

Antitrust Practice

**Ninth Circuit Provides Guidance on Product Bundling,
Spurs Debate**

By Bruce A. Blefeld

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On September 4, 2007, the Ninth Circuit vacated the jury verdict in *Cascade Health Solutions f/k/a McKenzie-Willamette Hospital v. PeaceHealth*, and provided much needed clarity concerning the proper analysis of antitrust claims challenging product bundling and related price discounts. The Ninth Circuit rejected *LePage's Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003) (en banc) and held that “[t]o prove that a bundled discount was exclusionary or predatory for the purposes of a monopolization or attempted monopolization claim under § 2 of the Sherman Act, the plaintiff must establish that, after allocating the discount given by the defendant on the entire bundle of products to the competitive product or products, the defendant sold the competitive product or products below its average variable cost of producing them.”

McKenzie-Willamette Hospital (“McKenzie”) and PeaceHealth are the only two providers of hospital care in Lane County, Oregon. McKenzie contended, among other things, that PeaceHealth violated the antitrust laws by monopolizing or attempting to monopolize the market for primary, secondary, and tertiary hospital services in Lane County. Primary and secondary acute care hospital services are common medical services like setting a broken bone. Some hospitals also provide more complex services called “tertiary care” which includes, for example, cardiovascular surgery and intensive neonatal care. McKenzie claimed that PeaceHealth violated the antitrust laws by offering insurers discounts of 35 percent to 40 percent on tertiary hospital services if the insurers made PeaceHealth their sole preferred provider for *all* hospital services, primary, secondary, and tertiary. In Lane County, PeaceHealth had about a 90 percent market share of tertiary services, and approximately a 75 percent share of the market for primary and secondary services. Unlike PeaceHealth, McKenzie did not provide tertiary hospital services.

The district court, following *LePage's*, instructed the jury that “[b]undled price discounts maybe anti-competitive if they are offered by a monopolist and substantially foreclose portions of the market to a competitor who does not provide an equally diverse group of services and who therefore cannot make a comparable offer.” The jury rejected McKenzie’s monopolization claim. However, it found in favor of McKenzie on its attempted monopolization claim and awarded damages of \$5.4 million (\$16.2 million after trebling). PeaceHealth argued on appeal that the jury instruction incorrectly stated the law because it allowed the jury to find that a defendant with monopoly power or, having a dangerous probability of achieving monopoly power, engaged in exclusionary conduct by simply offering a bundled discount that its competitor could not match. The instruction did not require the jury to consider whether the defendant priced below cost.

PeaceHealth’s argument is consistent with much of the scholarly commentary subsequent to *LePage's* as well as the 2007 report of the bi-partisan Antitrust Modernization Commission



(AMC). The AMC recognized that the fundamental problem with the *LePage's* standard is that it does not consider whether the bundled discounts constitute competition on the merits. Rather, *LePage's* simply concludes that all bundled discounts offered by a monopolist are anticompetitive with respect to its competitors who do not manufacture an equally diverse product line. *LePage's* does not require the jury to consider whether the plaintiff was at least as efficient of a producer as the defendant. By contrast, the AMC proposed that courts should adopt a three-part test to determine whether bundled rebates violated Section 2 of the Sherman Act: (i) after allocating all discounts and rebates attributable to the entire bundle of products to the competitive product, the defendant sold the competitive product below its incremental cost for the competitive product; (ii) the defendant is likely to recoup these short-term losses; and (iii) the bundled discount or rebate program has had or is likely to have an adverse effect on competition.

The Ninth Circuit parted ways with the Third Circuit when reversing the attempted monopolization judgment against PeaceHealth. “Given the endemic nature of bundled discounts in many spheres of normal economic activity, we decline to endorse the Third Circuit’s definition of when bundled discounts constitute . . . exclusionary conduct. . . . Instead, we think the course safer for consumers and our competitive economy to hold that bundled discounts may not be considered exclusionary conduct within the meaning of § 2 of the Sherman Act unless the discounts resemble the behavior that the Supreme Court in *Brooke Group* [*Brooke Group, Ltd. v. Brown & Williamson Tobacco, Corp.*, 509 U.S. 209 (1993)] identified as predatory.” As the Ninth Circuit recognized, “the Supreme Court has forcefully suggested that we should not condemn prices that are above some measure of incremental cost. . . . [T]he Court’s reasoning poses a strong caution against condemning bundled discounts that result in prices above a relevant measure of costs.” Ultimately, the Ninth Circuit adopted the first prong of the AMC’s proposed test for bundled discounts. (The court rejected the second and third prongs of the AMC’s proposed test. The second prong, dangerous probability of recoupment, does not translate to multi-product discounts since, unlike single-product predatory pricing, bundling does not necessarily involve a loss of profits to the defendant. The third element of the AMC’s test, an adverse effect on competition, is redundant of the general requirement of “antitrust injury.”)

The cost-based standard adopted by the court “makes the defendant’s bundled discounts legal unless the discounts have the potential to exclude a *hypothetical* equally efficient producer of the competitive product.” (emphasis in original). This standard, unlike the standardless rule of *LePage's*, provides clear guidance to sellers that bundle because they can readily determine their own prices and costs of production and thus calculate whether their bundle is lawful. The court recognized, however, that liability under its discount attribution standard has the potential to sweep more broadly than other proposed cost-based standards for bundled discounting (e.g., an “aggregate discount” rule—advocated for by PeaceHealth—which, similar to the single-product predatory pricing standard of *Brooke Group*, would condemn bundled discounts only in the narrow cases in which the discounted price of the entire bundle does not exceed the bundling firm’s incremental cost to produce the entire bundle). Unlike single-product predatory pricing, “there is limited judicial experience with bundled discounts, and academic inquiry into the competitive effects of bundled discounts



is only beginning.” The Ninth Circuit believed that the standard it adopted “will allow courts the experience they need to divine the prevalence and competitive effects of bundled discounts and will allow these difficult issues to further percolate in the lower courts.”

PeaceHealth provides welcome guidance and clarity on the Section 2 Sherman Act standards for bundled discounting. For courts that follow *PeaceHealth*, suppliers now have a degree of certainty about whether their product bundles may be held to violate Section 2. The debate over product bundling will continue and is an issue that suppliers, particularly with significant market share, need to pay close attention to.

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