ARNOLD & PORTER LLP

CLIENT ADVISORY

NINTH CIRCUIT REJECTS LEPAGE'S AND OFFERS DIFFERENT TEST FOR BUNDLED DISCOUNTS

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Washington, DC
+1 202.942.5000

New York
+1 212.715.1000

London
+44 (0)20 7786 6100

Brussels
+32 (0)2 517 6600

Los Angeles
+1 213.243.4000

San Francisco
+1 415.356.3000

Northern Virginia
+1 703.720.7000

Denver
+1 303.863.1000

INTRODUCTION

Since 2003 and the Third Circuit's much-criticized decision in *LePage's, Inc. v. 3M,* 324 F.3d 141 (3d Cir. 2003), the ability of dominant firms to offer bundled discounts without antitrust risk has been uncertain. But on September 4, 2007, the Ninth Circuit introduced a different test for determining the legality of bundled discounts that potentially offers clearer guidance and a safe harbor for firms considering bundled discounts—at least for those firms that are confident that they will be sued in the Ninth Circuit rather than the Third Circuit. *Cascade Health Solutions v. PeaceHealth,* No. 05-35627, Slip Op. (9th Cir. Sept. 4, 2007) ("Slip Op."). Under the Ninth Circuit's test, a defendant can be found liable for monopolization or attempted monopolization of a market in which the bundled product competes only when the price of the competitive product in the bundle is below the defendant's average variable cost to produce that product after the total amount of discounts and rebates attributable to the entire bundle is applied. This is a version of the test for bundling legality proposed by the Antitrust Modernization Commission ("AMC" or "Commission").

In adopting its new test, the court explicitly rejected the Third Circuit's bundled discount standard enunciated in *LePage's*, which did not require a showing of below-cost pricing and comes close to condemning all bundled discounts offered by a monopolist. *PeaceHealth*, Slip Op. at 11221; *LePage's*, at 151-52. The Ninth Circuit believed that, without the bright-line rule of below-cost pricing, antitrust laws might inadvertently condemn the "lowering [of] prices … the same mechanism by which a firm stimulates competition …[and] the very conduct the antitrust laws are designed to protect." *PeaceHealth*, Slip Op. at 11220-21 (citing *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.,* 127 S. Ct. 1069, 1075 (2007). The court's newly adopted discount attribution test, therefore, preserves the *Brooke Group* requirement that a seller's low prices not be condemned absent some showing of pricing below an appropriate measure of cost. *Brooke Group v. Brown & Williamson Tobacco Corp.,* 509 U.S. 209, 222 (1993).

Although the Ninth Circuit preserved *Brooke Group's* below-cost requirement, it did not apply the Court's single-product test to look at the total price and total cost of the bundle. Instead, the court believed that the discount attribution method of measuring

price and cost would yield better results in a bundled discount case than *Brooke Group's* below-incremental-cost measurement in a single-product case. Also, the court did not adopt *Brooke Group's* requirement that there be a reasonable risk that the defendant's investment in below-cost prices be recouped through supracompetitive prices charged after competitors were forced to exit the market. Because the court had declined to adopt *Brooke Group's* measurement of cost, it found no value in imposing a recoupment requirement where, in a bundled discount setting, recoupment is not necessary for the scheme to be successful. *PeaceHealth*, Slip Op. at 11234 & n.21.

In the end, the Ninth Circuit's decision offers clearer guidance for businesses by reaffirming the Supreme Court's below-cost requirement, but by the same token, it arguably reduces a plaintiff's burden in predatory pricing cases by altering the measurement of cost and eliminating the need to prove possible recoupment.

A. BACKGROUND

McKenzie-Willamette Hospital ("McKenzie") and *PeaceHealth* were the only two hospital care providers in Lane County, Oregon—the relevant geographic market in this case. *Id.* at 11200. McKenzie offered basic hospital procedures such as bone setting or tonsillectomies. PeaceHealth, on the other hand, offered tertiary care (*i.e.,* complex medical procedure) in addition to basic care. *Id.*

McKenzie claimed that it offered basic services "at a lower cost than PeaceHealth" therefore making it the more efficient producer of the competitive services. *Id.* at 11210. Notwithstanding its greater efficiency, McKenzie claimed that PeaceHealth's bundled discounts to insurers excluded it from the market. For example, McKenzie claimed that Regence, a health insurer, had a pre-existing contract with PeaceHealth to purchase primary, secondary, and tertiary services at a 76% reimbursement rate (which translates into a 24% discount). *Id.* at 11202. When Regence considered adding McKenzie as a preferred provider, however, PeaceHealth submitted a new reimbursement rate that would have reduced Regence's discounts by 14%. Regence decided not to add McKenzie as a preferred provider. *Id.* at 11202-03. Similarly, when Providence, another health insurer, added McKenzie as a provider of basic hospital services, PeaceHealth reduced Providence's discounts from 10% to 7%. *Id.* at 11203.

McKenzie filed federal antitrust claims against PeaceHealth for its allegedly anticompetitive bundled discounts, claiming that PeaceHealth's discounts were an unlawful tie under Section 1 of the Sherman Act[1] and constituted unlawful monopolization and attempted monopolization under Section 2.[2] *Id.* In response to the Section 2 claims, PeaceHealth claimed that the district court had failed to properly instruct the jury on *Brooke Group's* safe harbor for above-cost pricing. *Id.* at 11205. Having rejected PeaceHealth's safe-harbor arguments, the district court applied the Third Circuit's *LePage's* standard, which did not require a showing of below-cost pricing for bundled discounts. *Id.* at 11213; *LePage's*, 324 F.3d at 147. The jury awarded McKenzie $5.4 million which the court then trebled to $16.2 million. *PeaceHealth*, Slip Op. at 11199.

B. THE COURT'S OPINION

In *PeaceHealth*, the Ninth Circuit joined those courts that recognize that, absent bright-line rules, imposing liability for low prices has the potential to chill precisely the conduct (low prices and expanded output) that the antitrust laws are designed to foster. *See Cargill, Inc. v. Montfort of Colorado, Inc.,* 479 U.S. 104, 122, n. 17 (1986). Thus, the Ninth Circuit declined to follow the Third Circuit's much criticized approach in *LePage's*, which did not include a below-cost requirement and thus could not test whether the bundled discount excluded an equal or more efficient producer. *PeaceHealth*, Slip Op. at 11220-21; *see also id.* at 11230-31. The Ninth Circuit believed that without *Brooke*

1 The district court granted summary judgment to PeaceHealth on McKenzie's tying claims for lack of proof of coercion. The Ninth Circuit subsequently vacated the judgment, believing there was evidence in the record showing a genuine issue of fact on the issue of coercion. *PeaceHealth*, Slip Op. at 11246-48.

2 McKenzie also filed various state law claims which the court vacated.

Group's below-cost requirement, courts could inadvertently condemn discounts that would benefit consumers. The court stated that the safer course of action, therefore, would be to condemn only those bundled discounts that "resemble the behavior that the Supreme Court in *Brooke Group* identified as predatory." *Id.* at 11221.

In *Brooke Group*, the Supreme Court held that a plaintiff must prove that:

(1) a rival's discount fell below an appropriate measure of costs; and

(2) that the rival "had a reasonable prospect … of recouping its investments in below-cost prices."

Brooke Group, 509 U.S. at 222-24. The Supreme Court stated that low prices should not be condemned absent a showing of below-cost pricing, because "[l]ow prices benefit consumers regardless of how those prices are set, … so long as they are above predatory levels . . . ." *Id.* at 223 (internal quotations omitted). Although the Court did not rule out the possibility that above-cost predation was possible, it found that the administrative cost of ferreting out such cases would be "beyond the practical ability of a judicial tribunal to control . . . ." *Id.*; *PeaceHealth*, Slip Op. at 11223 (noting that past Supreme Court decisions advocating for a safe harbor for above-cost discounting did so more out of a concern for judicial cost and risk of error, than out of a belief that above-cost predation never could occur).

Having decided to preserve *Brook Group's* below-cost requirement, the Ninth Circuit then had to decide whether *Brooke Group's* method of measuring the defendant's discount price against its incremental cost in a single-product case would suffice in a multi-product, bundled discount situation. The court determined that it would not suffice, believing instead that "[d]efining the appropriate measure of costs in a bundled discounting case is more complex than in a single product case." *PeaceHealth*, Slip Op. at 11222. The court stated that asking simply whether the defendant has priced below its incremental costs would not:

> [A]lert [a court] to bundled discounts that threaten the exclusion of equally efficient rivals … [because a] competitor who produces fewer products than the defendant but produces the competitive product at or below the defendant's cost … may nevertheless be excluded from the market because the competitor cannot match the discount the defendant offers over its numerous product lines."
>
> *Id.* at 11222-23.

Having therefore determined that *Brooke Group's* measurement of cost would not be appropriate in a bundled discount case, the Ninth Circuit solicited amicus briefs for proposals suggesting which measurement of cost it should adopt. *Id.* at 11213 & n.9.

1. Aggregate Discount Rule

Some amici advocated that the court adopt an "aggregate discount" rule. *Id.* at 11222. This rule treats the entire bundle as a single product subject to the *Brooke Group* test and measures the discounted price of the entire bundle against the incremental cost to produce the bundle. *Id.* Under this test, bundled pricing would be anticompetitive only if the total price of the bundle was below the defendant's incremental cost of producing the entire bundle. *Id.* While the Supreme Court has endorsed this method for evaluating single-product discounting, it has not addressed whether the standard is appropriate for bundled discounts. *Id.* at 11223-24; *Brooke Group*, 509 U.S. at 222 (single-product pricing case).

As stated above, the Ninth Circuit rejected the aggregate discount rule, because it believed that the rule would not capture instances where an equal or more efficient producer of the competitive product is excluded from the market due to the fact that it did not offer as wide of an array of products as the defendant. *PeaceHealth*, Slip Op. at 11222.

2. The *Ortho Diagnostic* Test

The court next considered a test adopted by the district court in *Ortho Diagnostic Systems, Inc. v. Abbott Laboratories, Inc.,* 920 F. Supp. 455 (S.D.N.Y. 1996). In *Ortho,* the district court had to determine whether Abbott Laboratories' bundled discounts on five blood screening tests impermissibly excluded Ortho from the market, which offered only three

of those tests. *Id.* at 458, 461. The *Ortho* court dismissed a bundling charge where plaintiff could not show that:

(a) the monopolist had priced below its average variable cost; or

(b) the plaintiff is at least as efficient a producer of the competitive product as the defendant, but that the defendant's pricing makes it unprofitable for the plaintiff to continue to produce.

Id. at 469.

The Ninth Circuit rejected the *Ortho* test because the seller first would have to try to assess its rivals' costs before pricing its bundled discounts so as to make sure that its prices did not fall below its rivals' costs. *PeaceHealth*, Slip Op. at 11225. The Ninth Circuit found this approach to be unworkable. *Id.* Also, *Ortho's* test requires that the plaintiff prove that it is at least as *efficient* a producer of the competitive product as the defendant, which could lead to multiple lawsuits as other rivals try to establish the same. *Id.*

3. The AMC's Three-Part Test

Finally, the Ninth Circuit considered the AMC's three-part test. The AMC recommended that courts adopt a discount attribution rule for testing the competitive effects of bundled discounts. *AMC Report and Recommendations,* at 99 (Apr. 2007) ("AMC Report"). The Commission rejected the Third Circuit's test in *LePage's*, finding that the Third Circuit had "failed to evaluate whether 3M's program of bundled rebates represented competition on the merits[.]" *Id.* at 94. Also, the Commission believed that the Third Circuit had erroneously "focused on the claimed harm to LePage's…[and] did not require LePage's to prove it could make tape as efficiently as 3M[.]" *Id.* at 97.

As an alternative, the AMC proposed the following three-part test:

(1) After allocating all discounts and rebates attributable to the entire bundle of products to the competitive product, did the defendant sell the competitive product below cost;

(2) If so, would the defendant likely be able to recoup these short-term losses; and

(3) Did the bundled discount have or is it likely to have an anticompetitive effect?

Id. at 99.

The AMC believed that the first prong of the test would allow courts to determine whether the defendant's bundled discount potentially excluded an equal or more efficient producer of the competitive product. *Id.* at 100. The second and third prongs of the test were added to bring the test in line with *Brooke Group*, and to help ensure that below-cost bundled discounts that do not produce any anticompetitive effects would not be condemned. *Id.*

4. The Ninth Circuit's Discount Attribution Rule

Having considered the various approaches for calculating the appropriate measure of cost for bundled discounts, the Ninth Circuit was most persuaded by the AMC's reasoning and adopted a variant of the Commission's discount attribution test. *PeaceHealth*, Slip Op. at 11225.

Unlike the test in *Ortho*, the court stated that the discount attribution test would require that the seller consider only its own rebates and costs, rather than those of its rivals—information that could be "easily ascertain[ed]." *Id.* at 11229. Also, the discount attribution standard would allow a court to consider a bundled discount's effect on a "*hypothetical* equally efficient producer of the competitive product" and would not require that a specific plaintiff prove that it is as efficient (or more efficient) than the defendant, which could encourage more litigation. *Id.* at 11225-26 (emphasis in original).

Although the Ninth Circuit adopted the first part of the AMC's three-part test, it declined to adopt the AMC's last two parts—namely, whether the defendant was likely to recoup its so-called "short-term losses," and whether the bundled discount was likely to have an anticompetitive effect. *Id.* at 11234 & n.21; *see* AMC Report, at 100. The Ninth Circuit reasoned that a bundled discounter could exclude its rivals without having to sell its bundled products at a loss (*i.e.*

unprofitably), thus negating the need for recoupment in the future. *PeaceHealth*, Slip Op. at 11234 & n.21. Also, the court believed that the AMC's third prong, requiring a showing of anticompetitive effects, already was incorporated in "the general requirement of 'antitrust injury'[.]" *Id.*

C. IMPLICATIONS

Although *PeaceHealth* offers clearer guidelines for businesses considering offering bundled discounts, the decision also could be seen as a boon for antitrust plaintiffs. First, by allocating the total amount of discounts and rebates to just the competitive product, the court adopted a far more plaintiff-friendly test than looking to see whether the price of the entire bundle was below the cost of the entire bundle. Second, the Ninth Circuit's test allows a less efficient producer to challenge, and presumably recover damages, for a predatory discount bundle, because the test inquires only into the potential effects on a *hypothetical* producer and does not require that the party bringing the claim itself be as or more efficient. Perhaps of greater importance, the Ninth Circuit's test does not look to whether a particular plaintiff could have profitably matched the discounted price either on its own or by working with others to create an alternative bundle.

Finally, and possibly most importantly, in bundled discount cases *PeaceHealth* eliminates the recoupment element that is required in single product predatory pricing cases–arguably, one of the more difficult elements for a plaintiff in a predatory pricing case to establish. *See e.g. Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp.* 475 U.S. 574, 597 (1986) (plaintiff failed to establish a plausible recoupment theory). Indeed, the recoupment test was met in *LePage's*. *LePage's*, 324 F.3d at 151 & n.7 (noting that "3M had conceded that it could later recoup the profits"). It remains to be seen, however, whether courts in the Ninth Circuit will interpret the antitrust injury requirement of all antitrust claims in a way that bars bundled discounting challenges where consumers are not ultimately harmed through higher prices (or at least the plausible threat of higher prices in the future).

Even with the decision in *PeaceHealth*, firms that engage in bundled discounting must recognize that *LePage's* remains good law in the Third Circuit, and firms that sell nationwide remain subject to suit in a district court in that circuit.

D. CONCLUSION

PeaceHealth offers clearer guidance for businesses, but also reduces the burden for private plaintiffs challenging bundled discounts. It will be interesting to see whether the court's treatment of bundled discounts serves to encourage challenges to bundled discounting in courts in the Ninth Circuit. We expect, however, that any challenge to bundled discounting that can be brought in the Third Circuit will be brought there instead.

If you would like more information about PeaceHealth, please contact your Arnold & Porter attorney or:

Nadine Jones
+1 202.942.6598
Nadine.Jones@aporter.com

Jonathan Gleklen
+1 202.942.5454
Jonathan.Gleklen@aporter.com

Ken Letzler
+1 202.942.5921
Kenneth.Letzler@aporter.com