subsidiary of AT&T Inc. AT&T Inc. has no parent corporation and no publicly held corporation owns 10% or more of its stock.

Amicus curiae Visa U.S.A. Inc. is a non-assessable, non-stock membership corporation organized under Delaware law. Visa U.S.A. Inc. has no parent corporation and is not publicly held.

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STATEMENT OF INTEREST

Pacific Bell Telephone Company, d/b/a AT&T California ("AT&T") and other subsidiaries and affiliates of AT&T Inc., provide a variety of communications and data services, including wireline and wireless telephone service, high-speed Internet access service, and video services. To provide savings to its customers and compete effectively with rival suppliers, AT&T frequently bundles its services and offers them at prices discounted from their prices if purchased separately. These bundled discounts are sought after by AT&T's customers and play an important role in fostering competition in the rapidly evolving communications industry. AT&T thus is vitally interested in the development of sound antitrust standards for evaluating the legality of bundled discounts.

Visa U.S.A. Inc. is the United States affiliate of Visa International, a leading global payments network. Visa U.S.A.'s member financial institutions issue payment cards that are used by millions of consumers to make billions of dollars in purchases each day. Visa U.S.A. has a strong interest in predictable antitrust standards that promote competition, including the standards that govern bundled discounting.

SUMMARY OF ARGUMENT

This Court should rule that a plaintiff challenging bundled discounts under the Sherman Act must prove (1) that the aggregate price of the bundle is less than the defendants' cost of producing the bundle and (2) that the defendant has a dangerous probability of recouping its losses from those below-cost sales. Just like the single product discounts at issue in *Brooke Group, Ltd. v. Brown & Williamson*

Tobacco Corp., 509 U.S. 209 (1993), bundled discounts are widely recognized to be pro-competitive and pro-consumer. The antitrust standard under which they are judged thus should be one that resolves any doubts in favor of their legality and that preserves the ability of companies to compete on the merits, including the "merit" of their increased investment and efficiency.

Brooke Group recognized that low prices that are above a company's costs generally reflect that company's lower cost structure and thus represent legitimate competition on the merits – even when that company has monopoly power. This principle applies equally to bundled discounts. The company crosses the line into potential antitrust liability only when it goes beyond the advantage conferred by its lower cost structure to sell below those costs. And even then competition and consumer welfare are not threatened unless the company, having sacrificed profits and incurred losses in the short run, can recoup those losses by successfully raising its prices after rival suppliers of the competing product have been excluded from the market.

The Third Circuit's decision in *LePage's Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003) (en banc), refusing to apply these principles in bundled discount cases, has been widely condemned. It suffers from the same infirmities as the rule the Supreme Court rejected in *Brooke Group*. It penalizes companies for engaging in price competition reflecting their investment and efficiency. It protects competitors that have failed to make similar investments at the expense of consumers who are deprived of the lower prices and convenience bundled discounts provide. And it replaces an objective, theoretically sound and workable

rule with an amorphous leave-it-up-to-jury standard that will only promote groundless litigation and deter legitimate, pro-competitive conduct. This Court should not repeat the Third Circuit's error. It should instead adopt a rule that comports with *Brooke Group* and adheres to the basic antitrust principles it recognized.

ARGUMENT

I. A PLAINTIFF CHALLENGING BUNDLED DISCOUNT PRICING UNDER SECTION 2 OF THE SHERMAN ACT SHOULD, AT A MINIMUM, HAVE TO PROVE SOME MEASURE OF BELOW-COST PRICING

The sole aim of § 2 of the Sherman Act is to stop anti-competitive conduct. *See Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398 (2004); *Aspen Skiing Co. v. Aspen Highland Skiing Corp.*, 472 U.S. 585, 602 (1985). In defining the contours of § 2's language, the federal courts have classified conduct into different categories (such as predatory pricing, tying, and exclusive dealing) and have developed tests to determine whether the conduct is, in a particular case, actually anti-competitive. *See, e.g., Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp.,* 509 U.S. 209 (1993) (predatory pricing); *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U.S. 2 (1984) (tying); *Trinko*, 540 U.S. 398 (refusal to deal). Throughout, however, the overriding and unifying point of these efforts is to distinguish conduct that furthers competition from that which destroys it. *See Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447, 458 (1993).

The Supreme Court has narrowly defined the universe of anti-competitive conduct barred by § 2. As the Court has said time and again, it is "axiomatic" that

§ 2 protects *competition – not* competitors. *See, e.g.*, *Volvo Trucks North America, Inc. v. Reeder-Simco GMC, Inc.*, 126 S. Ct. 860, 872 (2006); *Brooke Group*, 509 U.S. at 224; *Cargill, Inc. v. Monfort of Colorado, Inc.*, 479 U.S. 104, 110 (1986); *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 488 (1977); *see also Hyde*, 466 U.S. at 15 (noting that the "consumer" is "whose interests [§ 2] was especially intended to serve"). Prohibited anti-competitive behavior is therefore limited to conduct that harms consumers and competition – not conduct that merely harms competitive rivals.

A monopoly firm's presence in a market is not by itself anti-competitive, despite any adverse effect on rivals, because the opportunity to achieve a monopoly "is an important part of the free-market system" that benefits competition and hence consumers. *Trinko*, 540 U.S. at 407; *id.* ("The opportunity to charge monopoly prices – at least for a short period – is what attracts 'business acumen' in the first place; it induces risk taking that produces innovation and economic growth."). A monopoly firm harms competition only when it also engages in "anti-competitive *conduct*" – that is, conduct not based on a superior product, business acumen, historical accident or, most critically, efficiency. *Trinko*, 540 U.S. at 407 (emphasis in original); *United States v. Grinnell Corp.*, 384 U.S. 563, 570-71 (1966); *Aspen*, 472 U.S. at 605.

A firm, even one with monopoly power, that successfully competes "on the merits" as a result of its greater investment or efficiencies does not engage in anti-competitive conduct under § 2, even if less efficient rivals are driven out of business. *See Brooke Group*, 509 U.S. at 224 ("That below-cost pricing may

impose painful losses on its target is of no moment to the antitrust laws if competition is not injured."); *Aspen*, 472 U.S. at 605 n.32 ("competition on the merits" is outside the ambit of § 2 liability); *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 767 (1984) ("An efficient firm may capture unsatisfied customers from an inefficient rival, whose own ability to compete may suffer as a result. This is the rule of the marketplace and is precisely the sort of competition that promotes the consumer interests that the Sherman Act aims to foster."); *Cargill, Inc.*, 479 U.S. at 116 (the "antitrust laws do not require the courts to protect small businesses from the loss of profits due to continued competition").[1]

A. Courts Must Evaluate a Practice That Is Usually Pro-Competitive Using a Rule that Resolves Doubts Against Antitrust Liability

The Supreme Court's emphasis on anti-competitive conduct has required that the judiciary develop rules that distinguish pro-competitive behavior from anti-competitive tactics, even though they may entail the same outward market behavior (for example, a reduction in prices). *See Trinko*, 540 U.S. at 414 ("applying the requirements of § 2 'can be difficult' because 'the means of illicit exclusion, like the means of legitimate competition, are myriad'") (citation omitted). Where particular practices are generally pro-competitive, the Court has adopted rules that resolve any doubts about legality against liability.

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[1] Legal scholars concur. *See, e.g.*, Phillip E. Areeda & Donald F. Turner, "Predatory Pricing and Related Practices Under Section 2 of the Sherman Act," 88 Harv. L. Rev. 697, 705 (1975); Daniel A. Crane, "The Paradox of Predatory Pricing," 91 Cornell L. Rev. 1, 9-10 (2005).

In *Brooke Group*, for example, the Court recognized that price cuts benefit consumers and, thus, are pro-competitive. 509 U.S. at 226 ("'cutting prices in order to increase business is often the very essence of competition'") (quoting *Cargill, Inc.*, 479 U.S. at 122 n.17); *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., Inc.*, 127 S. Ct. 1069, 1077 (2007) (same); *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328, 340 (1990) (same); *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227, 231 (1st Cir. 1983) (same). As a result, the Court imposed a heavy burden on plaintiffs seeking to establish that a price cut was nevertheless anti-competitive in a particular case; plaintiffs are required to prove that the price cut resulted in below-cost pricing (*i.e.,* was not based on efficiency) *and* was dangerously likely to result in higher prices in the future. *Brooke Group*, 509 U.S. at 226-27.

Recently, the Court made clear the breadth of the *Brooke Group* holding when it applied *Brooke Group*'s standard to a claim of predatory buying (as opposed to the predatory selling claim at issue in *Brooke Group*). *See Weyerhaeuser Co.*, 127 S. Ct. at 1074, 1077. The Court found the two practices "analytically similar" insofar as both practices "involve the deliberate use of unilateral pricing measures for anticompetitive purposes." *Id.* at 1076. In other recent cases, the Supreme Court has similarly rejected lower court decisions that adopted overly aggressive standards and did not allow sufficient latitude for competition on the merits. *See Trinko*, 540 U.S. at 409-11, 415 n.4 (restricting the reach of refusal-to-deal and monopoly leveraging liability); *cf. Illinois Tool Works, Inc. v. Independent Ink, Inc.*, 126 S. Ct. 1281, 1292 (2006) (abrogating

presumption of monopoly power from conferral of patent and use of price discrimination because both are pro-competitive); *Reeder-Simco GMC, Inc.*, 126 S. Ct. at 872-73 (refusing to extend antitrust liability to reach intra-brand competition in a special-order competitive bidding process).[2]

A judicial rule that accounts for the general pro-competitive nature of a given practice is not only the law, it makes sense. Where a practice is typically legitimate and pro-competitive, a rule that resolves doubts in favor of the practice's legality in any particular case is likely to be *correct*. Moreover, as *Brooke Group* recognized, where the practice is usually pro-competitive, it will be conversely more difficult to identify the rare case in which the practice is being used in an anti-competitive fashion. That task is often "beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate" instances of that conduct. *Brooke Group*, 509 U.S. at 223.

By the same token, a rule that employs more exacting scrutiny or presumes the unlawfulness of a practice that is usually pro-competitive will work twin harms. It will result in more findings of anti-competitive conduct where none in

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[2] The Supreme Court's recent decisions interpreting § 1 of the Sherman Act similarly have rejected rules that were quick to condemn practices that were potentially pro-competitive. *See, e.g.*, *Texaco Inc. v. Dagher*, 126 S. Ct. 1276 (2006) (holding that price-setting decisions of a legitimately formed joint venture are not *per se* illegal); *State Oil v. Khan*, 522 U.S. 3 (1997) (holding that vertical maximum price fixing is not subject to *per se* treatment); *Broadcast Music, Inc. v. Columbia Broad. Sys. Inc.*, 441 U.S. 1, 8 (1979) (rejecting *per se* challenge to a blanket license jointly issued by owners of copyrighted music); *Continental T.V. Inc. v. GTE Sylvania Inc.*, 433 U.S. 36 (1977) (holding that vertical nonprice restraints are not subject to *per se* treatment).

fact existed (so-called "false positives") and will discourage competitors from engaging in similar behavior, thereby chilling the very conduct the antitrust laws were intended to foster, *i.e.*, conduct that is objectively pro-competitive. *See, e.g., Matsushita Electric Indus. Co., Ltd. v. Zenith Radio Corp.*, 475 U.S. 574, 594 (1986) ("mistaken inferences [in cases where prices are cut] are especially costly, because they chill the very conduct the antitrust laws are designed to protect"); *Trinko*, 540 U.S. at 414 (same); David S. Evans & A. Jorge Padilla, "Designing Antitrust Rules for Assessing Unilateral Practices: A Neo-Chicago Approach," 72 U. Chi. L. Rev. 73, 75 (2005) ("Socially desirable antitrust rules would minimize the expected cost of errors resulting from condoning harmful practices or condemning beneficial ones, while maintaining a degree of predictability for businesses and administrative ease for the courts."). In the end, an overly critical rule will stifle pro-competitive conduct and end up *harming*, rather than helping, competition.

B. Nearly Everyone Agrees that The Practice of Offering Discounted Pricing on Bundled Goods or Services Is Pro-Competitive

Courts and commentators are unanimous that discount pricing of bundled goods or services – which combine the pro-competitive benefits of price cuts, *see Brooke Group*, 509 U.S. at 226, and of packaged sales, *Hyde*, 466 U.S. at 24 – are overwhelmingly good for competition and good for consumers. *See, e.g.,* Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law 325 (2006) [hereinafter "Hovenkamp"] ("Discounting is presumptively procompetitive . . ."); Antitrust Modernization Commission, Report and Recommendation 94 (Apr. 2, 2007),

available at www.amc.gov/report_recommendation/toc.htm (last viewed Apr. 18, 2007) [hereinafter "AMC Report"] (same); Timothy J. Muris, "Antitrust Law & Economics: Exclusionary Behavior and Bundled Discounts," Testimony Before the Federal Trade Commission and Department of Justice Single-Firm Conduct Hearings 47 (Nov. 29, 2006), *available at* www.law.gmu.edu/faculty/story.php?id=618 (last viewed Apr. 18, 2007) [hereinafter "Muris"] (same). Most immediately, bundled discounts result in lower prices for consumers, which, as noted above, is universally acknowledged as almost always good for competition. Additionally, bundling is often more efficient for consumers, enabling them to buy several goods or services at once or to have only a single bill. Muris at 6-7. Bundled discounts also allow the firm who offers them to capitalize on the "benefits of integration, economies of scope in distributing products, packaging cost savings, reduced transaction costs for businesses and consumers, and increased reliability for consumers." Evans & Padilla, at 90.

Bundled discounts have been especially prevalent in the telecommunications industry and have been recognized as an important factor in spurring competition among providers and providing substantial savings for consumers. Telecommunications firms offer discounted bundles of telephone calling features (such as call waiting, call forwarding and voicemail) as well as discounted bundles of different services (such as landline telephone service, wireless telephone service, high-speed Internet access, and video). Muris at 3, 7. The latter bundles have been used by both telephone companies and cable companies as a vehicle for attracting consumers and driving down prices in areas where one or the other had

not previously competed. *See, e.g.*, S. Ali, "Cable Rate Increases Are Smallest In Years – Heightened Competition Offers Consumers Chance to Play One Provider off Another; When to Bundle," The Wall Street Journal, p. D1 (Dec. 17, 2006); *see also* Federal Communications Commission, "Report on the Packaging and Sale of Video Programming Services to the Public," 2004 FCC Lexis 6518, at 67 (Nov. 18, 2004) ("Economic research indicates that two firms compete with each other by selling bundles have lower prices than firms that compete through a la carte sales.").

Tellingly, the benefits of offering discounts on bundled goods and services are sought by *all* market participants, including those without monopoly power in competitive markets. *See* Hovenkamp at 333. The use of a practice in competitive markets is strong evidence of its pro-competitive nature. *See, e.g., Illinois Tool Works, Inc.*, 126 S. Ct. at 1292 (noting that tying of patented and unpatented goods "occurs in fully competitive markets" and thus does not support a presumption of market power); *see generally* Evans & Padilla, at 81 ("Practices that generate efficiencies where firms lack market power logically should generate those same efficiencies where firms possess market power.").

In light of this undisputed pedigree, the judicial rule governing the evaluation of bundled discounts pricing, like the test governing price cuts in single-product cases, *see Brooke Group*, 509 U.S. at 222-23, should be one that recognizes the pro-competitive nature of these discounts and resolves doubts against § 2 liability.

C. ***LePage's* Lacks Any Inquiry Into Pricing or Cost And, As a Result, Effectively Treats Discounted Pricing on Bundled Goods or Services as Presumptively Anti-Competitive; It Will Inevitably Discourage Such Discounting**

The Third Circuit in *LePage's Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003) (en banc), ignored the above-stated principles. Indeed, it turned them on their head. To prevail on a § 2 claim against bundled discounting, the plaintiff under *LePage's* need only show two facts: (1) a monopoly firm (2) offered a bundled discount. *LePage's*, 324 F.3d at 155.[3] This is the position taken by the plaintiff in this case – and it is the position the district court adopted here when it instructed the jury in accord with *LePage's*. *See* Opening Brief at 54 ("The merit of *LePage's* is in its simplicity. Monopolists may not bundle discounts."). *LePage's* does not require *any* showing that competition – or even any competitor – was ever harmed or at risk of harm from the discounted pricing. Nor does it require any showing that the monopoly firm would be able to recoup its lower prices by charging higher prices in the future, *cf. Brooke Group*, 509 U.S. at 226, as such a requirement would be meaningless when *any* price is deemed invalid. In effect, this rule presumes that *all* bundled discounts offered by a firm with monopoly power as to any one of the goods or services in the bundle are anti-competitive *per se*.

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[3] Although *LePage's* enables an antitrust defendant to articulate a "legitimate business justification" in its defense, the Third Circuit rendered that defense a dead letter by dismissing evidence that the discounts resulted in greater efficiencies and discarding as illegitimate the defendant's desire to maintain a monopoly. 324 F.3d at 163-64.

This is simply wrong.[4] First and foremost, *LePage's* ignores the mandate of *Brooke Group*, *Weyerhaeuser*, and numerous other cases holding that pro-competitive practices such as bundled discounts should be evaluated using a rule that presumes their legality – not their illegality. The broad sweep of *LePage's* will all but require courts or juries to declare bundled discount pricing to be anticompetitive *per se*, even though it will not be in the vast majority of cases. This is precisely the sort of anti-price-cut rule the Supreme Court has condemned as "perverse." *Cargill, Inc.*, 479 U.S. at 116; *see also Barry Wright Corp.*, 724 F.2d at 231 ("a legal precedent or rule of law that prevents a firm from unilaterally cutting its prices risk[s] interference with one of the Sherman Act's most basic objectives: the low price levels that one would find in well-functioning competitive markets").[5]

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4 *See, e.g.*, Muris at 18-27; AMC Report at 94-97; Hovenkamp at 321-23; Richard A. Epstein, "Monopoly Dominance or Level Playing Field? The New Antitrust Paradox," 72 U. Chi. L. Rev. 49, 61 (2005) (calling *LePage's* a move in the "wrong direction").

5 *LePage's* dismissed *Brooke Group* as unpersuasive because it dealt with the Robinson-Patman Act, 15 U.S.C. § 13(a), rather than § 2; dealt with an oligopoly rather than a monopoly; and addressed predatory pricing rather than exclusionary conduct. 324 F.3d at 151-52. None of these reasons is persuasive. The Supreme Court explicitly rejected *LePage's* first two reasons in *Weyerhaeuser Co.*, holding that "the standard adopted in *Brooke Group* applies to predatory-pricing claims under §2 of the Sherman Act" and did not limit it to oligopolies. 127 S. Ct. at 1074 n.1; *accord Brook Group*, 509 U.S. at 220, 222 (holding that "the essence of the claim under either statute is the same" and both claims must adhere to "the broader policies of antitrust law"). Likewise, as this brief demonstrates, whether labeled "predatory pricing" or "exclusionary conduct," the underlying conduct in each of these cases – the alleged exclusion of rivals resulting from lower prices – is the same.

LePage's results in a virtual *per se* rule because it makes no effort to sort the vast majority of pro-competitive bundled discounts from the handful of potentially anti-competitive ones. *Cf. Dagher*, 126 S. Ct. at 1279 ("[W]e have expressed reluctance to adopt *per se* rules . . . where the economic impact of certain practices is not immediately obvious") (citing *State Oil Co.*, 522 U.S. at 10). The resulting specter of treble damage liability will undoubtedly discourage firms from offering any discounted bundled pricing at all. Because *LePage's* applies regardless of the relative efficiency (or inefficiency) of the antitrust plaintiff-rival, the rule has the effect of making "antitrust suits themselves . . . a tool for keeping prices high," *Brooke Group*, 509 U.S. at 226-27 – to the detriment of the very consumers those laws were designed to protect. By thus protecting plaintiff-competitors over consumers, *LePage's* violates one of the cardinal tenets of antitrust law. Indeed, *LePage's* admitted as much when it asserted that "[t]he principal anticompetitive effect of bundled rebates . . . is that when offered by a monopolist they may foreclose portions of the market to a potential competitor who does not manufacture an equally diverse group of products . . ." 324 F.3d at 155. Contrary to that court's assumption, that is not inevitably, or even commonly, an anti-competitive effect.[6]

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[6] *LePage's* focus on rivals rather than consumers reflects the particular situation before that court – namely, discounts alleged to exclude rivals from "key retail pipelines" but never passed along to consumers. 324 F.3d at 160, 163. Unmooring *LePage's* from its unique facts and applying it indiscriminately to the universe of consumer-beneficial bundled discounts would only compound its many deficiencies.

The havoc wrought by *LePage's* will not be easily confined. The ease of a *LePage's*-based action will most certainly prompt savvy plaintiff-rivals facing any bundled discounts to sue – and prevail –where they would be unable to prevail under traditional avenues of § 2 liability. Indeed, that is precisely what plaintiff did in this case after its traditional § 2 claims all failed. *See* Opening Brief of Peace Health at 5-6 (cataloguing that plaintiff lost its tying and exclusionary dealing claims, but prevailed on its *LePage's*-based claim).

D. A Price-Cost Test Is Necessary to Identify the Limited Instances In Which Discounted Pricing of Bundled Goods or Services Is Anti-Competitive

A discounted price on a bundle of goods or services is functionally no different from a price cut involving multiple goods or services. And it is settled that the preferred mechanism for evaluating whether a pricing decision is anti-competitive is a cost-based test. *See, e.g., Brooke Group*, 509 U.S. at 226 (holding that "evidence of below-cost pricing" along with a dangerous probability of recoupment are "essential components of real market injury"); *Weyerhaeuser Co.*, 127 S. Ct. at 1074 (same); *Cargill, Inc.*, 479 U.S. at 117 n.12 (same). That is because price cuts and discounts are pro-competitive as long as they entail competition on the basis of efficiency, *see Aspen*, 472 U.S. at 605, and the best measure of efficiency has proven to be cost.

When a firm's prices are above its costs, its ability to offer low prices is a function of its investment or relative efficiency, and is likely valid. *Brooke Group*, 509 U.S. at 223 ("As a general rule, the exclusionary effect of prices above a relevant measure of cost . . . reflects the lower cost structure of the alleged

predator, and so represents competition on the merits . . ."); Areeda & Turner, at 718-20 (monopoly firms may invest in additional expansion without violating antitrust laws). While there may be instances in which above-cost pricing could be anti-competitive, correctly identifying such cases "is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting." *Brooke Group*, 509 U.S. at 223; *Trinko*, 540 U.S. at 415 (noting that courts should impose no duty that "requires the court to assume the day-to-day controls characteristic of a regulatory agency").

By contrast, when the firm's prices are below its costs, it is losing money for every good or service sold and is therefore competing on the basis of something other than its greater prior investment or relative efficiency. *See* Areeda & Turner, at 712 ("pricing below marginal cost greatly increasing the possibility that rivalry will be extinguished or prevented for reasons unrelated to the efficiency of the monopolist"). These circumstances do not themselves condemn conduct as anti-competitive. *See Weyerhaeuser*, 127 S. Ct. at 1077 ("a failed predatory-pricing scheme may benefit consumers."). Because lower prices are good for consumers, below-cost pricing becomes anti-competitive only if there is *also* a dangerous probability that the firm will drive its equally efficient rivals out of business and subsequently raise its prices to higher-than-competitive levels to recoup the losses it sustained while offering below-cost prices. *Brooke Group*, 509 U.S. at 224-25; *Weyerhaeuser Co.*, 127 S. Ct. at 1074 ("For [a predatory pricing] scheme to make economic sense, the losses suffered from pricing goods below cost must be recouped (with interest) during the supracompetitive pricing stage of the

scheme."); *Matsushita Electric Indus. Co.*, 475 U.S. at 589 (same). Only when market conditions would permit a firm to later price at supra-competitive levels is there a likelihood of consumer harm. And only then should the conduct be labeled anti-competitive.

A cost-based test also provides judges and juries with a defined and predictable standard. Simply instructing a jury to outlaw a bundled discount because it is "unfair," "unnecessary," or "unreasonable" is too amorphous. Such formulations provide no guidance to the jury and no means of distinguishing pro-competitive or benign discounting from anti-competitive conduct. The Supreme Court rejected just such an instruction in *Weyerhaeuser*. 127 S. S. Ct. at 1073 (overturning jury verdict premised on finding that defendant "purchased [more of an item] than it needed"); *see also Spectrum Sports*, 506 U.S. at 459 (inquiry into "whether the defendant has engaged in 'unfair' or 'predatory' tactics" is "plainly" insufficient under § 2); *Kartell v. Blue Shield of Mass., Inc.*, 749 F.2d 922, 928 (1st Cir. 1984) (Breyer, J.) ("reasonableness" test too "uncertain") (quoting *United States v. Trenton Potteries Co.*, 273 U.S. 392, 398 (1927)); Frank H. Easterbrook, "On Identifying Exclusionary Conduct," 61 Notre Dame L. Rev. 972, 978 (1986) ("a fog-bound instruction . . . ensures that confusion and random results will emerge," along with "false positives and false negative[s]").

For all these reasons, a price-cost test is the best litmus test for anti-competitive conduct. Not surprisingly, both the academy and the judiciary concur. *See, e.g.*, Hovenkamp at 326-43; AMC Report at 94-100; Muris at 42-60; *Matsushita Elec. Indus. Co.*, 475 U.S. at 584-85 n.8; *Information Resources, Inc. v.*

Dun & Bradstreet Corp., 359 F. Supp. 2d 307, 370 (S.D.N.Y. 2004); *Ortho Diagnostic Systems, Inc. v. Abbott Labs., Inc.,* 920 F. Supp. 455, 470 (S.D.N.Y. 1996).

II. IN EVALUATING THE LEGALITY OF BUNDLED DISCOUNT PRICES OFFERED BY A FIRM WITH A MONOPOLY FOR ONE OF THE BUNDLED GOODS OR SERVICES, THE COURT SHOULD COMPARE THE DISCOUNTED PRICE OF THE ENTIRE BUNDLE TO THE AGGREGATE COST OF THE BUNDLE

In selecting among rules to govern the antitrust legality of a particular practice, the Supreme Court has looked to the rules' fit with antitrust theory and to their administrability. *See Weyerhaeuser*, 127 S. Ct. at 1077 (looking to "theoretical" and "practical" considerations in selecting antitrust rule). In terms of theory, courts seek a rule that protects consumers over competitors and that minimizes the number of "false positives," particularly for practices, like bundled discounts, that are overwhelmingly pro-competitive. In terms of practicalities, courts seek a rule that can be easily applied not only by the judiciary in litigation, *see Northeastern Tel. Co. v. AT & T*, 651 F.2d 76, 88 (2d Cir. 1981) ("The more complicated the standard, the greater the chance for misapplication."), but also by market participants wishing to avoid (or at least minimize) lawsuits by conforming their conduct to the law. If a rule is not reliable enough for firms to predict how courts will evaluate their conduct in the future, firms will not risk treble damages and will simply avoid the conduct altogether. *See Trinko*, 540 U.S. at 414 (noting possibility of "death by a thousand cuts" due to interminable antitrust litigation). This level of predictability must also be certain enough to warrant summary relief

in litigation, as prevailing after a lengthy and expensive trial is of little comfort. *See Virgin Atlantic Airways Ltd. v. British Airways PLC*, 257 F.3d 256, 263 (2d Cir. 2001) (antitrust courts should adopt rules that avoid "[w]asteful trials and prolonged litigation that may have a chilling effect on pro-competitive market forces"); 6 James Wm. Moore, Moore's Federal Practice ¶ 26.46[1], at 26-146.24 (2d ed. 2003) ("antitrust cases have become known as 'serpentine labyrinths' in which discovery is a bottomless pit").

A. The Two Leading Price-Cost Rules are the Aggregate Rule and the Conflated Discount Rule

Two variations of a price-cost rule have been proposed.[7] The first rule – the "aggregate rule" and which we urge this Court to adopt – measures anti-competitive effect by examining whether the discounted price of the entire bundle exceeds the monopoly firm's cost of producing the entire bundle. Muris, at 28-30. The second rule – the "conflated discount rule" – compares the price of a single good or service in the bundle (the same one produced by the plaintiff-rival) reduced by the discount for the *entire* bundle with the monopoly firm's cost of producing that individual product or service. AMC Report at 99; Hovenkamp at 335.[8]

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[7] There is a third possible test that compares the discounted price and cost of each individual product in the bundle, but it suffers from the same pragmatic drawbacks as the "conflated discount rule" discussed in the text. Muris, at 33.

[8] For either rule, the most appropriate measure of cost is average variable cost – that is, the non-fixed costs of producing an additional unit of the product or service. Areeda & Turner, at 719; *Barry Wright Corp.,* 724 F.2d at 232 ("modern antitrust courts look to the relation of price to 'avoidable' or 'incremental' costs"). Although the Supreme Court has not yet selected a measure of cost, *see Cargill,*

(continued)

The "aggregate rule" recognizes that the same "analytical similar[ity]" that prompted the Supreme Court to extend *Brooke Group*'s rule to bidding discounts in *Weyerhaeuser* applies with equal force to discounts on bundled goods and services. In *Brooke Group* and *Weyerhaeuser* – as is the case with bundled discounts – the core of the allegedly unlawful conduct is a firm's decision to offer a lower price. As the Supreme Court reasoned in *Brooke Group* and *Weyerhaeuser*, courts can be assured that the reduced prices are the product of greater efficiencies and not unlawful predation as long as the firm's lowered prices are above its costs. *Brooke Group*, 509 U.S. at 223; *Weyerhaeuser*, 128 S. Ct. at 1074. The same logic holds true whether the price cuts are for a single item or for a bundle of related goods or services. Thus, this Court should use an analytically similar test for evaluating the functionally indistinguishable conduct of bundled discount pricing.

The sole difference in the case of a bundle is that the "aggregate" rule, as it necessarily must when applied to a bundle of multiple goods or services, looks to the aggregate discounted price of the bundle and aggregate cost of the goods or services in the bundle. Thus, under the "aggregate rule," a firm will not incur § 2 liability where the discounted aggregate price exceeds the aggregate cost of the

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Inc., 479 U.S. at 118 n.12, this Court has relied upon a cost test keyed to average variable cost to allocate burdens of proof in predatory pricing cases. *See William Inglis & Sons Baking Co. v. ITT Continental Baking Co., Inc.*, 668 F.2d 1014, 1035-36 (9th Cir. 1981); *Transamerica Computer Co., Inc. v. IBM, Corp.*, 698 F.2d 1377, 1385-87 (9th Cir. 1983). Moreover, average variable cost most closely tracks "marginal cost," which is the factor that most economists agree is relevant to assessing efficiency in the antitrust context. *See* Areeda & Turner, at 700, 716, 717, 719.

goods or services in the bundle. *Brooke Group*, 509 U.S. at 223; *Weyerhaeuser Co.*, 127 S. Ct. at 1074. In this situation, the firm is competing "on the merits" to the benefit of consumers, and a rival's inability to match the lower prices reflects nothing more than the rival's failure to make the investment necessary to achieve similar efficiencies. However, where the discounted price of the bundle drops below its aggregate cost, the plaintiff may be able to prevail if it additionally proves that the monopoly firm had "a dangerous probability . . . of recouping its investment in below-cost prices." *Accord Brooke Group*, 509 U.S. at 224; *Weyerhaeuser Co.,* 127 S. Ct. at 1074.

Advocates of the other rule – the "conflated discounted" rule – are divided over its applicability. Hovenkamp would apply the aggregate rule in bundled discount cases *except* where no rival or group of rivals could produce all of the goods or services in the challenged bundle; in that narrow circumstance, Hovenkamp would apply the conflated discount rule. A finding of above-cost pricing would preclude liability, while a finding of below-cost pricing would result in liability unless the defendant-firm could prove that (1) it possessed greater economies of scale or scope; (2) it was engaging in lawful price discrimination; or (3) third-party brokers or intermediaries were responsible for the lower aggregate discount price. Hovenkamp, at 332-43.

In its recent report, the Antitrust Modernization Committee – over some dissent and with very little explanatory justification – recommended that the conflated discount rule be used to evaluate *all* discounted bundles. AMC Report, at 99-100. The Committee would, however, require the plaintiff to prove that there

was a "dangerous probability" of recoupment in the market where the contested product was offered and that the discount had or is likely to have an adverse effect on competition. *Id.*[9]

B. <u>The Conflated Discount Rule Is Theoretically and Practically Unsound</u>

In all its variations, the conflated discount rule is deficient in theory and in practice and should not be adopted. The rule is theoretically unsound because it effectively puts the rival-plaintiff producing a single good or service on the same economic footing as the diversified competitor who offers a bundled discount price on several related goods and services. This rule therefore fails to account for a diversified firm's prior investment or for the efficiencies and economies of scale that such a firm garners from offering a bundle of related goods or services. As discussed above, such investment and efficiencies unquestionably exist and are largely why so many firms (monopolies or not) are able to, and do, offer bundled discounts in the first place. The conflated discount rule eliminates that efficiency and the advantage of prior investment and, as a result, discourages a diversified company with a monopoly as to *any* of its goods or services from offering bundled discount prices and from passing along to consumers the full savings of its economies of scale because that total savings (that is, the full discount) will be

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[9] The Court in *Ortho Diagnostic Systems, Inc.*, 920 F. Supp. 455, adopted a third variant of the conflated discount rule. Under *Ortho*, a court applies the rule only where no other firm or firms offer the same bundle of goods or services; the plaintiff has to prove below-cost pricing and a "dangerous probability" of recoupment; and the defendant, as a defense, may prove that it was more efficient. *Id.* at 470.

attributed under the rule to each of its individual goods or services. The conflated discount rule consequently has the effect of encouraging a diversified company to maintain higher prices. Worse yet, it sustains these elevated price levels, or a "price umbrella," for the sake of keeping a less diversified (and arguably less efficient) rival in business. *See* Richard A. Posner, Antitrust Law 196 (2d ed. 2001) ("It would be absurd to require the firm to hold a price umbrella over less efficient entrants."); *see also* Hovenkamp at 335. This directly undermines one of *the* fundamental tenets of antitrust law – namely, that consumers and competition come before competitors.

The conflated discount rule is also unworkable in practice. The efficiencies of bundling related goods or services result from their synergy; attempts to desegregate those efficiencies and assign a cost to each individual product or service within the bundle will necessarily be arbitrary. *Northeastern Tel. Co.*, 651 F.2d at 89 n.19 ("the accounting conventions used to allocate joint costs, i.e., those costs that are not directly attributable to a particular product, are all arbitrary to a degree"); Muris at 30 (when "a court or jury must allocate joint and common costs among the products contained in the bundle," it will either be done "arbitrarily" or "is likely to be an administrative nightmare"). Even if a diversified company is able to develop an internal mechanism for allocating its costs for goods or services within a bundle, that methodology likely will vary from company to company and will be disputed by plaintiff-rivals' experts in such a way as to create an appearance of material issues of fact that preclude summary judgment and necessitate trial. *See* Fed. R. Civ. P. 56; *see also* Areeda & Turner, at 699 (arguing

that "extreme care be taken in formulating . . . rules, lest the threat of litigation, particularly by private parties, materially deter legitimate, competitive pricing"). A diversified firm facing this prospect is likely to avoid offering the discounted price, thereby harming consumers.

Hovenkamp attempts to ameliorate the deleterious effects of the conflated discount rule on competition by permitting diversified firms to argue, in their defense, that their ability to offer the discounted price springs from their greater efficiencies and economics of scale. Hovenkamp, at 339-40. The need for this defense at all highlights the overbreadth of the conflated discount rule. Moreover, Hovenkamp provides no rational mechanism for courts to apply in assessing efficiency – undoubtedly because Hovenkamp refuses to use the best gauge of efficiency of a diversified firm, that is, a comparison of the aggregate discount price of a bundle to that bundle's aggregate cost.

Under either variant, however, the conflated discount rule produces illogical results that go beyond protecting non-diversified rivals at the expense of consumers. To begin with, the conflated discount rule would apply regardless of whether the plaintiff-rival is itself offering a bundle of goods or services – as long as the plaintiff-rival does not offer the *full* bundle offered by the diversified defendant. By effectively eliminating a defendant's economies of scale while allowing a plaintiff to sue while enjoying the same, the conflated discount rule appears to erect a double standard.

In addition, the conflated discount rule permits double- and triple-counting because nothing prevents less diversified rivals as to each of a diversified firm's

goods or services from asserting § 2 violations in individual lawsuits, and asking the court in each case to adjudge each violation by applying the discounted price for the entire bundle against each challenged good or service. *See* Hovenkamp, at 339 ("rivals are very quick to complain that a larger firm's price cut is anticompetitive"). It makes no sense to apply the full discount price multiple times – especially when it will multiply the number of goods or services as to which the diversified firm will be unable to pass along its greater efficiency to consumers. See Epstein, 72 U. Chi. L. Rev. at 71. This multiplier effect amplifies the injury to competition inflicted by use of the conflated discount rule.

C. The Aggregate Rule Is More Consistent With Antitrust Theory and Practice

In contrast to the conflated discount rule, the aggregate rule we urge is the approach most consistent with antitrust policy and practical reality. It ensures that competition is "on the merits" – that is, based on prior investment and efficiency. At the same time, it recognizes the economic reality that greater efficiencies may exist with diversified firms offering bundles of related goods and services. Measuring aggregate cost against the aggregate discount price of any entire bundle ensures that a diversified firm *is* operating based on efficiency but does not penalize the firm for achieving those greater efficiencies or making its prior investments. More to the point, it allows the firm to pass those greater efficiencies on to consumers through greater discounts. By looking to aggregate cost rather than requiring firms and courts to arbitrarily allocate costs among items in a bundle, the aggregate test also avoids the "administrative nightmare" of such cost allocation – and the chilling effect that inevitably accompanies such uncertainty.

The aggregate rule also recognizes the fact that monopoly firms may use their monopoly power in pro-competitive ways and have latitude in how they chose to conduct their business. *See Cargill, Inc.,* 459 U.S. at 116 ("[I]t is in the interest of competition to permit dominant firms to engage in vigorous competition, including price competition.") (citation and internal quotations omitted); *Trinko*, 540 U.S. at 407-08 ("Compelling [monopoly] firms to share the source of their advantage is in some tension with the underlying purpose of antitrust law . . ."). Finally, this rule properly ensures that consumers come before competitors. By requiring proof of a dangerous probability of recoupment as well, this rule penalizes only those discounts which have a realistic chance of harming consumers at some time in the future.

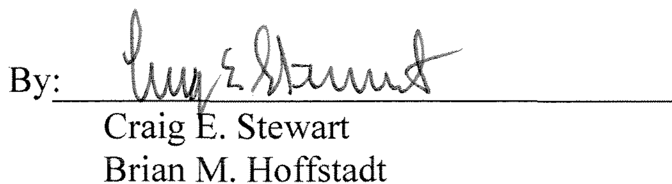
CONCLUSION

For all these reasons, this Court should adopt the aggregate rule when evaluating claims under § 2.

Dated: April 19, 2007

Respectfully submitted,

JONES DAY

By: 

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