Can Bundled Discounts Be Illegal If Offered by a Firm Without Market Power?

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Bundled discounts are common marketing schemes that normally benefit consumers and competition; however, courts and commentators have found certain circumstances when they might be illegal monopolization. The line between hard competition and exclusionary conduct has confounded antitrust counselors and their pricing clients for years, but, it seemed like only companies with monopoly power need be concerned. Now, a Pennsylvania district court in *Schuylkill Health Systems v. Cardinal Health, Inc., et al.*, has further muddied the waters by allowing a bundling claim to proceed under Sherman Act Section 1, even after dismissing other claims for lack of market or monopoly power.
A bundled discount is when Manufacturer 1 sells Products A and B together in one bundle for one price. That bundle can bring efficiencies to customers, perhaps even lower total prices. For Manufacturer 2 that sells only Product B, however, the bundling can hurt its sales if Manufacturer 1's discount is so great that customers feel "forced" to buy from them. In the long run, that can be bad for customers if Manufacturer 2 eventually goes away.

Such an anticompetitive story has only seemed plausible, however, if there are few, if any, Manufacturers 3, 4 and 5 selling Product A so that Manufacturer 1 has monopoly power and customers really are "forced" to buy the bundle.

Because we want even monopolists to compete aggressively, not all bundled discounts have been considered anticompetitive. Articulating the test for competitive harm, however, has eluded courts and commentators. The Third Circuit's attempt in *LePage's v. 3M* in 2003 was roundly criticized for focusing on the effects on one competitor, not competition, and providing no guidance to future discounters. In its 2007 report, the Antitrust Modernization Commission (AMC), a bipartisan panel of antitrust experts, endorsed a variation of *Brooke Group*'s comparison of the discounted price to some measure of costs, along with likely recoupment of losses through later price increases. That test was one of several discussed and accepted, but only with modifications, by the Ninth Circuit later in 2007 in *PeaceHealth*. As a result of this confusion, counselors have had to guess how courts would judge such bundled discounts.

In late 2012, Schuylkill Health Systems (SHS) accused Cardinal Health and Owens & Minor (O&M) of various anticompetitive actions. Cardinal and O&M sell dozens of medical-surgical products, including sutures and endomechanical products ("endo products"), and SHS is a customer of both companies. Each company allegedly enjoys a 30-40 percent share in each of the medical-surgical product markets.

Suture Express sells only sutures and endo products, and, allegedly, was doing so successfully before Cardinal and O&M instituted nearly identical bundled discount programs. Under those programs, customers who purchased less than 10 percent of their sutures and endo products from Suture Express or other competitors received one price. Customers who purchased more than 10 percent from Suture Express or other competitors were forced to pay a 1-5 percent penalty on <u>all</u> medical-surgical product purchases. Allegedly, that price penalty overwhelmed any potential savings to customers for purchasing their sutures and endo products from competitors like Suture Express.

SHS claimed the discount program constituted several antitrust violations, including: monopolization and conspiracy to monopolize under Sherman Act Section 2; exclusive dealing under Clayton Act Section 3; and anticompetitive horizontal agreements, tying and bundling under Sherman Act Section 1. SHS supported its claim that "courts in this Circuit have recognized that bundling is a Section 1 claim separate and distinct from tying," with references to the district court opinion in *LePage's* and an unpublished 2012 opinion from the New Jersey District Court in *Castro v. Sanofi Pasteur, Inc*. In *LePage's*, however, 3M had a 90 percent market share and eventually admitted to having monopoly power. In *Castro*, the plaintiffs alleged—and that court accepted as true—that Sanofi had monopoly power in all relevant markets and used it "to impose contractual terms . . . that are expressly or effectively exclusive" and so might violate Section 1 (emphasis added). The *Castro* court separately denied a motion to dismiss a Section 2 claim regarding Sanofi's bundled discounts.

Defendants jointly moved to dismiss all the claims, chiefly because of lack of standing. Specifically, as to the monopolization claims, they argued that each defendant's individual market share was too low to find monopoly power and there was no evidence of any agreement or conspiracy to justify adding the shares together. Specifically, regarding the bundling claim, defendants cited *LePage's* to show that unlawful bundling is simply one way a monopolist might maintain monopoly power. *LePage's* required a showing that the defendant "used its monopoly" to "squeeze out" competitors. Because SHS could not properly plead monopoly power, defendants reasoned that the bundling claim must fail.

The court dismissed both the conspiracy to monopolize and illegal horizontal agreement claims because SHS did not adequately allege the existence of an agreement. The court also dismissed the monopolization claim because the individual market shares of each defendant—below 40 percent—were inadequate to plead market power. Also, SHS made no more than conclusory statements about entry barriers or any other market factors that might otherwise lead to an adequate allegation of monopoly power. The court was skeptical, but allowed the tying claim to proceed, though only under a rule of reason, not per se, theory because "Defendants individually do not have the requisite market power." (The court also refused to dismiss the exclusive dealing claims, finding that SHS's allegations of foreclosure of at least 16 percent were adequate at this stage.)

Defendants probably thought the court would dismiss the bundling claim because it found that neither monopoly nor market power was adequately plead. In a two-paragraph footnote, however, the court refused to dismiss the bundling claim under Section 1. The court noted that SHS had asserted that customers were "forced" to purchase products from the defendants, leading to increased prices for all consumers, and that defendants had no procompetitive justification. The court never mentioned any need for an adequate pleading of market or monopoly power. The only case citations in the footnote are to *LePage's* and *PeaceHealth* (where the defendant's shares ranged from 75-95 percent).

It is difficult enough to know when a monopolist's bundled discount might be found illegal; now, claims against manufacturers with about one-third of the market might need to be defended. It is unclear how a Manufacturer 1 with a 33 percent share of the market for Product A can "force" a customer to take a bundle that includes Product B if other sellers of Product A make up two-thirds of the market.

In 2007, the AMC called for further empirical research on the competitive effects of bundled discounts in hopes of ending confusion about how they should be analyzed. In 2014, the FTC/DOJ workshop on conditional pricing practices showed that such empirical work is still rare and the analysis still confused. Cases like *Schuylkill Health Systems* only add to the confusion.