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Ninth Circuit Adopts a Cost-Based Standard to Evaluate Whether a Competitor's Bundled Discounts Are Anticompetitive

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by Jonathan Gowdy, Nicole D. Devero

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The Ninth Circuit recently issued an important antitrust decision (*McKenzie-Willamette Hospital v. PeaceHealth*) that establishes a cost-based standard to evaluate whether a "bundled discount" program violates U.S. antitrust law - namely the prohibition against monopolization and attempts to monopolize in Section 2 of the Sherman Act. The Ninth Circuit's decision is notable for several reasons:

- First, the standard set forth in the decision requires an antitrust plaintiff to demonstrate that the discounts resulted in prices that are below an appropriate measure of the defendant's costs.

  The cost-based rule adopted by the Ninth Circuit is known as the "discount attribution" standard. Under this rule, "a plaintiff who challenges a package discount as anticompetitive must prove that, when the full amount of the discounts given by the defendant is allocated to the competitive product or products, the resulting price of the competitive product or products is below the defendant's incremental [*i.e.,* average variable] cost to produce them."

- Second, the Ninth Circuit rejected the defendant's proposed "aggregate discount" standard to measure whether its prices were below cost. Under the aggregate discount method, bundled discounts would only be deemed anticompetitive when the discounted price of the entire bundle does not exceed the bundling firm's incremental cost to produce the entire bundle.

- Third, in adopting the "discount attribution" standard, the Ninth Circuit expressly declined to follow the standards applied in other prominent court decisions evaluating the legality of bundled discount programs offered by firms with high market shares, including the Third Circuit's decision in *LePage's v. 3M* and the Southern District of New York's decision in *Ortho Diagnostic v. Abbott Labs*.

- Fourth, while the discount attribution standard by the Ninth Circuit provides clearer guidance to firms engaged in bundled discounting practices than the standards in *LePage's* or *Ortho*, the rule also has the potential to classify more pricing behavior as anticompetitive than either the aggregate discount rule or the *Ortho* standard. Thus, companies with large market shares should carefully evaluate the potential antitrust risks of bundled rebates or similar discount programs in light of the Ninth Circuit's decision.

Case Background

The parties in *McKenzie-Willamette Hospital v. PeaceHealth* are the only two hospital care providers in Lane County, Oregon. McKenzie, a provider of primary and secondary acute care services,

alleged that PeaceHealth, a provider of primary, secondary and tertiary acute care services, engaged in anticompetitive conduct by offering insurers bundled discounts. Specifically, McKenzie asserted that PeaceHealth – with a 90% market share of tertiary neonatal services, a 93% share of tertiary cardiovascular services and approximately a 75% share of primary and secondary care services – offered insurers discounts of 35% to 40% on tertiary services if insurers designated PeaceHealth sole preferred provider for all services.

Following *LePage's*, the district court instructed the jury that bundled discount packages could be exclusionary and anticompetitive if "they are offered by a monopolist and substantially foreclose portions of the market to a competitor who does not make an equally diverse group of services and who therefore cannot make a comparable offer." Based on this instruction, the jury found that PeaceHealth had engaged in an unlawful attempt to monopolize and awarded damages to McKenzie.

Prior to the Ninth Circuit's decision in *PeaceHealth*, the *LePage's* standard has been heavily criticized by antitrust scholars and the Antitrust Modernization Commission (AMC) because:

- The standard had the potential to discourage procompetitive conduct (*i.e.,* lower prices) without any clear showing that (1) the defendant was pricing below cost or (2) an equally efficient rival would be foreclosed from the market, and
- The standard offered no clear standards by which businesses could assess whether their bundled discount programs are likely to run afoul of the antitrust laws.

Ninth Circuit Decision in *PeaceHealth*

In *PeaceHealth*, the Ninth Circuit expressly rejected the *LePage's* standard applied by the district court and held that an antitrust plaintiff must demonstrate that the bundled discounts resulted in prices that are below an appropriate measure of the defendant's costs. According to the Ninth Circuit, simply demonstrating the plaintiff lost sales because it did not offer an equally diverse product line and could not match the discounts is not sufficient to establish that the defendant's conduct should be condemned as "exclusionary" or something other than "competition on the merits."

Instead, the Ninth Circuit's holding requires a plaintiff contending that bundled discounts are exclusionary and anticompetitive to demonstrate that "when the full amount of the discounts given by the defendant is allocated to the competitive product or products, the resulting price of the competitive product or products is below the defendant's incremental cost to produce them." The court reasoned that this rule would provide clear guidance for sellers that offer bundled discounts as a seller "can easily ascertain its own prices and costs of production and calculate whether its discounting practices run afoul of the rule we've outlined."

In adopting this so-called "discount attribution" standard," the Ninth Circuit also expressly declined to follow an alternative standard adopted by the Southern District of New York in *Ortho Diagnostic v. Abbott Labs*, which would permit a finding of antitrust liability "if the plaintiff is at least as efficient a producer of the competitive product as the defendant, but … the defendant's pricing makes it unprofitable for the plaintiff to continue to produce." The Ninth Circuit also rejected PeaceHealth's proposed "aggregate discount" standard to measure whether its prices were below cost. Under this measure of cost, bundled discounts would only be deemed anticompetitive when the discounted price of the entire bundle does not exceed the bundling firm's incremental cost to produce the entire bundle.

While there is an ongoing debate among antitrust scholars and economists as to whether the Ninth Circuit's "discount attribution" standard is the most "appropriate" measure of cost to use when evaluating the lawfulness of a bundled discount pricing policy, the standard does provide businesses with a clearer and more objective standard than those adopted by the courts in *LePages's* and *Ortho Diagnostic* because it examines the pricing practices from the perspective of the defendant's cost. In contrast, the *LePage's* and *Ortho Diagnostic* standards were difficult for businesses to follow because the liability standards looked primarily at the capabilities and cost structure of the plaintiffs, thereby making it extremely difficult or impossible for the potential discounter to determine whether its bundled discount program would survive antitrust scrutiny if challenged. Not surprisingly, therefore, those decisions may have had a chilling effect on firms that wished to offer bundled discount for legitimate and procompetitive reasons or who simply wanted to engage in "competition on the merits" with their rivals.

On the other hand, the "discount attribution" standard has also been criticized by some scholars and is generally more favorable to plaintiffs than the "aggregate discount" standard proposed by the defendants in *PeaceHealth*. It remains to be seen whether other courts will follow the Ninth Circuit's holding or one of the other proposed standards used to evaluate this type of pricing conduct. At some point, we expect the Supreme Court will likely have to weigh in and resolve the debate