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VIEWPOINT:

ANTITRUST ANALYSIS OF BUNDLED DISCOUNTS

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Many thanks to the Department of Justice and the Federal Trade Commission for inviting me to present in this hearing on loyalty discounts. My presentation will focus on "bundled" discounts – that is, discounts (or rebates) that are conditioned on purchasing multiple products from disparate product markets. I will leave to my co-panelists the issue of single-product loyalty discounts, such as volume or market share discounts.

I will attempt to cover three matters in the brief time allotted for my remarks. First, I'll briefly explain the primary competitive danger created by bundled discounts. Next, I'll summarize and critique six approaches courts and commentators have proposed for determining the legality of bundled discounts. Finally, I'll propose an alternative evaluative approach that is, I believe, both targeted and easily administrable.

Before I begin, a word about the scope of my remarks. I am a lawyer, not an economist. Accordingly, my primary focus is on structuring rules. Economics, of course, informs my thinking on the merits of proposed rules, but the role it will play in my remarks is secondary. I will leave the complicated theorizing to my co-panelists, and I will take to heart then-Judge Stephen Breyer's admonition in the *Barry Wright* case: [U]nlike economics, law is an administrative system the effects of which depend upon the content of rules and precedents only as they are applied by judges and juries in courts and by lawyers advising their clients. Rules that seek to embody every economic complexity

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and qualification may well, through the vagaries of administration, prove counter-productive, undercutting the very economic ends they seek to serve.[1]

I. Why Are Bundled Discounts Troubling?

A bundled discount occurs when a seller offers a collection of different goods for a lower price than the aggregate price for which it would sell the constituent products individually. Bundled discounts thus have the immediate effect of lowering prices. If the discounted price of the bundle is above the cost of producing the bundle (so that the price is not predatory), could that ever be bad? Several courts and commentators have answered that question in the affirmative. They have observed that an above-cost bundled discount may have the effect of excluding from the market rivals that (1) are more efficient at producing the products that compete with the discounter's but (2) produce a less extensive product line than the discounter. Bundled discounts may, in other words, cause equally efficient but less diversified rivals to be driven from the market.

The *Ortho Diagnostic* court offered an example of how this anticompetitive exclusion could occur.[2] Assume that you have two sellers: ***A*** sells both shampoo and conditioner, and ***B*** sells shampoo only. Assume also that customers normally use both products in cleaning their hair. Now, suppose that ***B*** is the more efficient shampoo producer – its average variable cost (AVC) of producing a bottle of shampoo is $1.25, while ***A***'s is $1.50. ***A***'s AVC of producing conditioner is $2.50. If both products are sold separately, ***A*** charges $2.00 for shampoo and $4.00 for conditioner (a total of $6.00), but

[1] Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 234 (1st Cir. 1983).

[2] Ortho Diagnostic Sys., Inc. v. Abbott Labs., Inc., 920 F. Supp. 455, 467 (S.D.N.Y. 1996). (Note that I've slightly altered the numbers utilized in the *Ortho Diagnostic* hypothetical.)

if a consumer purchases both shampoo and conditioner, ***A*** will sell the combination for $5.00, a price that's still $1.00 greater than ***A***'s cost. Thus, the following situation is presented:

	MFR. *A*		**MFR. *B***
	Shampoo	**Conditioner**	**Shampoo**
AVC	$1.50	$2.50	$1.25
Separate Price	$2.00	$4.00	$2.00
Package Price	$5.00 ($1.00 > A's Cost)		No package available. To remain competitive, shampoo price must be ≤ $1.00.

Under these circumstances, ***B*** could stay in the market only if it charged no more than $1.00 for shampoo (so that a consumer's total price of ***B***'s shampoo and ***A***'s conditioner would not exceed $5.00, ***A***'s package price). Of course, ***B*** couldn't do so, given that its cost of production is $1.25. ***A***'s bundled discounting would therefore seem to eliminate ***B*** as a competitor even though ***B*** is the more efficient producer and even though ***A*** charges a price greater than the AVC of its shampoo/conditioner combination. This example illustrates the primary competitive concern that has troubled courts considering the legality of bundled discounts – namely, that a monopolist who sells in multiple product markets will use such discounts to exclude equally efficient rivals that do not sell as broad a line of products (and thus have fewer products on which to give up margin).[3]

II. Summary and Critique of Proposed Evaluative Approaches

Having set forth the primary competitive concern created by bundled discounts, I will now briefly summarize and critique the various approaches courts and commentators have proposed for determining the legality of such discounts.

a. Per Se Legality (if Above-Cost)

The least restrictive approach to bundled discounts would deem them per se legal if they are above cost, in the sense that the discounted price of the bundle exceeds the aggregate cost of the products within the bundle.[4] This is the approach embraced by Professor Herbert Hovenkamp in his recently published book, *The Antitrust Enterprise: Principle and Execution*.[5] It's also the approach advocated by a number of business-oriented amici who urged the Supreme Court to hear an appeal of the *LePage's* case.[6]

Advocates of a per se legality rule for above-cost bundled discounts do not argue that such discounts can never be anticompetitive. Instead, they concede that the

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[3] *See*, *e.g.*, LePage's, Inc. v. 3M, 324 F.3d 141, 155 (3d Cir. 2003) (en banc) ("The 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 and who therefore cannot make a comparable offer.").

[4] This approach would not require "above-cost" pricing in the sense that each component of the bundle is priced above cost when the entire amount of the bundled discount is attributed to that product. Almost certainly, a bundled discount that was "above cost" in that sense should be per se legal. Such a discount could be matched by any equally efficient single-product rival. *See* Daniel A. Crane, *Multiproduct Discounting: A Myth of Nonprice Predation*, 72 U. CHI. L. REV. 27, 42-43 (2005).

[5] HERBERT HOVENKAMP, THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION 172-73 (2005).

[6] See Brief for Amici Curiae Morgan Stanley et al. at 5-7, 3M v. LePage's Inc., 124 S. Ct. 2932 (2004) (No. 02-1865), available at 2003 WL 22428378; Brief for Amicus Curiae the Business Roundtable at 6, 16, LePage's Inc. (No. 02-1865), available at 2003 WL 22428382; Brief for the Boeing Company et al., as Amici Curiae at 13, LePage's Inc. (No. 02- 1865), available at 2003 WL 22428377; Brief of Washington Legal Foundation and National Association of Manufacturers as Amici Curiae at 19, LePage's Inc. (No. 02-1865), available at 2003 WL 22428379.

discounts may have exclusionary effects, but they maintain that any attempt to police above-cost bundled discounts will have the perverse effect of deterring nonexclusionary, procompetitive discounts. Their reasoning thus parallels the argument for *Brooke Group*'s below-cost requirement for predatory pricing:[7] That requirement is not based on a conclusion that above-cost prices can never be anticompetitive; instead, it's based on the ground that any consumer benefit created by an approach that condemns *some* low but above-cost prices (those found to be truly exclusionary) would likely be outweighed by the consumer harm resulting from overdeterrence of price cuts.

While per se legality advocates raise valid concerns – and may, in the end, offer the best policy response – I believe it's too soon to conclude that antitrust tribunals should grant a pass to all above-cost bundled discounts. The argument for per se legality assumes that the search for exclusionary bundled discounts is not worth the effort – either because exclusionary effects are quite unlikely or because the costs of policing exclusionary discounts (including the costs resulting from overdeterrence) are unduly great. At this point, I am not prepared to concede either point. As work by Professors Nalebuff and Sibley has shown, it is not difficult to imagine instances of multi-product sellers using bundled discounts to create or maintain monopoly power by driving less diversified rivals from the market.[8] Moreover, as Part III of these written remarks explains, there is an easily administrable evaluative approach that could identify bundled discounts that would exclude equally efficient rivals.

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[7] Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 222-23 (1993) (holding that below-cost pricing is required for predatory pricing liability).

[8] *See* Patrick Greenlee, David Reitman, & David S. Sibley, *An Antitrust Analysis of Bundled Loyalty Discounts*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=600799; Barry Nalebuff, *Exclusionary Bundling*, mimeo, Yale University (2004).

b. Raising Rivals' Costs Unjustifiably

At the opposite end of the spectrum from the per se legality position lies an evaluative approach that would condemn bundled discounts that had the effect of "unjustifiably" raising rivals' costs. Advocates of this approach – including Willard Tom (who will present in the afternoon panel today) and Professor Einer Elhauge – reason that discounts conditioned upon purchasing a bundle, or even a specified amount of a single product, may foreclose marketing opportunities for the discounter's rivals, thereby raising those rivals' costs of production and/or distribution.[9] By usurping business from rivals, loyalty and bundled discounts may (1) prevent rivals from attaining minimum efficient scale, (2) force rivals to utilize less cost-effective means of distribution, and (3) make it more difficult for rivals to raise capital for research and development. Of course, it would be bad policy to condemn all practices that reduced rivals' market shares and thereby increased their costs, for many procompetitive business practices – including straightforward price cuts and quality enhancements – tend to have this effect. The test for liability must therefore require raising rivals' costs *without justification.*

With respect to loyalty and bundled discounts, the $64,000 question is, "What constitutes an adequate justification for a business-usurping discounting practice?" On this question, commentators have diverged. Former FTC officials Willard Tom, David Balto, and Neil Averitt have advocated that antitrust tribunals conduct "a case-by-case analysis of the actual effects of the particular practice to determine whether

[9] Willard K. Tom, David A. Balto & Neil Averitt, *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 ANTITRUST L. J. 615, 638 (2000); Einer Elhauge, The Exclusion of Competition for Hospital Sales Through Group Purchasing Organizations 18 (June 25, 2002), available at http://www.law.harvard.edu/faculty/elhauge/pdf/gpo_report_june_02.pdf.

anticompetitive outcomes are likely."[10] This seems troubling, for it leaves businesses with virtually no guidance. They run the risk that a judge – or, worse yet, a jury – will determine in retrospect that the structured discount at issue was unreasonably exclusionary. The prospect of treble damages based on fact-finder whim will likely have the effect of chilling procompetitive structured discounts.

Recognizing the danger inherent in a case-by-case balancing of competitive effects, Professor Elhauge has proposed a more structured method for determining whether a business-usurping discount is justified. Under his suggested approach, the antitrust tribunal would ask whether the exclusionary effect of the discount arises from an enhancement in the discounter's efficiency. If so, the discount is justified; otherwise, it is not. Thus, "justifiable" discounts are those where rivals' loss of business to the discounter resulted because the discount enhanced the discounter's productive or distributional efficiency.[11]

This more structured approach to determining when discounting practices are "justified" is also troubling. First, the approach would have the perverse effect of preventing price cutting by any monopolist that had achieved all available economies of scale and was unable to achieve additional distributional efficiencies by discounting. Consider, for example, a widget monopolist that commands a 70% market share and sells widgets for $2.00, a 100% markup over its per unit cost of $1.00. Suppose all available economies of scale are achievable at a production level reflecting a 50% market share and that there are no distributional efficiencies to be gained by increasing market share via a

[10] Tom, et al., *supra* note 9, at 638.

[11] Einer Elhauge, *Defining Better Monopolization Standards*, 56 STAN. L. REV. 253, 330 (2003).

straight price cut. If the monopolist decided to cut its price to $1.75, it would sell more widgets, impairing its rivals' efficiencies. That price cut would therefore enhance the widget seller's monopoly power even without improving its efficiency and would, under Professor Elhauge's test, be exclusionary and illegal. A rule that precludes monopolists from cutting their supracompetitive prices, unless such price cuts are necessary to achieve productive efficiencies, is inconsistent with the very goal of antitrust law, which is to protect consumers from supracompetitive prices.

In addition, Professor Elhauge's proposed test would be exceedingly difficult to administer. If the test for justifiability is whether the discount enhances efficiency, then a court must determine *how great* any discount must be in order to win for the discounter enough business to attain all available productive and distributional efficiencies. Any "excess" discount would not be justified. Antitrust tribunals would therefore have to ask, "Is selling the product in this fashion somehow making the discounter more efficient, or is the discounter merely giving up margin?" If the latter, the discount would be illegal. If the former, the tribunal would have to ask a follow-up question: "Could the efficiencies be achieved by giving a smaller discount (or by structuring the discount in some other fashion that would win less business from rivals)?" If so, the "excess discount" (or the part of the structured discount whose efficiency-enhancing ends could be achieved in a manner that would raise rivals' costs less) would be anticompetitively exclusionary. In effect, this approach puts antitrust tribunals in the position of price regulator, where discounts may not result in prices below the point necessary to achieve all available productive and distributional efficiencies. This is simply beyond the competence of the courts.

Finally, Professor Elhauge's approach is likely to chill procompetitive discounting. Any business that offered a bundled discount would face a risk that a jury would conclude either that the discounting program did not create productive or distributional efficiencies or that the efficiencies that were created could have been achieved by offering a smaller discount or by requiring fewer purchases to qualify for the discount. A jury could award treble damages if convinced that the defendant was giving up surplus (to consumers, incidentally) not because doing so was necessary to achieve some productive or distributional efficiencies but because doing so would win market share from rivals, thereby reducing their efficiencies. The possibility of an adverse treble damages judgment and the lack of any reliable safe harbor would likely deter proconsumer structured discounts and constrain the size of any discounts that were offered.

Ultimately, then, an evaluative approach that determines the legality of bundled discounts based on whether rivals' costs have been raised unjustifiably is unworkable. The problem with the approach is that much (perhaps most) procompetitive conduct raises rivals' costs, and it is difficult to provide an easily administrable, but not overly proscriptive, means of determining when such cost-raising is "justifiable." Perhaps it would be possible to articulate an easily administrable (and not overly proscriptive) test for determining whether rivals' costs are being raised "unjustifiably," but the approaches proposed so far are deficient.

c. The *LePage's* Approach

A third approach to evaluating bundled discounts is that utilized in the (in)famous *LePage's* decision, in which the Third Circuit upheld the jury's determination that defendant 3M's bundled rebates, which were conditioned upon meeting purchase targets in up to six product lines, amounted to illegal monopolization.[12] In that decision, the en banc Third Circuit reasoned that the primary concern with bundled discounts is that a multi-product seller that offers a bundled discount may be able to usurp business from an equally efficient rival that does not sell as broad a product line, has fewer products on which to give up margin, and thus must provide the entire value of the bundled discount on its narrower product offering.[13] The court thus focused on the relative breadth of the discounter's bundle and held (apparently) that (1) bundled discounts are presumptively exclusionary if the discounter is bundling products not sold by its rivals and is winning business from those rivals, but (2) the presumption may be rebutted if the discounter proves a "business reasons justification" for the bundled discounts, meaning that the bundling saves costs approaching the amount of the total discount.[14]

[12] LePage's, Inc. v. 3M, 324 F.3d 141 (3d Cir. 2003) (en banc). Plaintiff LePage's was a manufacturer of transparent tape, which it sold as "private label" tape—tape that retailers such as Wal-Mart and OfficeMax labeled with their own brand name. Defendant 3M manufactured Scotch brand transparent tape, by far the leading brand, as well as private label tape, "Post-it Notes," and other packaging, home care, and leisure products. Beginning in 1993, 3M began rebate programs that rewarded retailers for purchasing packages of 3M products. The size of available rebates depended on the number of product lines in which customers met specified purchase targets, and the rebates covered purchases from six of 3M's product lines. LePage's sued, contending that 3M, which admittedly possessed monopoly power in the transparent tape market, was monopolizing that market because customers could not meet 3M's growth targets without eliminating LePage's as a supplier. The jury found for LePage's on its monopolization claim.

[13] *See supra* note 3.

[14] The Third Circuit did not require that LePage's prove that it could not meet 3M's discount without pricing below cost. Nor did it require LePage's to show that it was as efficient a tape producer as 3M. All LePage's was required to prove was that the bundle 3M's customers had to buy to secure the discounts included products that LePage's did not sell, and that this fact made it difficult for LePage's to compete with 3M. Once LePage's made that showing, the burden shifted to 3M to prove that its bundled discounts were "justified" by cost-savings of some sort. Because 3M failed to present proof that selling its products in a bundled fashion reduced costs by an amount equal to or exceeding the amount of the total bundled discounts, its bundled discounts were deemed unjustified and thus exclusionary. Thus, the *LePage's* court appeared to adopt the two-part rule stated in the text.

The *LePage's* approach is troubling for at least two reasons. First, because the approach focuses on the breadth of the bundle and does not inquire into a complaining rival's relative efficiency, it could permit less efficient rivals to avoid the price competition created by a bundled discount. Indeed, an expert for LePage's admitted that the company was a less efficient tape manufacturer than 3M.[15] The judgment in favor of LePage's thus created a price umbrella for a less efficient rival.

A second problem with the *LePage's* approach is that its focus on product line breadth threatens to chill bundling, a business practice that frequently creates efficiencies and provides benefits to consumers. On the sellers' side, bundling and bundled discounts may reduce costs by creating economies of scope or by facilitating output increases so as to achieve economies of scale.[16] The practices may also lower costs by reducing uncertainty about aggregate demand,[17] reduce overhead and marketing expenses by economizing on the quality-signaling benefits of well-known brands,[18] and facilitate efficiency-enhancing differential pricing.[19] There is also evidence that bundled discounts stimulate consumer demand for the bundler's products.[20] On the buyers' side, bundled discounts reduce supracompetitive prices, at least in the short run, and buyers (especially

[15] *See LePage's*, 324 F.3d at 177 (Greenberg, J., dissenting).

[16] See, e.g., THOMAS T. NAGLE & REED K. HOLDEN, THE STRATEGY AND TACTICS OF PRICING: A GUIDE TO PROFITABLE DECISION MAKING 306-07 (3d ed. 2002); Yannis Bakos & Erik Brynjolfsson, *Bundling Information Goods: In Pricing, Profits, and Efficiency*, 45 MGMT. SCI. 1613, 1619 (1999) ("Bundling can create significant economies of scope even in the absence of technological economies in production, distribution, or consumption."); Stefan Stremersch & Gerald J. Tellis, *Strategic Bundling of Products and Prices: A New Synthesis for Marketing*, 66 J. MARKETING 55, 68 (2002).

[17] Yannis Bakos & Erik Brynjolfsson, *Bundling and Competition on the Internet*, 19 MKTG. SCI. 63, 64-65 (2002).

[18] See, e.g., Michael A. Salinger, *A Graphical Analysis of Bundling*, 68 J. BUS. 85, 87-97 (1995).

[19] PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 749, at 341-42 (Supp. 2006).

[20] Dilip Soman & John T. Gourville, *Transaction Decoupling: How Price Bundling Affects the Decision to Consume*, 38 J. MARKETING RES. 30, 42-43 (2001).

retailers) frequently prefer purchasing in bundles because doing so reduces the number of vendors with whom they must deal.[21] For both buyers and sellers, pre-announced bundled discounts reduce the transaction costs associated with negotiating multi-product purchases.[22] In short, there are many procompetitive, or at worst competitively neutral, reasons for bundling and thus for offering bundled discounts. The *LePage*'s approach would discourage such discounts, for firms offering them would be subject to antitrust suits by competitors that sell some, but not all, of the bundled products.

An advocate of the *LePage's* approach might argue that the approach will not inhibit procompetitive bundled discounting because discounters are afforded the opportunity to justify their behavior by proving that their bundled discounts generate cost savings. But that argument ignores the real-world effect of placing the burden of justification on the discounter. Any business considering whether to offer a bundled discount covering products not sold by some rivals would have to ensure in advance that it could convince a jury that the discount created cost savings at least equal to the amount of profit sacrificed.[23] This proof burden seems misplaced. Given that an above-cost bundled discount always provides some procompetitive benefit (in that it drives prices

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[21] See, e.g., Philip B. Evans & Thomas S. Wurster, *Strategy and the New Economics of Information*, 75 HARV. BUS. REV. 70, 79-80 (1997); Robert J. Vokurka, *Supplier Partnerships: A Case Study*, 39 PROD. & INVENTORY MGMT. J. 30 (1998); Gary D. Eppen et al., *Bundling--New Products, New Markets, Low Risk*, 32 SLOAN MGMT. REV. 7, 7-12 (1991);

[22] *See* Nagle & Holden, *supra* note 16, at 245.

[23] For example, any monopolist participating in multiple product markets would be reluctant to offer a discount on any product bundle that included its monopoly product—the very product for which it is most likely to charge a supracompetitive price—because its rival(s) presumably could not replicate the bundle. Similarly, a multi-product firm that competed with similarly diversified firms would be dissuaded from engaging in consumer-friendly bundle-to-bundle competition. Suppose, for example, that firm ***A***—like its four chief rivals, ***B***, ***C***, ***D***, and ***E***—sells products **1**, **2**, and **3** and believes that it could win business from those rivals by offering a package discount on the three products. If tiny emergent rival ***F*** sells only product **1**, ***A*** is unlikely to offer the package discount, even if it could be matched by rivals ***B***-***E*** (assuming their equal efficiency) and would reflect consumer desires for package pricing.

closer to the level of costs, which is where they would be in perfect competition) and always provides some immediate consumer benefit (lower prices), it seems perverse to burden the defendant with "justifying" its discount. The law instead ought to require the *plaintiff* to prove that the discounting scheme is designed to be exclusionary rather than procompetitive.

d. The *Ortho Diagnostic* Approach

As noted, an evaluative approach focused on the relative breadth of the discounter's bundle vis-à-vis its rivals' product lines may condemn discounts that would exclude only less efficient rivals and may, as in *LePage's* itself, force consumers to subsidize rivals that are less efficient than the discounter. Accordingly, some courts have reasoned that a competitor complaining of an above-cost bundled discount should have to prove that it is at least as efficient a producer of the competitive product as the discounter. Requiring such proof would prevent less efficient competitors from using the law to create a price umbrella that would shield them from vigorous price competition.

This approach is best exemplified by the *Ortho Diagnostic* case, in which plaintiff Ortho challenged defendant Abbott's bundled discounts on five types of blood tests.[24] Abbott argued that its discounts should be per se legal, since they resulted in an above-cost price for the bundle. The court rejected a rule of per se legality. Instead, it attempted to articulate a test that would condemn only those bundled discounts that would exclude a plaintiff that was at least as efficient as the discounter. Under that test, a complaining plaintiff must demonstrate either that the discounted bundled price is below

[24] Ortho Diagnostic Sys., Inc. v. Abbott Labs., Inc., 920 F. Supp. 455 (S.D.N.Y. 1996). Ortho sold blood tests that competed with three of the tests in Abbott's bundle; to meet Abbott's discount, it would have to provide the full five-test discount on its three-test product line.

the average variable cost of the bundle or that the plaintiff is at least as efficient a producer of the competitive product as the defendant but cannot charge prices high enough to turn a profit because of the defendant's pricing.[25] (Because Ortho failed to make either showing, it could not establish Abbott's liability.)

While the *Ortho Diagnostic* approach avoids forcing purchasers to subsidize less efficient competitors by foregoing discounts, the approach creates serious administrability difficulties. Under the approach, a plaintiff would have to prove, and a judicial tribunal would have to determine, what the plaintiff's per unit production and distribution costs are and how those costs compare to the defendant's per unit costs. Ascertaining costs is notoriously difficult, and proving another party's costs is even more difficult, given that the relevant evidence is in that other party's control.

Of course, the difficulty of proving another's costs cannot, by itself, doom the *Ortho Diagnostic* approach, for well-established doctrine requires plaintiffs complaining of predatory pricing to make precisely such a showing.[26] But the burden the *Ortho Diagnostic* approach places on plaintiffs and judicial tribunals exceeds the burden in run-of-the-mill predatory pricing cases. First, the approach requires the plaintiff to make (and the tribunal to evaluate) two cost showings: the plaintiff must prove its own per unit costs as well as the defendant's. In a predatory pricing case, by contrast, the defendant's cost is compared to price, which is easily ascertainable. Second, determining the defendant's cost in a bundled discount case will likely be particularly complicated because there will always be joint costs—i.e., costs pertaining to two different products.

[25] *Id*. at 469.

[26] *See* Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 222-23 (1993) (holding that plaintiff complaining of predatory pricing must establish below-cost pricing by defendant).

Determining how to allocate these common costs among the competitive product and the other products for which the costs were incurred (some of which might not even be included within the bundle) can be exceedingly difficult—arbitrary, in fact. Proving a discounter's costs will therefore be particularly difficult when bundled discounts are involved. Thus, the *Ortho Diagnostic* approach, while properly focusing on whether an equally efficient rival is being excluded by a bundled discount, creates intractable difficulties of administrability and is likely to underdeter truly exclusionary bundled pricing, for plaintiffs will find it difficult to make the showing necessary to establish illegality.[27]

e. The Original *Antitrust Law* Approach

Recognizing the administrative difficulties associated with the *Ortho Diagnostic* approach, the *Antitrust Law* (Areeda-Hovekamp) treatise recommends a test that would similarly focus on the degree to which the bundled discount could exclude equally efficient rivals but would be easier to administer. Under the original *Antitrust Law* test (which persists, along with some additional analysis, in the 2006 update), a court deciding whether an above-cost bundled discount is exclusionary would ask not whether the particular plaintiff is as efficient as the discounter but instead whether the discount would, without reasonable justification, exclude a hypothetical equally efficient rival.[28] The treatise maintains that "[a] requirement that the bundling practice be sufficiently

[27] Moreover, if the plaintiff happens not to be the discounter's most efficient rival, it is possible that the plaintiff's legal challenge will not prevail (because the plaintiff is not an equally efficient rival) but that there are, or could in the future be, equally efficient rivals that would be excluded by the defendant's bundled discounts. Thus, the *Ortho Diagnostic* approach may require multiple lawsuits where the plaintiff is not the rival best able to match the discounter's productive efficiencies.

[28] Areeda & Hovenkamp, *supra* note 19, ¶ 749, at 322 (Supp. 2006).

severe so as to exclude an equally efficient single-product rival, and without adequate business justification, seems to strike about the right balance between permitting aggressive pricing while prohibiting conduct that can only be characterized as anticompetitive."[29]

The *Antitrust Law* test would be easier to administer than the *Ortho Diagnostic* test, for ascertaining whether "an equally efficient single-product rival" could be excluded by a discount would be simpler than determining whether the plaintiff itself is as efficient a producer of the competitive product as the bundled discounter. In practice, the test would require a court to attribute the full amount of the bundled discount to the competitive product and then ask whether the price of that product, as discounted, was below the bundled discounter's cost. If so, an "equally efficient single-product rival" would not be able to compete with the discount and would be excluded, and the bundled discounter could avoid liability only by showing "an adequate business justification" for its bundled discounting.

Despite its relative ease of administrability, the *Antitrust Law* approach is troubling. Most significantly, it would prevent a multi-product seller from funding a discount on a bundle of its products by giving up margin on one or more supracompetitively priced products within the bundle. Suppose, for example, that the defendant discounter sells products ***A***, ***B***, and ***C*** in concentrated markets that are subject to oligopolistic pricing but are not actually cartelized. Assume that the plaintiff competes with the defendant in the market for product ***A*** but does not sell either product ***B*** or ***C***. The defendant's cost of producing each of products ***A***, ***B***, and ***C*** is $4 per unit. Sold

[29] *Id*.

separately, the defendant charges $5 per unit for each of ***A***, ***B***, and ***C***, but it sells the ***A-B-C*** package for $13.50. This package pricing more closely aligns the defendant's prices and costs and will tend to destabilize the coordinated supracompetitive pricing in each of the ***A***, ***B***, and ***C*** markets. From the standpoint of consumers and competition, this is a good thing: prices have been pushed toward costs (where they would be in a perfectly competitive market), oligopolistic pricing has been disrupted (and nondiscounting rivals are likely to respond with discounts of their own), and consumers are paying less. The (original) *Antitrust Law* approach, however, would condemn this arrangement because a hypothetical ***A*** seller whose per unit cost is $4 (i.e., a "hypothetical equally efficient" ***A*** seller) would have to lower its ***A*** price to $3.50 to compete and would thus be driven out of business. The approach may therefore condemn discount cross-subsidization that would be good for consumers and competition in the long run.

In addition, the approach would allow plaintiffs to condemn bundled discounts that could not harm consumers. The approach does not require any proof that the market from which the hypothetical equally efficient rival is excluded is structurally susceptible to supracompetitive pricing. Even if an equally efficient single-product rival would be excluded because of the discount, consumers could not be harmed if entry barriers into the competitive product market were so low that supracompetitive pricing in that market was infeasible. Before being allowed to enjoin a discount, a plaintiff should have to demonstrate the likelihood of future supracompetitive pricing by showing that such entry barriers exist.

f. The Revised *Antitrust Law* Approach

The 2006 Supplement to the *Antitrust Law* treatise, while never abandoning the "hypothetical equally efficient single-product rival" test,[30] has added some supplemental analysis that makes the proposed approach more attractive.[31] The treatise suggests that courts analyze bundled discounts as de facto tie-in arrangements but then subject them to a rule of reason analysis. First, the court would determine whether the discount involves the "coercive" element of a tie-in by asking whether the discounted price could be matched by a hypothetical equally efficient competitor. To make this determination, the tribunal should "attribute[] the entire discount on all products in the package to the product for which exclusion is claimed" and ask whether "the resulting price is less than the defendant's cost."[32] If so, then an equally efficient rival could not match the discount and the required "coercion" element is established. Notably, though, the treatise maintains that the coercion element is *not* established – and the discounting should be legal – if there is any significant rival in the market that offers the same package the defendant is discounting.[33] (If such a rival exists, consumers are not effectively coerced into taking the defendant's package.)

If de facto tying is established, the court should proceed to a rule of reason analysis.[34] In that analysis, the court should query whether the market allegedly being

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[30] *Id*. at 322.

[31] *Id*. at 323-43 (new section on "Section 2 challenges to [package] discounts").

[32] *Id*. at 335-36.

[33] *Id*. at 334.

[34] *Id*. at 336 ("This cost/price test establishes only that the two products are 'tied together,' in the sense that the customer cannot reasonably be expected not to take them together. Once this test has been satisfied, from this point on the analysis resembles that in a rule of reason tying or exclusive dealing case.").

monopolized is, in fact, structurally capable of monopolization. If entry barriers into the market are sufficiently low, then supracompetitive pricing would be impossible and there should be no liability.[35] The court should also ask whether a collaborative bundle is possible – i.e., could the less diversified rival who finds itself excluded by the discount at issue collaborate with other product sellers to craft a competing bundle? If so, liability is inappropriate.[36] Finally, the court should consider business justifications for the bundled discounting. In particular, it should ask whether the bundling permits achievement of scale or scope economies, quality control, or output-enhancing price discrimination.[37]

The 2006 Supplement represents a notable improvement on the original *Antitrust Law* position.[38] Because it calls for consideration of whether the purportedly foreclosed market is capable of monopolization, it is more consumer-focused and less focused on protecting rivals. Its safe harbor for bundled discounts in markets containing a significant rival capable of replicating the bundle will permit consumer-friendly "bundle-to-bundle" competition that might have been chilled by the original *Antitrust Law* test.[39] And, by recognizing the possibility of a collaborative bundle, it places responsibility on

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[35] *Id*. at 337.

[36] *Id*. at 337-38.

[37] *Id*. at 339-42.

[38] Interestingly, the revised *Antitrust Law* position conflicts with the per se legality position Prof. Hovenkamp, the apparent author of the 2006 Supplement to *Antitrust Law*, has advocated elsewhere. *See* Hovenkamp, *supra* note 5, at 172-73.

[39] The original *Antitrust Law* test would tend to dissuade multi-product firms that competed with similarly diversified firms from engaging in consumer-friendly bundle-to-bundle competition. Suppose, for example, that firm ***A*** – like its four chief rivals, ***B***, ***C***, ***D***, and ***E*** – sells products **1**, **2**, and **3** and believes that it could win business from those rivals by offering a package discount on the three products. Under the original *Antitrust Law* test, rival ***F***, which sells only product **1**, might be able to establish ***A***'s liability by showing that allocating the entire amount of ***A***'s discount to product **1** resulted in a price below ***A***'s cost. Fearing a lawsuit by ***F***, ***A*** might well forego the consumer-friendly discount war with rivals ***B***-***E***. The revised *Antitrust Law* approach provides a safe harbor for ***A***'s bundled discount.

purportedly foreclosed rivals to take reasonable steps to compete with a bundled discount.

Yet, the approach is not wholly satisfactory. As an initial matter, one wonders why the treatise strains to construe bundled discounts as tie-ins. Despite the antiquated per se rule against tying, there is nothing *inherently* troubling about a tie-in arrangement. Tie-ins are troubling because they may have foreclosure effects. If foreclosure is the real problem, would it not make sense to forego asking whether the discount amounts to a tie-in (because it "coerces") and instead ask whether it could result in anticompetitive foreclosure? The second part of the revised *Antitrust Law* test (the rule of reason analysis) would ask that question. But wouldn't it be easier just to ask the question up front? Moreover, the prescribed rule of reason analysis leaves out two means by which a purportedly foreclosed rival could stay in the market in the face of a bundled discount: it might be able to enter the market(s) in which it currently does not participate, or it might become a supplier to the bundled discounter. At a minimum, the "part two" rule of reason analysis should consider those possibilities. My proposed approach for evaluating bundled discounts, explained below, requires that they be considered.

III. An Alternative Approach

Each of the above approaches would either overdeter, underdeter, or be overly difficult to administer. Antitrust tribunals instead need an evaluative approach that will condemn those bundled discounts that are ultimately likely to reduce consumer welfare, will not condemn bundled discounts that are not likely to cause long-run consumer harm, and is easily administrable. Specifically, the approach needs to reserve liability for those situations in which (1) the excluded rival has exhausted its competitive options, (2) the excluded rival is (or could become, if minimum efficient scale were achieved) at least as efficient a producer as the defendant, and (3) the purportedly foreclosed market is structurally capable of monopolization (i.e., because there are barriers to entry). An approach that would presume the legality of above-cost bundled discounts, but would allow a plaintiff to rebut that presumption by proving certain easily administrable facts indicating exclusion of a competitive rival,[40] would meet these criteria. Accordingly, I propose the following evaluative approach:

Plaintiff's Prima Facie Case:

As long as a bundled discount results in a price that exceeds the bundle's cost, it is legal unless the plaintiff cannot match the discount on its narrower product line[41] and—

(1) there are barriers to entry (a) in the product market(s) in which the plaintiff does not participate[42] and (b) in the market for the competitive product[43];

(2) the plaintiff cannot practicably coordinate with other producers to create a competing bundle[44]; and

[40] I define "competitive rival" as a rival that is at least as efficient as the bundled discounter *or* would likely become so if not prevented (by the discount) from achieving minimum efficient scale.

[41] This element requires a plaintiff to cut its price to competitive levels (i.e., to cost).

[42] This element requires a plaintiff to show that it could not compete by entering the markets in which it does not currently participate.

[43] This element requires the plaintiff to show that actual consumer harm could result from its exclusion, because the market from which it is excluded could sustain supracompetitive pricing.

[44] This element requires the plaintiff to show that it could not compete by collaborating with other product sellers. Cross-seller product bundles are quite common. A recent trip to a Target store revealed (among many others) the following cross-seller bundles: an Olympus digital voice recorder bundled with Duracell batteries, Suave-for-Men body wash bundled with a Schick Xtreme 3 razor, Almay mascara bundled with Bausch & Lomb Renu contact lens cleanser, Colgate Simply White Night Plus teeth-whitening cream bundled with a disposable Konica camera, a First-Alert smoke detector bundled with Energizer batteries, and Soft Lips lip balm bundled with an Apple i-Tunes music download.

(3) the plaintiff made a good faith offer to become a supplier to the discounter but was rebuffed.[45]

Defendant's Rebuttal Opportunity:

If the plaintiff proves each of these facts, the defendant may nonetheless escape liability by showing that it rejected the plaintiff's offer to become a supplier because either (a) the price the plaintiff would have charged exceeded the defendant's cost of producing the product, or (b) the quality of the plaintiff's product was inferior to that of the defendant's product.[46]

This proposed evaluative approach aims to identify situations in which a bundled discount could exclude a competitive rival (i.e., one that has exhausted its competitive options and has the ability to match the discounter's efficiency) and lead to supracompetitive pricing in the market in which the excluded rival participates. Parts 1(a), 2, and 3 of the plaintiff's prima facie case ensure that the challenging rival has exhausted all its options for staying in the market [i.e., by taking reasonable steps to enter new markets (part 1(a)), seeking to collaborate with other sellers to craft a competing bundle (part 2), and seeking to become a supplier to the discounter (part 3)]. The defendant's rebuttal opportunity ensures that successful plaintiffs are, in fact, as efficient as the discounter (or could become so if permitted to attain minimum efficient scale). Part 1(b) of the plaintiff's prima facie case ensures that *consumer harm* – not just harm to

[45] This element requires the plaintiff to exhaust its competitive option of supplying the bundled discounter. If the plaintiff is more efficient than the discounter and offers to supply the product for a price equal to its cost, the discounter would presumably accept the offer.

[46] The defendant's rebuttal opportunity will show the court whether the plaintiff is, indeed, an equally efficient rival. If the plaintiff has made its "best offer" but the offer is not good enough for the defendant (i.e., it doesn't constitute a mutually beneficial transaction), then the plaintiff is not equally efficient and its exclusion should not create liability for the defendant.

a rival – is likely to occur because of the bundled discounts. If a plaintiff can establish all elements of the prima facie case, and the defendant cannot rebut the case, then the discount should be deemed exclusionary. Otherwise, it should be permitted (unless, of course, it results in a below-cost price for the bundle, in which case it should be judged under the *Brooke Group* test).

CONCLUSION

Bundled discounts present a classic example of what Judge Easterbrook calls "the puzzle of exclusionary conduct."[47] That puzzle exists because "competitive and exclusionary conduct look alike,"[48] and it is often difficult for courts to condemn the latter without discouraging the former. With respect to bundled discounts, it can be difficult to tell which are procompetitive (i.e., which ones reflect efficiencies and/or represent a whittling away of supracompetitive prices) and which are likely to injure consumers in the long run by driving out those rivals whose continued presence in the market is desirable. The "puzzle," then, is to develop an easily administrable evaluative approach that will identify and condemn only those bundled discounts that could injure consumers by excluding rivals that are, or are likely to become, as efficient as the discounter. The evaluative approach proposed in these remarks provides a plausible solution to the puzzle.

[47] Frank H. Easterbrook, *When Is It Worthwhile to Use Courts to Search for Exclusionary Conduct?*, 2003 COLUM. BUS. L. REV. 345, 345.

[48] Frank H. Easterbrook, *Workable Antitrust Policy*, 84 MICH. L. REV. 1696, 1710 (1986).