# LOYALTY REBATES – A CORPORATE COUNSEL GUIDE

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## I. INTRODUCTION

Corporate counsel is most often asked to provide reliable and business-oriented guidance on business practices, assess whether those practices may result in foreseeable and avoidable contingencies, and structure those practices in such a way that the company is able to maximize its profits. Companies doing business on a global basis further need to make sure those business practices may be pursued in a consistent manner across the various jurisdictions, or otherwise be adapted according to the prevailing legal environment. In circumstances where companies have dominant or otherwise strong market positions, such position imposes higher standards towards competitors.

In his dissent in *ZF Meritor v. Eaton Corp.*, a 2012 case involving loyalty rebates, Judge Morton Greenberg stated that "I do not know how corporate counsel presented with a firm's business plan at least if it is a dominant supplier that seeks to expand sales through a discount program that might be challenged by competitors as providing for a *de facto* exclusive dealing program and asked if the plan is lawful under the Sherman and Clayton Acts will be able to advise the management. The sad truth is that the counsel only will be able to tell management that it will have to take a chance in the courtroom casino at some then uncertain future date to find out."[2]

## II. THE NOTION OF LOYALTY

Management — including corporate counsel — is asked to maximize a firm's results, and business performance targets are normally measured *vis-à-vis* certain indicators achieved by the firm in prior periods, including volumes, EBITDA, market shares, or other thresholds that need to be maintained or maximized. Management thus implements business programs geared towards achieving those targets, including conditional pricing practices or contracts that reference rivals.[3] Loyalty incentives are envisioned as minimizing agency costs and aligning performance targets between suppliers and buyers, where buyers undertake to provide sales-shifting services towards increasing their demand for the seller's product, normally at the expense of its rivals.

Loyalty is not only praised, but has unambiguously positive connotations when analyzed from an ethical, political, and legal perspective. But when it comes to the antitrust arena, such unambiguously positive connotation is often put into doubt, particularly when the firm may enjoy a strong market share.[4] The antitrust concerns that the notion of loyalty may bring are normally associated with the ability of dominant firms to foreclose rivals.

2 *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d 254.

3 Fiona M. Scott Morton, *Contracts that Reference Rivals, American Bar Association*, Antitrust, Vol. 27 No. 3, Summer 2013.

4 Daniel A. Crane, *Bargaining Over Loyalty*, 92 TEXAS L. REV. 253, 274–75 (2014).

Loyalty discounts are "a particular form of non-linear pricing in which the unit price of a good declines when the buyer's purchases meet a buyer-specific minimum threshold requirement."[5] Non-linear pricing occurs when the buyer's total expenditure on an item does not rise linearly with the amount purchased. In a loyalty discount setting, the buyer gets a better price per unit if it purchases specified percentages of its requirements from the vendor, once the stipulated non-linear threshold is met.

Loyalty discounts may take many forms and vary in at least three important dimensions.[6] The first dimension is the nature of the threshold purchased for the discount to be triggered, which may include a market share discount, a volume discount, a shelf facing or space share discount, and a growth discount *vis-à-vis* prior periods in any or a combination of these thresholds. The second dimension involves the units the discounts will be applied to upon meeting the threshold, and may include an all-units discount — resulting in a rebate that shall apply retroactively to all units purchased, both above and below the stipulated threshold — or a traditional incremental discount, being one that shall only apply to those incremental purchases exceeding the agreed upon threshold. Finally, the third dimension is the number of products upon which the thresholds are applied, and may include a single product loyalty discount or a bundled rebate that may involve more than one product.

## III. THE LEGAL STANDARDS

The legal framework under which these conditional pricing practices are analyzed remains polarized between two main views.

A first group endorses the analysis of loyalty rebates from an exclusionary perspective and would argue that any competitive concerns that may arise are similar to those that may arise from exclusive dealing. Thus, discounts may be used as a strategy to exclude rivals, raise rivals' costs to ultimately reduce output, increase prices, and harm consumer welfare. Loyalty discounts that require a substantial threshold, but less than one hundred percent, would qualify as a *de facto* exclusive dealing, and conversely, exclusive dealing may be portrayed as loyalty discounts that are triggered at a one hundred percent threshold.[7]

A second group advocates in favor of analyzing loyalty rebates from a predation perspective. As per this approach, antitrust law should not penalize unilaterally established prices unless they are predatory, because preventing above-cost conditional discounts could otherwise chill beneficial price competition and have adverse effects for consumer welfare.

Preventing discounts that are above an appropriate measure of cost would otherwise reduce price competition, which is a goal that antitrust ultimately pursues in order to promote consumer welfare. This safe harbor for conditional discounts that are above cost echoes Brooke Group,[8] would provide predictability — as claimed by Judge Greenberg in the opening statement — and would ensure that less efficient firms should not be able to turn their defeat in the market into an antitrust claim.

The *ZF Meritor* decision highlights the tension between analyzing conditional pricing practices following the exclusive-dealing approach and the predation approach. The court analyzed the claim as exclusive dealing and concluded that "[t]he legality of an exclusive dealing arrangement depends on whether it will foreclose competition in such a substantial share of the relevant market so as to adversely affect competition." In turn, eighteen highly reputed scholars submitted an *amici curiae* brief in support of the Petitioner (Eaton) to argue that "a plaintiff challenging market share or other loyalty discounts as exclusionary must prove below-cost pricing" and favoring a price-cost analysis rather than asking whether rebates were coercive.[9]

Supplementing these two main theories of harm, additional perspectives have been suggested to analyze loyalty rebates. Some make a distinction on whether the rebate may be characterized as a penalty rather than as a reward. Whenever a supplier is able to threaten its customers with financial penalties and deploy a coercive strategy, the retailer is likely to be unable to afford not carrying the supplier's products to attend its customers' needs, because of their preference for the dominant supplier's products.

5 Bruce H. Kobayashi, *The Economics of Loyalty Discounts and Antitrust Law in the United States*, COMPETITION POL'Y INT'L, Autumn 2005, at 115, 116.

6 Joshua D. Wright, "Simple but Wrong or Complex but More Accurate? The Case for an Exclusive Dealing-Based Approach to Evaluating Loyalty Discounts," Bates White 10th Annual Antitrust Conference Washington, DC June 3, 2013.

7 Derek W. Moore & Joshua D. Wright, *Conditional Discounts and the Law of Exclusive Dealing*, 22 GEO. MASON L. REV. 1205 (2015).

8 *Brooke Group v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209.

9 Brief for Eighteen Scholars as *Amici Curiae* in Support of Petitioner, *Eaton Corp. v. ZF Meritor, LLC*, No. 12-1045 (U.S. Mar. 28, 2013), 2013 WL 1309073. Interestingly, they took "no position on how the cost-price test should be applied to market share discounts".



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A variation of this "discounts as penalties" argument consists in defining the discounts as disguised taxes on disloyalty. This argument proposes that discounts are used by a supplier to impose a "tax" on retailers who purchase products from rival manufacturers, equal to the units discounts these purchasers give up by not buying from the supplier, and may ultimately result in barriers to entry or in foreclosure effects.

Another view states that if the price set by the dominant vendor is above marginal cost, an equally efficient competitor can still compete and make sales. The 'as efficient competitor' test, known as the "AEC test," plays an important role in the EU legal framework to assess the possible existence of a strategy aiming to exclude from the market competitors that are at least as efficient as the dominant firm.

An interesting notion is the one that refers to the contestable units or volume, which would mean the portion of the demand for which customers may consider switching between different suppliers. Some inframarginal customers may buy the leading firm's products even if a competing firm would offer a lower price and thus, the leading firm may structure the discount to induce purchases beyond that uncontestable threshold in the hope of foreclosing rivals.[10] However, others advocate against trying to isolate the contestable and incontestable volume as it would constitute "a fruitless exercise" which is "modeled beautifully in economic papers but in the real world is just not practical."[11]

The analysis of the legal standards that would apply to loyalty rebates would not disregard the three categories of rebates drawn by the EU General Court in *Intel*.[12] First, quantity rebates, which are those linked solely to the volume of purchases made and which are *prima facie* lawful, as they are deemed to reflect gains in efficiency and economies of scale. Second, exclusivity rebates, which are conditional on the customer's obtaining all or most of its requirements from the undertaking in a dominant position and that, as per the EU General Court, are *prima facie* prohibited. And finally, rebates falling within the "third category," which depend on the attainment of individual sales objectives and do not constitute exclusivity rebates. These "third category" rebates require an assessment of all circumstances, particularly the criteria and the rules governing the granting of the rebate, to determine whether there is an economic service that justifies it.

The EU General Court in *Intel* had concluded that the Intel rebates fell within the second category as "fidelity rebates within the meaning of Hoffmann-La Roche," the first major judgment of the European Court of Justice dealing with rebates in 1979, and which imposed a strict standard finding it abusive for an undertaking in a dominant position to offer rebates conditional on the customer's obtaining all or most of its requirements — whether the quantity of its purchases be large or small, even in circumstances where they were entered at the request of the purchasers. Rebates by dominant firms would constitute an abuse "by object" without inquiring whether they resulted in harmful effects on consumer welfare or whether they foreclosed competition. This €1.06 billion fine imposed by the EU Commission on Intel in 2009 and upheld by the General Court in 2014 was heavily criticized because the approach to the application of Article 102 TFEU was formalistic and because it had declared that there was no need to prove whether AMD, the competing microprocessor supplier, was an equally efficient competitor.

In 2017, the EU Court of Justice set aside the judgement of the General Court[13] concluding that the presumption of abuse arising from the dominant undertaking could be reversed in the event supporting evidence could be produced. The Court of Justice further argued that the AEC test played an important role in the assessment of whether the rebate scheme was capable of having foreclosure effects and should include (i) the extent of the undertaking's dominant position on the relevant market; (ii) the share of the market covered by the challenged practice; (iii) the conditions and arrangements for granting the rebates, their duration, and their amount; (iv) the possible existence of a strategy aiming to exclude competitors that are at least as efficient as the dominant undertaking from the market (i.e. the AEC test); and (v) whether the exclusionary effect arising from such a system, which is disadvantageous for competition, may be counterbalanced, or outweighed, by advantages in terms of efficiency which also benefit the consumer.

The *Intel* decision of the EU Court of Justice is said to have made two fundamental contributions to understand the notion of abuse.[14] First, that Article 102 TFEU is only concerned with the exclusion of rivals that are as efficient as the dominant firm. This implies that the departure from the market of rivals that are less attractive in terms of, inter alia, price, quality or innovation is deemed to be a natural outcome of the

10 Cf. *Eisai, Inc. v. Sanofi Aventis U.S., LLC*, 821 F.3d 394 (3d Cir. 2016), in which Eisai argued that Sanofi bundled the contestable and incontestable portion of the demand as an exclusionary tool. Cf. Article 39 of EU Guidance on Article 102 Enforcement Priorities.

11 Jonathan Jacobson, Partner, Wilson Sonsini Goodrich & Rosati, Presentation at the DOJ/FTC Workshop on Conditional Pricing Practices (June 23, 2014). Leah Brannon, Partner, Cleary Gottlieb Steen & Hamilton, LLP, also raised similar objections at the same Workshop.

12 Case T286/09, *Intel Corp v. Commission*, EU:T:214:547.

13 *Intel v. Commission*, Case C-413/14P.

14 Pablo Ibañez Colomo, *The Future of Article 102 TFEU after Intel*, Journal of Competition Law & Practice, 2018, Vol. 9, No. 5.



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competitive process and as such unproblematic. And second, that practices are only caught by Article 102 TFEU insofar as they are capable of having anticompetitive effects, which translates into the ability of dominant firms to provide evidence showing that the practice was incapable of having anticompetitive effects.

The EU Court of Justice decision in *Intel* is consistent with the Commission's approach to conditional rebates in its Guidance on Article 102 Enforcement Priorities,[15] which was adopted in 2009 after the investigation on Intel had started. The Guidance Paper provides certain benchmarks and criteria[16] to conduct a price/cost analysis that shall be integrated into a more general assessment of anti-competitive foreclosure, in its aim to add rigor to the assessment of exclusionary practices.

## IV. GUIDELINES FOR CORPORATE COUNSEL

Consistent with the conclusions of the EU Court of Justice in *Intel*, Judge Richard A. Posner has stated that "[t]he 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."[17] And similarly, the U.S. Supreme Court concluded in Matsushita that "cutting prices in order to increase business is often the very essence of competition."[18] In short, even when a firm enjoys a significant market share, it should not be prevented from competing.

A first approach would suggest corporate counsel to confirm that the discount program does qualify as competition on the merits and has a business justification different than simply pursuing exclusionary effects on as efficient rivals and ultimately, adversely affecting consumers. The efficiency gains or objective justification of the program may be explained by the sales-shifting services provided by the buyer, the stimulation of retailer services and dealer focus, the protection of manufacturer investments in relationship-specific assets, brand positioning, or otherwise. "If it appears that the conduct can only raise obstacles to competition and that it creates no efficiencies, its anti-competitive effect may be inferred."[19]

A price-cost analysis of conditional pricing practices, particularly in industries with low average variable costs, high profit margins and/or high R&D investments, like the pharma industry, would not constitute a fruitful endeavor. It may be, however, a starting point for analyzing whether the discounts lead to above-cost prices, which would in principle be easier for counsel than analyzing the (exclusionary) effects in the industry or the market or assessing whether the program violates the rule of reason. However, by no means would an above-cost price measured against all units represent a safe harbor, as such discount may still produce anticompetitive effects. The pricing orientations contained in the EU Guidance on Article 102 Enforcement Priorities "to determine whether even a hypothetical competitor as efficient as the dominant undertaking would be likely to be foreclosed by the conduct in question" or otherwise to conduct the AEC test would indeed be very helpful for counsel, but not necessarily would those automatically fit every industry.[20]

As regards the analysis of the potential exclusionary and foreclosing effects, and further to the standards developed in the preceding chapter, the exercise would be identical to the one to be conducted in connection with exclusive dealing agreements and the principles laid down in *Tampa*[21] would apply, to wit: "[e]xclusive dealing arrangements are unlawful when they foreclose a substantial share of the relevant market to rivals." The notions of "substantial share" and of "minimum efficient scale" would not be consistent notions across industries, and a variety

15 2009/C 45/02.

16 "The Commission considers that: where a dominant firm is charging an effective price below AAC [average avoidable cost], the rebate is generally capable of foreclosing competitors as efficient as the dominant firm; where a dominant firm is charging an effective price that is between AAC and LRAIC [long-run average incremental cost], other relevant factors, such as competitors' counterstrategies, should be taken into account to determine the possibility of anti-competitive foreclosure; where a dominant firm is selling at an effective price above LRAIC, the rebate is normally not capable of anti-competitive foreclosure." Richard Whish & David Bailey, Competition Law, Seventh Edition, Oxford University Press 2012, page 735. As per footnote 18 of the Guidance Paper, AAC may be assimilated to the Average Variable Cost, while LRAIC may be assimilated to the Average Total Cost.

17 Richard A. Posner, Antitrust Law, quoted by Jacobson, Jonathan & Weick, Daniel, *Countering Exclusion: The Complainant's Obligation*, Antitrust Law Journal, Chicago, Volume 81, No. 2 (2017); 423-446.

18 *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 594 (1986).

19 EU Guidance on Article 102 Enforcement Priorities, article 22.

20 *Supra* note 16.

21 *Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961).



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of economic and business facets would need to be analyzed, including the structure of the market, the fixed and variable costs in the industry, whether the industry deals with differentiated or homogeneous products, barriers to entry, capacity and distribution constraints, the ability of expansion of existing competitors, and the ability of rivals to compete for exclusives.[22]

The retroactive or incremental nature of the rebates (all-units discount) is an element to consider carefully, as it may, in general terms, favor market foreclosure and make it less attractive for customers to switch even small amounts of demand to competitors.[23] While retroactive or all-units discounts "can benefit consumers by reducing prices and increasing output beyond what the monopolist would otherwise have charged or produced, leading to more efficient resource allocation," [24] they "may be anticompetitive in certain circumstances."[25]

In the event the product were to qualify as a must-have or a must-stock item, this would be an important element for analyzing the coercion to be exerted on customers if they fail to comply with the loyalty or exclusivity conditions, and the potential effect of locking-in customers and excluding rivals. After *Intel* and *ZF Meritor*, coercion and the structure of the market would not qualify as stand-alone arguments to question the legality of rebates.

The duration of the agreement or agreements and their ease of termination would be important elements for analyzing the potential exclusionary nature of the rebates, along with the other facets of the pricing program. In *Concord Boat* the court reiterated that "contracts terminable in less than a year [are] presumptively lawful."[26] In *Tampa*,[27] a twenty-year exclusive arrangement foreclosing only a very small percentage (one percent) of the market was upheld, and the long-term agreements at issue in *ZF Meritor*, with rebates triggered on minimum purchases between 70 and 97.5 percent, were of at least five years.

Another aspect to pay attention to would be the reference period upon which to calculate discounts *vis-à-vis* the turnover, particularly in retroactive or all-units discounts settings: "[t]he longer the reference period, the more loyalty-inducing the quantity rebate system."[28]

Market thresholds would be another issue to be considered. May a company with a 40 percent market share seek to increment its market share to 45 percent? And what about one with a 70 percent market share? And one with a 90 percent market share? And would they play safe if their exclusives do not exceed their existing market shares or could those exclusives constitute barriers to entry or expansion to competitors? An increase in the market share shall entail a reduction of its competitors' shares — but not necessarily their volumes or income may be adversely affected.

In 2013, the FTC voted to issue a Complaint and Order against Graco, Inc.[29] to remedy the allegedly anticompetitive effects of Graco's acquisition of Gusmer Corp. and GlasCraft, Inc. Graco's market share of between 90 and 95 percent in the fast-set equipment industry had remained intact since its 2008 acquisition of GlasCraft.

FTC confirmed it tended to "believe that exclusive dealing relationships can have procompetitive benefits and that such relationships should not be condemned in the absence of a thorough factual and economic assessment of the circumstances surrounding such conduct." However, the FTC also indicated that "when employed by a competitor that has acquired significant market power or monopoly power, exclusive dealing arrangements have the potential to cement such power and prevent or deter entry that would lead to lower prices, higher quality, and

22 For an analysis of the notion of foreclosure, cf. Joshua D. Wright, *Moving beyond naïve foreclosure analysis*, George Mason Law Review, Vol. 19, No. 5, Summer 2012, pp. 1163-1198.

23 EU Guidance on Article 102 Enforcement Priorities, article 40.

24 U.S. Dep't of Justice, Competition and Monopoly: Single-Firm Conduct under Section 2 of the Sherman Act 106 (2008).

25 *Idem* at 107.

26 *Concord Boat Corp. v. Brunswick Corp.* 207 F.3d 1039 (8th Cir. 2000), which in turn quoted *Rowland Mach. Co. v. Dresser Indus., Inc.*, 749 F.2d 380, 395 (7th Cir. 1984).

27 *Supra* note 21.

28 Case T-2 03/01 *Michelin v. Commission* [2003] ECR II-4 071.

29 Statement of the Federal Trade Commission *In the Matter of Graco, Inc.* FTC File No. 101-0215 April 17, 2013. Commissioner Wright issued a separate statement supporting the decision but disagreeing on two aspects, namely the provisions prohibiting Graco from entering into exclusive dealing contracts with distributors and establishing purchase and inventory thresholds that must be satisfied in order for distributors to obtain discounts. Cf. Statement of Commissioner Joshua D. Wright *In the Matter of Graco, Inc.* FTC File No. 101-0215, April 17, 2013.



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better service for consumers." As a consequence thereof, behavioral remedies were imposed to restrict the scope of loyalty discounts that Graco was able to grant its distributors — requiring distributors to meet annual purchase and inventory thresholds to qualify for discounted prices — by prescribing the maximum threshold levels Graco may set in 2013 and by only allowing those maximums to increase by 5 percent year to year.

The FTC said nothing as to whether those thresholds would ultimately foreclose rivals from achieving minimum efficient scale, but rather authorized a (compounded and unlimited) 5 percent increase year after year. The *ex ante* review and further sign-off by corporate counsel of loyalty rebates to be granted by a company that enjoys such a significant amount of market share, and that may increase year after year, in a compounded and unlimited manner, would not be free from doubt. While such a sign-off was indeed given by the FTC itself, we would be careful of simply relying on the fact that that the FTC arguably blessed a compounded and unlimited *per se* legality that may be satisfied within those formal settings.

Corporate counsel shall be asked to provide orientation and structure conditional pricing practices or contracts that reference rivals in a variety of market and industry conditions. In between casino-gambling and full certainty, numerous legal and economic elements are available to give a reliable and thoughtful guidance for the firm to be able to promote efficiencies, maximize results and ultimately benefit consumers. We trust these thoughts may contribute to such analysis.

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