A Note on Loyalty Discounts

Jonathan M. Jacobson

Loyalty (or "market share") discounts have become increasingly visible in antitrust policy debates.[1] Loyalty discounts are prevalent in the sale of medical devices and pharmaceutical products, especially by dominant firms,[2] and are being used more frequently by firms in other industries as well. Intel's use of them has led to antitrust proceedings by AMD,[3] the European Commission,[4] the New York Attorney General,[5] and, most recently, the Federal Trade Commission.[6]

This note examines reasons firms offer for the use of loyalty discounts, the sparse case law addressing their use, and how antitrust policy might be applied going forward in evaluating their legality. The note's analysis suggests that loyalty discounts are essentially a form of exclusive dealing. Application of the sort of price-cost test typically used in analyzing predatory pricing therefore seems inappropriate. And while use of an attribution test similar to that used in analyzing bundled pricing conduct might make sense in theory, the real-world difficulties in applying such a test to loyalty discounts render that approach impractical. The suggestion here, therefore, is to apply basic rule of reason analysis—to determine whether the impairment of rivals, net of efficiencies, is likely to reduce market output or otherwise cause material consumer harm.

Introduction

A loyalty or market share discount is a price break given by a supplier in return for the customer's commitment to take a given percentage of its requirements from the supplier in question. A simple type of discount might be one that is limited to the units in excess of a stated amount. So, if a supplier's nominal price for its product is $100, the supplier might offer customers a discount of $15 on all units in excess of 50 percent of the customer's requirements. In this example, a customer whose total requirements are 100 units would pay the supplier $7550 for 80 units, saving $450 from the nominal price ($15 apiece on the incremental 30 units).

Another type of loyalty discount is the "first dollar" discount. The same supplier using this sort of discount would offer the $15 price break on *all* units purchased provided that the customer

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[1] *Compare, e.g.*, U.S. Dep't of Justice, Competition & Monopoly: Single-Firm Conduct Under Section 2 of the Sherman Act 106–19 (2008) [hereinafter Bush DOJ Report] (withdrawn effective May 11, 2009), *available at* http://www.usdoj.gov/atr/public/reports/236681.pdf (urging largely laissez-faire approach), *with, e.g.*, Statement of Commissioners Harbour, Leibowitz & Rosch on the Issuance of the Section 2 Report by the Department of Justice 5–6 (FTC Sept. 8, 2008), *available at* http://www.ftc.gov/os/2008/09/080908section2stmt.pdf (evaluating loyalty discounts as a form of exclusive dealing).

[2] *See* Einer Elhauge, *The Failed Resurrection of the Single Monopoly Profit Theory*, Competition Pol'y Int'l, Spring 2010, at 11.

[3] Advanced Micro Devices, Inc. v. Intel Corp., No. 05-441 (D. Del. filed June 27, 2005). The case settled on November 12, 2009.

[4] Commission Decision, COMP/C-3/37.900—Intel Corp., May 13, 2009, *available at* http://ec.europa.eu/competition/sectors/ICT/intel.html.

[5] New York v. Intel Corp., 1:2009cv00827 (D. Del. filed Nov. 4, 2009).

[6] Complaint, Intel Corp., FTC Docket No. 9341 (Dec. 16, 2009), *available at* http://www.ftc.gov/os/adjpro/d9341/091216intelcmpt.pdf.

obtains at least 50 percent of its requirements from the supplier. Using the same example, the customer buying 80 units would pay $6800. The loyalty devices that most frequently encounter antitrust scrutiny are these "first dollar" discounts, and the discussion below will focus on them.

Why do firms use loyalty discounts? The main reason, of course, is to sell more. In this example, the customer will be tempted to buy more if its average unit price is $85 rather than $100. The analysis cannot stop there, however, because a loyalty discount is not a simple price cut. The supplier could always simply charge $85 for its product across the board. By conditioning the discount on a percentage requirement, the supplier is inducing the customer to take more from the supplier and also to take *less* from rivals. In some instances, moreover, the "discount" might in fact be a disguised penalty for "disloyal" buyers. The competitive equilibrium price, in the same example, might be $85, meaning that, if the 50 percent loyalty requirement is not met, the supplier's resulting price of $100 per unit will include a $15 per unit penalty.

Altering the example to incorporate the sort of numeric values encountered in actual cases highlights the problem. Take a supplier with a significant market share who is applying a discount of 20 percent to customers who purchase at least 90 percent of their requirements. For a customer purchasing 100 units, there is a strong inducement to purchase all (or at least 90 percent) from the supplier. If rival suppliers charge $80, the customer purchasing 90 units or more from the supplier pays $8000 in total for 100 units. But if the customer wants to take 20 units from rivals, there is a significant penalty. The 80 units from the defendant supplier cost $8000 at the $100 price, the same price as 100 units if the customer had met the 90 percent loyalty requirement. Rivals therefore must give their product away for free for the customer to avoid paying more. The first dollar loyalty discount, in this example, may operate effectively as an exclusive dealing requirement.

Is that a problem? Exclusive dealing arrangements are typically associated with potentially significant efficiencies. An exclusive dealer will focus its energies on the supplier's products and promote them more effectively. Exclusivity tends to limit free riding, assure quality, inhibit passing off, reduce out-of-stocks, and may provide commitments of volume necessary to achieve economies of scale.[7] Traditional exclusive dealing thus involves significant complementary investments in which both supplier and customer devote time, energy, and money to their mutual success.

Many loyalty discounts, however, are generally associated with *no* complementary investments and are different from exclusive dealing in this respect. Because some competitive product purchases are permitted, the supplier generally is not trying to get its dealer to provide an entirely dedicated focus to the distribution of its products. Loyalty discounts, moreover, are sometimes applied to end-user purchasers, such as hospitals, where complementary investments are rare. Typically, then, the principal goal underlying a loyalty arrangement is not to further more effective distribution, it is just to get the customer to buy more—and to get rivals to supply less. So firms using first dollar loyalty discounts, at least in the general case, *might* be trying to compete on the merits by selling more, *might* be trying to exclude rivals, but may *not* be seeking to achieve the efficiencies achieved by the complementary investments with which ordinary exclusive dealing is typically associated. Importantly, the customer benefit is limited to the lower price associated with the discount—a benefit that could be achieved equally by simply reducing the price. Adding the loyalty condition generally provides no benefit to the customer. It benefits only the supplier, and may cause rivals considerable harm.

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[7] *See* Jonathan M. Jacobson, *Exclusive Dealing, "Foreclosure" and Consumer Harm*, 70 ANTITRUST L.J. 311, 357–60 (2002).

These general principles are not without some exceptions. If a supplier uses its loyalty discount, for example, to reward distributors who invest in the supplier's products—by providing better facilities, more adequate stock, dedicated promotional activity, and the like—the efficiency effects may well resemble those associated with more traditional exclusive dealing arrangements. In some instances, moreover, involving products with high fixed costs, loyalty discounts may assure greater sales and, thus, lower prices. Whether loyalty discounts are reasonably necessary to achieve these goals, however, is less clear. A supplier can offer volume discounts or other price concessions, without loyalty commitments, to generate volume to account for high fixed costs. Similarly, dealer services can be compensated directly or achieved through incentive payments, without imposing a condition of loyalty. Nevertheless, in cases where loyalty less than complete dedication may give rise to more effective distribution, and where the arrangements in question are likely to achieve that goal, condemnation may not be appropriate.

Case Law

The legality of loyalty discounts can be analyzed as agreements in restraint of trade under Sherman Act Section 1[8] or, if the product in issue is a commodity, as condition or agreement lessening competition under Clayton Act Section 3.[9] If the defendant has significant market power, analysis under Sherman Act Section 2[10] may be appropriate as well. The primary issue addressed in this note is whether the arrangement at issue is anticompetitive, and, for purposes of answering that question, the analysis under each of the three statutes should essentially be the same.

Analysis of loyalty discounts has led to diverse treatment in the rather sparse case law. Three of the reported cases on the issue involve fact patterns in which there was little, if any, harmful effect because the plaintiff could easily overcome the discount by offering an above-cost favorable price. In each of *Concord Boat Corp. v. Brunswick Corp.*,[11] *Allied Orthopedic Appliances v. Tyco Health Care Group*,[12] and *Virgin Atlantic Airways v. British Airways*,[13] the defendant prevailed because of insufficient evidence that customers were economically coerced into buying from the defendant. In *Concord*, for example, the court agreed that de facto exclusive dealing achieved by a discounting scheme could be a violation,[14] but that the discounts at issue were sufficiently modest, and the plaintiff enjoyed sufficient room to compete for any and all of the available business, such that a violation finding could not be sustained.[15]

In *Masimo Corp. v. Tyco Health Care Group*,[16] in contrast, the Ninth Circuit sustained a jury verdict of loyalty discount liability. The district court concluded that Tyco's 90 percent market share requirement was coercive because the existing installed base of Tyco equipment required customers to take some appreciable portion of their requirements from Tyco no matter what, such that, at least for some customers, Masimo "could not price its sensors low enough" to compensate for

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[8] 15 U.S.C. § 1.

[9] 15 U.S.C. § 14.

[10] 15 U.S.C. § 2.

[11] 207 F.3d 1039 (8th Cir. 2000).

[12] 592 F.3d 991 (9th Cir. 2010).

[13] 257 F.3d 256 (2d Cir. 2001).

[14] 207 F.3d at 1062–63.

[15] *Id*. at 1059–60.

[16] No. CV-02-4770 (MRP), 2006 WL 1236666 (C.D. Cal. Mar. 22, 2006), *aff'd*, 30 Fed. App'x 95 (9th Cir. 2009).

the discounts lost by the failure to satisfy the market share requirement.[17] Put differently, on the volume for which Masimo could compete—the "contestable volume"—Tyco's prices were below cost.

The much-discussed (and often criticized) decision in *LePage's, Inc. v. 3M*,[18] typically thought of as a bundled discount case, can also be viewed as involving loyalty discounts. 3M provided discounts on transparent tape that applied not only to its dominant "Scotch" brand but to private label tape (where LePage's competed) as well. The Third Circuit condemned the discounts as exclusionary, notwithstanding the absence of any evidence that the prices were below cost under an "attribution" standard or any other basis, because they had the practical effect of requiring customers to award all or almost all their tape business to 3M.[19]

Loyalty discounts were also involved in the recent district court decision in *Univac Dental Co. v. Dentsply International Inc.*,[20] a private damages action filed in the wake of the Justice Department's successful exclusive dealing case against the company.[21] In a brief discussion, the court denied summary judgment to the defendant in connection with a claim that rebates conditioned on exclusivity violated Section 2—without any requirement of proof of pricing below cost (however measured).[22]

Somewhat surprisingly, given all the current debate about loyalty discounts, these cases provide the only decisions specifically addressing loyalty discounts in the modern antitrust era. And they provide scant guidance. *LePage's* and *Dentsply* involved a variety of different practices. *Concord*, *Allied*, and *Virgin* involved contexts where there was little, if any, harmful impairment of rivals,[23] while *Masimo* involved a context in which impairment was obvious. The considerable middle ground has not been touched in any meaningful way.

Arguments Against Applying Exclusive Dealing Standards

The purpose of any loyalty discount, by definition, is to induce partial or complete exclusivity. The customer is offered a price break in return for a promise to take all, or a stated minimum percentage, of its requirements from the supplier. Without more, of course, there is nothing anticompetitive in that sort of arrangement. If the supplier lacks market power, for example, exclusivity—whether induced by loyalty discounts or not—will not be problematic. Even where the supplier has market power, application of standard exclusive dealing analysis will condemn only those arrangements that lack significant efficiencies and have the actual or probable effect of causing significant consumer harm.

Still, even though loyalty discounts are designed to create results essentially the same as exclusive dealing arrangements, arguments have been advanced to suggest that exclusive dealing standards should not apply. None of these arguments has much merit.

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[17] *Id*. A similar result was reached in *Eisai Inc. v. Sanofi-Aventis LLC*, No. 3:08 Civ. 4168 (D.N.J. June 12, 2009) (transcript of hearing).

[18] 324 F.3d 141 (3d Cir. 2003) (en banc).

[19] *Id*. at 159–63. Although the relevant market in the case was all tape, branded or private label, the case is still better viewed from the multiple-product bundled discount perspective because the 3M discounts were premised on purchases of all its various products, not just tape. The "attribution" standard is discussed further below in the text accompanying notes 38–42.

[20] No. 1:07-CV 0493 (M.D. Pa. Mar. 31, 2010).

[21] United States v. Dentsply Int'l, 399 F.3d 181 (3d Cir. 2005).

[22] *Dentsply*, No. 1:07-CV-0493, slip op. at 13.

[23] Courts regularly use the term "foreclosure" to signify a harmful impairment of rivals. For an argument that the "foreclosure" terminology is confusing, circular, and ultimately not useful, see Jacobson, *supra* note 7.

One argument is that, because loyalty discounts involve pricing, the predatory pricing standard of *Brooke Group* [24] should apply.[25] None of the decided cases supports that view, however, and it does not withstand analysis.

In circumstances where loyalty discounts may be harmful, the problem is not the price level; it is that rivals are denied access to customer volume. If the effect is to prevent rivals from constraining the defendant's market power, consumer harm may result.[26] Application of a predatory pricing standard does not accomplish the necessary analysis.

Professor Elhauge provides a useful example of why exclusivity, rather than price levels, should be the focus of the analysis:

> Suppose a monopolist charges $200 for a product that costs $100 to make. Other firms stand poised to enter the market, or to expand until they achieve sufficient scale to reduce their costs to $100, in which case competition will drive prices down to $100. To prevent this competitive outcome, the monopolist announces a loyalty program under which its price is $250 unless buyers agree to be loyal and buy 90% of their needs from the monopolist, in which case buyers get a nominal "discount" of $50. All the buyers agree to avoid the $50 price penalty, foreclosing 90% of the market. As a result, rivals cannot enter, or expand enough to achieve their minimum efficient scale, and the buyers all continue to pay the monopoly price of $200, which is double the $100 price they would have paid but for the loyalty program.[27]

As this illustration demonstrates, the seller's prices can remain well above cost on any measure while still excluding rivals and, in so doing, raising customer prices above competitive levels. No court in any traditional exclusive dealing case has asked whether the defendant's prices are above or below cost because the question is simply not relevant in that context. The same is true in cases involving loyalty discounts.[28]

A second argument is that exclusive dealing analysis is not applicable because a loyalty percentage requirement less than 100 percent is not "exclusive" dealing.[29]

The argument is unpersuasive. Plainly, a 99.9 percent loyalty requirement is "exclusive" in every meaningful sense of the term. Requirements of 90%, 80%, or 65%, are variously less so, but they may still bar rivals from access to the levels of volume needed to compete effectively. An outright exclusive dealing arrangement affecting 60 percent of a given market may or may not be unlawful but clearly merits scrutiny. The analysis is no different if the arrangement is for 80 percent of customer's "loyalty" requirements by a firm with a 75 percent market share. In both instances, 60 percent of the available market may be out of reach of rival firms.

The case law appears to put this argument out of bounds in any event. The Supreme Court has twice held under Section 3 of the Clayton Act that the question is whether the arrangement has the "practical effect" of excluding rivals,[30] and lower court cases apply the same analysis in

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[24] Brooke Group v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993).

[25] *See* Bush DOJ Report, *supra* note 1, at 116–17 ("the standard predatory-pricing approach to single-product loyalty discounts has a number of advantages").

[26] *E.g.*, Jacobson *supra* note 7, at 347–57.

[27] Declaration of Professor Einer Elhauge on behalf of Eisai Inc. ¶ 3, Eisai Inc. v. Sanofi-Aventis LLC, No. 3:08 Civ. 4168 (D.N.J. Nov. 17, 2008).

[28] *See* Harbour, Leibowitz & Rosch Statement, *supra* note 1, at 6–7; Willard K. Tom, David A. Balto & Neil W. Averitt, *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 Antitrust L.J. 615, 636–38 (2000).

[29] *See* Bush DOJ Report, *supra* note 1, at 115.

[30] *See* Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320, 326 (1961); United Shoe Mach. Corp. v. United States, 258 U.S. 451, 457 (1922).

cases under Sections 1 and 2 of the Sherman Act.[31]

Yet another argument is that exclusive dealing analysis should not apply because exclusivity is not an absolute requirement; it is instead, conditioned on discounts.[32] Again, however, logic and precedent are to the contrary.

Although many loyalty discounts are nominal and not at all coercive, that is not so universally true to warrant exempting them from effective scrutiny. If a loyalty condition is sufficiently steep, and if customers must take some portion of their requirements from the defendant in any event, the condition is not much different from express exclusivity. As Professor Elhauge's illustration demonstrates, there are often cases in which rivals cannot meet the discount without giving their product away.

The specific text of Section 3 of the Clayton Act is informative. It refers expressly to any agreement to sell or lease goods "or [to] fix a price charged therefor, or *discount* from, or rebate upon, such price," conditioned on exclusivity.[33] Supreme Court precedent is to the same effect. In *Northern Pacific Railway v. United States*,[34] the agreement in issue required shipment over the defendant's railroad only if "its rates (and in some instances its service) were equal to those of competing carriers."[35] The Court held that this type of exclusivity was sufficient to hold the conduct unlawful because "these agreements are binding obligations held over the heads of vendees which deny defendant's competitors access to the fenced-off market on the same terms as the defendant."[36] The ability of customers to avoid exclusivity by charging a lower price was no defense. *Northern Pacific* is more than fifty years old, but no recent case has suggested any contrary result in this context.[37]

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It seems reasonably clear that neither the conditional nature of loyalty discounts nor the absence of total exclusivity provides any basis for exempting loyalty arrangements from traditional antitrust scrutiny. It seems equally clear that the analysis should not be based on predatory pricing standards.

Alternative Approaches

Because loyalty discounts most closely resemble exclusive dealing, logic suggests analyzing them under a similar standard. Loyalty discounts differ, however, from standard exclusive dealing arrangments in two important respects: first, their exclusion of rivals will tend to be less severe; and, second, they often lack the complementary investment efficiencies that exclusive dealing typically yields. Do these differences warrant a different kind of analysis? The answer, ultimately, seems to be "no," but the other potential approaches at least merit further discussion.

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[31] *E.g.*, United States v. Microsoft Corp., 253 F.3d 34, 61–62 (D.C. Cir. 2001); United States v. Standard Oil Co., 362 F. Supp. 1331, 1335, 1337–38, 1341 (N.D. Cal. 1972) (60% requirements), *aff'd*, 412 U.S. 924 (1973); Sewell Plastics Inc. v. Coca-Cola Co., 720 F. Supp. 1196, 1209–10, 1217–20 (W.D.N.C. 1989) (80% requirements), *aff'd mem.*, 912 F.2d 463 (4th Cir. 1990).

[32] *See* Bush DOJ Report, *supra* note 1, at 115.

[33] Clayton Act § 3, 15 U.S.C. § 14 (emphasis added). The text and legislative history of the Act demonstrate Congress' desire to overrule *Whitwell v. Continental Tobacco*, 125 F. 454 (8th Cir. 1903), which had held otherwise. *See, e.g.*, 51 Cong. Rec. 9161–62 (1914); Jacobson, *supra* note 7, at 317–18.

[34] 356 U.S. 1 (1958).

[35] *Id.* at 3.

[36] *Id.* at 12.

[37] The one decision to address the point, *Masimo*, 2006 WL 1236666, at *5, is consistent with *Northern Pacific Railway*.

Discount Attribution Test. One way of analyzing the question would be to attempt to mirror the analysis adopted for bundled pricing arrangements by the Ninth Circuit in *PeaceHealth*,[38] based on a recommendation by the Antitrust Modernization Commission.[39] Under that test, with variations not relevant here, the discount on all products in the bundle is attributed to the competitive product in which exclusion is claimed. If the defendant's "price" (on this attribution basis) is below an appropriate measure of cost, *and* the net effect of the bundled pricing is to cause material consumer harm (for example, by leading to higher prices overall), the arrangement is considered unlawful.

The utility of this attribution test in bundling cases is that findings of illegality are limited to instances in which the discounts in issue exclude equally efficient rivals. But the test, while useful and important, especially in the bundling context, is no panacea. The difficulties in determining the appropriate measure of cost in important industries where marginal costs are unusually low—such as pharmaceuticals, software, and microprocessors—and the corresponding difficulty in accounting for significant costs (such as research, development, and marketing)[40] render any cost-based test difficult to administer. The attribution safe harbor this test creates for bundled discount arrangements remains appropriate in light of the frequent customer demand for these discounts so frequently encountered in the bundling context. But the test is not as useful in the loyalty discount arena for two main reasons.

First, determining how to apply the attribution test to a loyalty discount is problematic. Doing so requires identification, and separation, of "contestable" and "incontestable" portions of a customer's demand. To illustrate, suppose that the customer needs 100 units. It must take 50 from the defendant (the incontestable portion) because only the defendant sells a full line with all sizes; no rival sells a full line. The defendant's pre-entry price is $75 but, upon entry, it raises prices to $100, with a 25 percent loyalty discount for customers who agree to take 90 percent or more of their requirements from the defendant. Cost for the defendant and rivals is $60 per unit. If the customer takes 90 or more units from the defendant, and if rivals' prices are also $75, the customer pays $7500 for 100 units. But what if the customer wants to get 50 units from rivals? The 50 units will cost $5000, so rivals must charge no more than $2500 for the remaining 50 (the contestable portion) to make the customer whole. That comes to $50 per unit. Since cost is $60, however, the defendant's sales on the contestable 50 units are below cost—applying the same sort of attribution analysis used in the bundling context.

The difficulty is that, while there are fact patterns, such as the one above, in which determining how to apply a discount attribution analysis in loyalty cases is readily achievable, in the real world these patterns are difficult to discern. In contrast to bundling cases, where distinct products are involved, and where it is comparatively easy to determine the sum of the discounts being

[38] Cascade Health Solutions v. PeaceHealth, 515 F.3d 883 (9th Cir. 2008).

[39] Antitrust Modernization Commission, Report & Recommendations 83 (2007); *see also* Jonathan M. Jacobson, *Exploring the Antitrust Modernization Commission's Proposed Test for Bundled Pricing*, Antitrust, Summer 2007, at 23; Janusz Ordover & Greg Shaffer, *Exclusionary Discounts* (CCP Working Paper No. 07-13, Aug. 25, 2006), *available at* http://www.ftc.gov/os/sectiontwo hearings/docs/Ordover_Shaffer_two-units_final.pdf. Application of this discount attribution test to loyalty discounts is recommended in 3A Phillip Areeda & Herbert Hovenkamp, Antitrust Law ¶ 749e, at 341 (3d ed. 2008); the authors do not, however, address the problems associated with the application of this test in the loyalty context that are identified below.

[40] *See* Jonathan M. Jacobson, Cost-Based Rules in the New Economy, Paper Prepared for ABA Section of Antitrust Law Spring Meeting (Mar. 25, 2009), *available at* http://www.wsgr.com.

applied to all the products in the bundle,[41] the analysis of what is contestable and what is not in loyalty cases can be extremely difficult. How do we know whether the incontestable portion is 50 units, or 70, or 20, or zero? The defendant will argue that none or very little of its volume is incontestable, and the plaintiff will argue otherwise. Adding this complexity to the pre-existing problems, inherent even in bundling cases, of determining the appropriate measure of costs results in a mode of analysis that, while useful in theory, fails as a workable rule of decision (or counseling) far more often than it succeeds.

Second, loyalty discounts are different from bundled discounts in that the harm they cause may be worse and the benefits they yield tend to be fewer. The harm from impairment of rivals is similar to the harm that bundled discounts may cause. But with loyalty discounts, there is an additional problem. As Professor Elhauge has explained, the imposition of loyalty discounts by dominant firms tends to reduce large firm incentives to compete for available customers not subject to loyalty discounts while also discouraging rivals from competing for the business of firms receiving the discounts. The consequence of these reciprocal incentives is that prices may be raised to all customers across the board.[42]

Correspondingly, in many cases, there are few, if any, cost-reducing efficiencies associated with loyalty discounts. The principal benefit is the reduction in price to the customer, but—as we have seen—that price reduction may simply be the elimination or reduction of a price *penalty*. Net prices may well not be reduced, and may even increase. The defendant can always charge the same or even lower prices without attaching any loyalty requirement. Application of an attribution discount safe harbor therefore has far less justification than in the bundling context in which that safe harbor originated.

Coercion Requirement. The most significant problem with loyalty discounts, when there is one, is the same sort of impairment of rivals encountered in traditional exclusive dealing cases. Therefore, another way to analyze loyalty discounts would be to develop a test to determine when the discount is sufficiently coercive to amount to de facto exclusive dealing. This approach has considerable merit in theory. If the customer has no practical economic choice other than to accept the minimum loyalty requirement, the arrangement is the same as exclusive dealing in every important sense. To date, however, no one appears to have been able to propose a reasonable test of "coercion" in this context. So while this option may be attractive, alternative methods of analysis would seem preferable until some operable test comes along.

Competitive Effects/Rule of Reason Approach. In the present state of knowledge, one approach to loyalty discount analysis that seems to work is a straight competitive effects analysis. This would require the plaintiff to demonstrate (1) that the defendant has (or is likely to achieve) market power, (2) that an appreciable portion of the relevant market is covered by the loyalty arrangements in question, and (3) that the effect is to lessen competition substantially—by raising the price, reducing output or quality, or significantly limiting the choices available to consumers in the market as a whole.

Calculating the portion of the market covered should not be complicated. It is the share of the market covered by the defendant's arrangements times the loyalty percentage requirement. So,

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41 This is certainly not always the case, however. Determining what the "discount" is on any given product may be difficult if the price changes for all products are not adopted at the same time. The determination may be difficult in other contexts as well.

42 *See* Einer Elhauge & Abraham L. Wickelgren, *Robust Exclusion Through Loyalty Discounts* (Working Paper, Jan. 28, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1544008.

if the defendant has a 70 percent share, has loyalty arrangements for all of its customers, and the loyalty percentage is 70 percent, the percentage of the market affected is 49 percent (70% × 70%). The resulting value is appropriately treated in the same way as the "foreclosure" percentage in standard exclusive dealing cases. If the percentage is lower than 30%–40%, the plaintiff's case will be weak and subject to a motion to dismiss or for summary judgment on that basis.[43]

If the plaintiff can satisfy this market coverage requirement, the remaining analysis should focus on the actual and potential harm to consumers: Is there an impairment of the plaintiff and other rivals to a degree sufficient to prevent them from constraining the defendant? If so, is the result to create or enhance the defendant's market power such that consumers are likely to be harmed? Has the arrangement in fact reduced sellers' incentives to discount to new and existing customers such that price competition is reduced in a material way? This analysis is standard in rule of reason cases and is similar to the approach used in evaluating mergers. It is a process with which litigants, agencies, and courts are familiar.[44]

One difference between loyalty discount and standard exclusive dealing cases is that, in the latter, at least in theory, a difficult balancing may be required to conclude the analysis. If there are adverse competitive effects and potentially countervailing efficiencies, the two may have to be weighed and a conclusion reached as to the net effect on competition and consumers. In fact, cases involving such a difficult balancing are extremely few and far between; but the potential need to balance has still been perceived as a potential problem.[45] Whatever one's view on that subject, however, it seems clear that it is not any kind of a serious problem in loyalty discount cases because, as mentioned, loyalty discounts generally involve no cost-saving or similar customer benefits that cannot be achieved with equal effectiveness through simple price reductions without associated loyalty conditions. In this respect, rule of reason analysis for loyalty discounts is simpler and easier.

Safety Zone

As in many areas of antitrust, determining a precise boundary between the lawful and the problematic may not be easy, but determining what conduct is reasonably safe is not especially difficult. Application of the rule of reason in the manner suggested should enable adequate counseling in this regard. Specifically, firms can be advised that loyalty discounts are safe where:

- The supplier lacks market power;
- Less than 30%–40% of the market is covered by the agreements in question;
- The discount is not coercive, either because it is not a first-dollar discount or because it can be met or exceeded by an equally efficient rival; or
- Competition for customer contracts is sufficiently effective that the exclusivity effect poses little risk of raising the market price of the product in question.

Is this type of guidance a roadmap to certainty? Plainly not. But it is sufficient to allow counselors and their clients to determine which loyalty discounts are unlikely to be challenged and which, in contrast, carry litigation risk.

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[43] *See* ABA Section of Antitrust Law, Antitrust Law Developments 216–18 (6th ed. 2007).

[44] *See, e.g.*, United States v. Microsoft Corp., 253 F.3d 34, 58–59 (D.C. Cir. 2001) (en banc).

[45] *See* A. Douglas Melamed, *Exclusive Dealing Agreements and Other Exclusionary Conduct—Are There Unifying Principles?*, 73 Antitrust L.J. 375 (2006); Gregory J. Werden, *Identifying Exclusionary Conduct Under Section 2: The "No Economic Sense" Test*, 73 Antitrust L.J. 413 (2006). For a contrary view, see Jonathan M. Jacobson & Scott A. Sher, *"No Economic Sense" Makes No Sense for Exclusive Dealing*, 73 Antitrust L.J. 779 (2006).

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Loyalty discounts present significant issues for antitrust analysis. As they become more and more prevalent in real world markets, the need to develop a fair test that allows firms to receive even more accurate counseling in their use, and more specific guidance for rules of decision for courts and agencies, will become increasingly important. Loyalty discounts most closely resemble exclusive dealing and should be analyzed in largely the same manner. Accordingly, until specific rules applicable to these discounts can be developed, standard rule of reason analysis appears to be the most appropriate decisional guide. ●