THE TAX THEORY IN CONDITIONAL PRICING ANALYSIS

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I. INTRODUCTION

Loyalty and bundling arrangements have been the subject of antitrust scrutiny for decades. A comparatively recent development in this respect is the "tax theory" of rival exclusion. The idea is that, when a dominant firm offers discounts conditioned on the buyer's agreement to purchase a minimum percentage of its needs, rivals must not only meet or beat the dominant firm's discounted price to gain a sale; they must also match the discounts the customer will lose if the minimum percentage requirement is not met. This need to match the lost discounts has been described as a "tax" on rivals, and has been argued to lead to anticompetitive foreclosure.[2] The issue has received increased prominence recently, having been relied on by the court in *FTC v. Qualcomm Inc.*[3] to conclude that Qualcomm had engaged in anticompetitive exclusive dealing.[4]

This paper argues that the tax theory is misguided and should play little to no part in an appropriate analysis.

II. TAX THEORY IN THE COURTS

Exclusive dealing and its variants, including bundled and loyalty discounts, have long been understood to raise competition concerns. Dominant firms can deploy these arrangements in a manner that excludes efficient rivals and allows the defendant firm to raise price or otherwise harm consumers. If enough of rivals' customer opportunities are truly foreclosed by one of these arrangements, their costs will increase and their ability to constrain the defendant's market power will be compromised. The result can be higher prices and reduced quality for consumers. In concept, the tax theory is one way to evaluate the potential for these tactics to cause consumer harm.

Although variants of the theory had appeared earlier, the first explicit case discussion of the tax theory was in *Concord Boat v. Brunswick Corp.*[5] in 2000. There, the plaintiffs' expert "testified that Brunswick had monopoly power in the stern drive market [for boats] that enabled it to use its market share discount programs to impose a 'tax' on boat builders and dealers who chose to purchase engines from other manufacturers. He defined the 'tax' as the discount these purchasers gave up by not buying from Brunswick."[6] The Eighth Circuit rejected the argument for two

2 See, e.g. Joseph Farrell, Janis K. Pappalardo & Howard Shelanski, *Economics at the FTC: Mergers, Dominant-Firm Conduct, and Consumer Behavior*, 37 Rev. Indus. Org. 263, 267 (2010); Roman Inderst & Greg Shaffer, *Market-share contracts as facilitating practices*, 41 Rand J. Econ. 709 (2010).

3 2019 WL 2206013 (N.D. Cal. May 21, 2019). The author's firm is one of many representing Qualcomm.

4 *Id.* at *85-87. The court referred to this effect as a "surcharge" rather than a "tax," but the terms are synonymous for these purposes. The FTC's expert used the "tax" nomenclature.

5 207 F.3d 1039 (8th Cir. 2000).

6 *Id.* at 1046.

main reasons: first, customers "were not unable to forego Brunswick's discounts" and therefore were not coerced into accepting Brunswick's boat engines; and, second, customers often bought more than the 80 percent required for the discount, suggesting that the "tax" was not the sole motivation for rejecting the plaintiffs' overtures and further negating any idea of coercion.[7] The court ruled, essentially, that loyalty discounts that incentivize buyers are lawful. Discounts that coerce buyers are not.

The tax theory also failed in *Church & Dwight Co. v. Mayer Labs.*[8] There, C&D had discount programs with increasingly larger rebates for 65, 70, and 75 percent of the shelf space at the affected retailer.[9] But, as in *Concord*, the theory of competitive harm was not borne out by the evidence. Of the top 25 retailers, six did not participate at all and some participated only at the lowest levels. These facts, as in *Concord*, negated any concept that the rebates were coercive.

In both cases, the concept of "coercion" was important. A purchase a customer makes based on lower prices or superior quality is the essence of competition on the merits. As *Concord* and *Church & Dwight* both recognized, in contrast, a purchase made because the buyer had little choice or against its will suggests something may well be amiss.[10] The lack of any coercion in the two cases was central to the courts' opinions.

A few years after *Church & Dwight*, the tax theory was approved on summary judgment in *Insight Equity v. Transitions Optical, Inc.*[11] The case involved agreements under which Transitions' lenses would be the "preferred" photochromic lenses for optical labs and the exclusive photochromic lenses at some retailers in return for discounts or rebates off the standard prices. The defense argued that, because the plaintiff could have met or beaten all the discounts *profitably*, the discount programs could not be unreasonably coercive. But the court said that the discounts "increase[d] rivals' costs and thus harm[ed] competition."[12] The lack of coercion and the plaintiff's ability to compete for all the affected business did not alter the result.

The most recent decision is *Qualcomm*, where the tax theory was also sustained. The court found that Qualcomm used its market power in modem chips to collect "unreasonably high" royalties for its patents rather than to collect higher prices on the chips. Because much of the technology in the chips is subject to Qualcomm patents, OEM customers are obliged to pay Qualcomm royalties on its patents even if the chips they use are from rivals, not Qualcomm. The district court concluded that customers view the bargain as implicating an "all in" price for rivals' chips that includes an excessive "surcharge" from Qualcomm's patent royalties. The court thus determined that Qualcomm's royalties operate as a tax, not by the customers that actually pay it, but by Qualcomm's competitors selling modem chips because the chip rivals' prices must take into account the royalties on their chips the customers are obligated to pay. As a result, rivals are unable to charge customers as much as they otherwise could, their margins are diminished, and they are unable to compete as effectively with Qualcomm.[13] The effect, the court ruled, was to maintain monopoly power unlawfully. Again, the concept of coercion – so central to the earlier cases – was just ignored. The decision is now on appeal to the Ninth Circuit

Of the four courts to address the tax theory head on, two sustained it and two rejected it on the facts. But how does the theory square with basic economics and competition law principles? Let us turn to those questions now.

7 *Id.* at 1056-57.

8 868 F. Supp. 2d 876 (N.D. Cal. 2012).

9 *Id.* at 905.

10 See also *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d 254, 285 (3d Cir. 2012).

11 2016 WL 3610155 (D. Del. July 1, 2016). The author's firm represented the defendant in this case.

12 *Id.* at *7.

13 2019 WL 2206013, *supra* note 3, at *85-89.

III. TAX THEORY ECONOMICS

The concept underlying the tax theory is straightforward. If buying from a rival will lead to a loss of the discounts the customer would otherwise get from the defendant, the rival will have to make the customer whole to gain the sale. This, the argument goes, is one variety of raising rivals' costs, a recognized theory of antitrust liability.

There are at least three defects in this reasoning.

First, the tax theory is not "raising rivals' costs" at all. If effective, the dominant firm's strategy will not raise its rivals' costs; it will reduce their revenues. Nothing about a defendant's discount program strategy will raise a rival's actual unit costs; the effect instead is to force the rival to cut prices further to make up for the customer's loss of some of the defendant's rebates or discounts.

This distinction between raising rivals' costs and reducing rivals' revenues has important implications. If a dominant firm strategy raises the actual costs of rivals, rivals must recover those costs in their selling prices. That necessarily reduces the degree of constraint on the defendant's market power and may allow consumer prices to rise. Rivals cannot reduce prices further to gain share from the defendant because, as a result of the increased costs, they will lose money from doing so. If, however, the strategy is one that effectively forces rivals to reduce their prices, there is no such price-raising effect. Loyalty discounts are, after all, *discounts*; and if both the dominant firm and its rivals are *reducing* their prices, consumers stand to gain.

Second, relatedly, raising rivals' costs alone is not an antitrust problem. Competition *necessarily* tends to increase rival costs, as rivals typically must improve their product offering, add more sales support, sign more effective distributors, and the like in order to keep up. All this takes money, but the expenses in issue are aspects of competition in action, not any kind of anticompetitive effect. A rival's costs may be raised, but consumers pay an effective lower (quality-adjusted) price as a result of the product, sales, and distribution improvements. As the seminal article on the topic explains, raising rivals' costs is problematic only when it enhances the defendant's power over price.[14] A conclusion that conduct is anticompetitive just because it raises the costs of competitors is wrong. The question is the effect on consumers, and changes in the costs of rivals may or may not cause them harm. It depends on the facts.

And third, the tax theory has no limiting principle. There is no data point or theorem to calculate how much rival revenues must be reduced before a problem can be identified. Since, as mentioned, all competition tends to raise rival costs or reduce rival revenues, there needs to be some objective metric to determine how much is too much for antitrust purposes. But no such limiting principle has been articulated.

IV. A SUGGESTED APPROACH

Although the tax theory, as currently articulated, is beset with very serious problems, it does provide a valid insight: discounts conditioned on a percentage of the customer's needs affect not only the seller and the customer, but the rival as well. But that should be a starting point for further analysis, not the end of the inquiry.

To determine whether the "tax" effect of a loyalty discount has the potential to be harmful, a first step should be to determine whether the complainant can *profitably* underbid the defendant taking the discounts fully into account. If it can, that should end the inquiry. Under those circumstances, there is no coercion and a complainant has not been foreclosed at all. It just has to reduce its price while still making a profit – a consequence antitrust should encourage.[15] Imposing antitrust liability in this context would have the perverse effect of rewarding a complainant's voluntary decision not to compete.

The more difficult question is what the outcome should be when the complainant cannot profitably meet the defendant's prices net of the "tax." Should that alone be sufficient to make out a case of anticompetitive foreclosure?

The answer should be "no." There can be a variety of reasons why a rival cannot match a defendant's pricing net of loyalty discounts. While some may suggest foreclosure, others do not. An obvious example is where the rival is an inefficient high-cost producer. Practices should not be deemed foreclosing unless they would exclude rivals as efficient as the defendant. As Judge Posner has said:

14 Thomas Krattenmaker & Steve Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 Yale L.J. 209 (1986).

15 See Jonathan Jacobson & Daniel Weick, *Countering Exclusion: The Complainant's Obligation*, 81 Antitrust L.J. 423, 431-33 (2017).

> The fact that a firm has monopoly power doesn't mean that the law should prevent it from competing. It would be absurd to require the firm to hold a price umbrella over less efficient entrants. . . . Only when monopoly power is used to discourage equally or more efficient firms and thus perpetuate a monopoly not supported by superior efficiency should the law step in.[16]

Both the *Qualcomm* and *Insight Equity* opinions are inconsistent with this approach. The *Insight Equity* court found no relevance in the fact that the plaintiff could profitably meet the defendant's prices. *Qualcomm* did not even address the issue notwithstanding the contrary *Church & Dwight* opinion in the same district just a few years earlier. The court there relied instead on the *margin squeeze effect* of Qualcomm's low chip prices to OEMs on one side and the rivals' need to reimburse the royalty payments on the other – a proposition in direct conflict with the Supreme Court's 2009 decision in *linkLine*.[17]

The equally-efficient rival approach is far from perfect and has a number of critics. As they point out, inefficient rivals can still exert competitive pressure on a dominant firm, resulting in consumer benefit.[18] While an equally-efficient rival framework may allow a dominant firm to exclude inefficient competitors that in fact constrain the firm's power to some extent, any alternatives would reduce the incentives for these less-efficient firms to invest in improving their competitive capacities, and would likely also chill aggressive procompetitive conduct by more successful firms fearful of legal troubles.

The equally-efficient rival paradigm tends to be more objective than the alternatives. In bundled discount cases, for example, the "discount attribution test" applies an equally-efficient rival analysis on an objective basis. Under that test, the court subtracts the total amount of the discount on all products from the price of the product in the bundle accused of excluding rivals. If the "attributed price" calculated on that basis is below the defendant's cost for that product, the bundled pricing will be deemed anticompetitive if competitive harm is shown. If, however, the price is above cost on that basis, the bundle is deemed not to be exclusionary.[19] Firms as efficient as the defendant will be able to match the attributed price. If the attributed price is below cost, however, equally-efficient rivals may not be able to match the price and still survive. This comparison between price and the defendant's costs provides an objective measure. Alternatives put the fact-finder largely at sea in trying to determine whether the price is exclusionary.

A similar test can be applied in some circumstances to single-product loyalty discounts. Doing so requires identification of the "contestable" and "incontestable" demand for the product in issue as the argument is that the loyalty discount ties the contestable demand to the incontestable demand (similar to bundling) to achieve a foreclosure effect. An illustration of that concept is provided in the margin.[20] If there is a basis to identify and segregate these separate demands, the discount attribution test can be applied in the same manner as in bundled discount cases: the discounts applicable to the incontestable demand are subtracted from the price of the contestable volume to determine whether the defendant's prices on this basis are below cost. The problem is that it is truly a rare case when incontestable and contestable demands can be separated in this manner. In *Eisai v. Sanofi-Aventis*,[21] for example, the effort failed as there was no *objective* way to determine whether rivals could actually compete effectively for the supposedly incontestable sales in issue. And that will frequently be the case, as determining whether a sale is contestable or not will often depend on subjective analysis of rivals' ability to compete effectively for the "incontestable" sales.[22]

16 Richard A. Posner, Antitrust Law 196 (2d ed. 2001); see also Eur. Comm'n, *Guidance on the Commission's Enforcement Priorities in Applying Article 82 of the EC Treaty to Abusive Exclusionary Conduct by Dominant Undertakings*, [2009] OJ C 45/7, ¶¶ 23-24.

17 *Pacific Bell Tel. v. linkLine Communc'ns*, 555 U.S. 438 (2009).

18 See, e.g. Steven C. Salop, *Exclusionary Conduct, Effect on Consumers, and the Flawed Profit-Sacrifice Standard*, 73 Antitrust L.J. 311, 328 (2006).

19 See, e.g. *Cascade Health Sols. v. PeaceHealth*, 515 F.3d 883, 904 (9th Cir. 2008) ("[A] defendant offering a bundled discount, without pricing below cost either the individual products in the bundle or the bundle as a whole, can, in some cases, exclude a rival who produces one of the products in the bundle equally or more efficiently than the defendant."); *Collins Inkjet Corp. v. Eastman Kodak Co.*, 781 F.3d 264, 274 (6th Cir. 2015).

20 "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." Jonathan Jacobson, *A Note on Loyalty Discounts*, Antitrust Source, at 7 (June 2010).

21 821 F.3d 394, 406 (3d Cir. 2016).

22 In the many instances where it is not feasible to segregate the "contestable" volume, a standard rule of reason exclusive dealing analysis should be used. See Jacobson, *supra* note 20, at 7-8.

V. CONCLUSION

Aside from bundled discount cases and isolated loyalty discount cases where the discount attribution test can be applied, application of the equally-efficient rival test may be difficult. In concept, it requires an analysis of whether the defendant can profitably compete with itself – given the accused exclusionary tactic in question. But while application may be difficult, the equally-efficient rival test still provides the best outcomes – at least until something better comes along – because it asks the right question: are rivals being excluded on the basis of superior efficiency? Asking that question will lead to better answers in just about every case.

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