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Cascade Health Solutions v. PeaceHealth: The Ninth Circuit Clarifies The Circumstances When Discounted Bundled Sales May Violate Antitrust Laws

A recent ruling by the U.S. Court of Appeals for the Ninth Circuit provides important guidance for suppliers and retailers regarding whether, and under what circumstances, the offering of more than one product for sale at a bundled discount price may expose a vendor to liability for monopolization or attempted monopolization in violation of federal antitrust law.[1] In short, the Ninth Circuit ruled that bundling is actionable only if the product(s) within a bundle that is subject to competition is priced below the seller's marginal cost, and that the price of that competing product(s) for purposes of that determination would be calculated by allocating the aggregate discount on all of the bundled products onto only the competitive one(s). The Ninth Circuit ruling creates a split with the Third Circuit that may ultimately lead to Supreme Court review of the issue.

Bundled or package discounts have become both common and accepted. At the local Target or Costco store you can purchase shampoo and conditioner nearly at the price of one alone. Special rates for combined cable television, internet and telephone service appear everywhere. At first blush, such packages provide lower prices for consumers who choose to purchase them, a result generally favored by the antitrust laws. However, such bundling may create challenges for a competitor that cannot offer the full bundle -- a telephone company that can offer internet access but not television service, for example, even if the competitor is otherwise an efficient producer. Although the struggles of a single competitor are generally not a concern of the antitrust laws, bundled discounting is a potential antitrust concern if the bundle could harm competition -- in our hypothetical, for example, if a company that dominated the telephone business (or, in antitrust lingo, had "market power" in that business) used the bundled discount to gain a dominant position in the television business as well. Under such circumstances, several courts have found that the bundled discount may have the unlawful effect of preventing competition from suppliers of less than all of the bundled products or services.

For example, one federal Court of Appeals to address this issue (the Third Circuit) upheld a jury verdict of $22.8 million against 3M Company -- automatically trebled under the Sherman Act to $68.4 million -- based on 3M's bundling its sales of generic, store brand cellophane tape with discounts on its Scotch brand tape and a host of other office supplies.[2] 3M's liability for monopolization of the generic tape market was upheld based largely on the finding that the plaintiff could not match 3M's bundled discounts because it did not supply Scotch tape or the other office products in the bundle. Thus, it was ruled, 3M had leveraged its market power from Scotch tape and other products to eliminate competition for sales of generic tape. Significantly, however, neither the trial court nor the Third Circuit made any ruling regarding whether (1) 3M had priced any of its bundled products below cost, or (2) the plaintiff had been an equally efficient supplier of generic tape as 3M.

In Cascade Health Solutions v. PeaceHealth, the Ninth Circuit's appellate opinion addressed both issues, providing a more objective standard to guide business decision-making in advance of any litigation.[3] The parties were the only hospitals in Lane County, Oregon. However, plaintiff McKenzie-Willamette Hospital (McKenzie) provided only primary and secondary healthcare services (*e.g.*, setting broken bones and minor surgery), whereas defendant PeaceHealth, provided those as well as tertiary services (*e.g.*, more invasive surgery, intensive neonatal care). McKenzie claimed that PeaceHealth attempted to monopolize the market for primary and secondary services by offering insurers a discount on all of its services if the insurers agreed not to make McKenzie an additional preferred provider of primary-secondary services. At least one major insurer made PeaceHealth its sole preferred

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[1] As defined by the Ninth Circuit, bundling of products or services is the practice of offering for a single price, two or more goods or services that are also available for sale separately, but at a higher total cost.

[2] LePage's, Inc. v. 3M, 324 F.3d 141 (3rd Cir. 2003) (*en banc*).

[3] 502 F3d 895 (9th Cir. 2007). The Ninth Circuit also addressed the plaintiff's related tying and state law claims, which are not examined here. On February 1, 2008 the Court amended its prior order to certify plaintiff McKenzie's state law price discrimination claim to the Oregon Supreme Court, and stayed the entire case until that court determines the proper application of that Oregon law. 2008 WL 269475 (9th Cir. Feb. 1, 2008).

provider in order to obtain discounts on all of PeaceHealth's services. In essence, McKenzie claimed that the bundled discount was anticompetitive because it was unable to match the defendant's discount -- and therefore lost business in primary and secondary services -- since it did not provide the tertiary healthcare services that PeaceHealth was heavily discounting in the bundle. McKenzie prevailed on its attempted monopolization claim at trial and was awarded $5.4 million, automatically trebled to $16.2 million, plus attorneys' fees and costs.

On appeal, the Court of Appeals vacated the judgment for McKenzie and remanded the case for a new trial. Parting ways with Third Circuit's analysis in LePage's v. 3M, the Ninth Circuit held that such bundled discounts could only be anticompetitive if a defendant prices the competing product(s) (*i.e.*, those that the plaintiff also supplies) below an appropriate measure of the defendant's marginal cost. Specifically contradicting the Third Circuit's earlier analysis, the Ninth Circuit held that the requirement that a sale be below cost in order to be anticompetitive is equally applicable in multi-product bundling cases as in the single product cases from which that rule stems.[4]

Thus, the Ninth Circuit ruled, only if the defendant's pricing is below a relevant measure of its cost of the competing product(s) can it be concluded that the plaintiff's inability to match the defendant's discount was due to anticompetitive conduct rather than the plaintiff's own relative inefficiency as a supplier. In the absence of such below-cost pricing an antitrust claim could actually have the effect of causing consumers to lose out on non-predatory lower prices -- a result entirely at odds with the goals of the antitrust laws.

The big question, then, was what should be the "appropriate measure of cost" for products collectively priced at a discount only when sold in a bundle? The Ninth Circuit shared the concern, expressed by an earlier ruling from the Southern District of New York,[5] that even a more efficient supplier of one product might still be unable to compete with the bundled discount over a defendant's portfolio of products. For example, even if a McKenzie were hypothetically more efficient in providing primary and secondary services, if PeaceHealth's discounts on its bundled tertiary services (those not provided by McKenzie) were sufficient, it would be possible that McKenzie might not be able to match such total discounts on only the services it did provide. In that event, the result would be that a more efficient supplier could be lost, and competition harmed, as a result of the bundled discounts.

The Southern District of New York's earlier solution was to require the plaintiff to establish that it was at least an equally efficient supplier, but still could not profitably match the defendant's bundled discount. However, the Ninth Circuit was troubled by a measure that would make plaintiff's efficiency the determining factor. First, sellers who offer procompetitive bundled discounts are not likely to know the actual cost of their competition (*i.e.*, possible plaintiffs), and therefore could not judge the legality of such discounts prior to adopting them. Second, since the cost and productivity of competitors would differ, it might take multiple law suits to determine whether a particular bundled discount was in fact lawful.

Supreme Court precedents dealing with pricing of only a single product were also of limited guidance with respect to allocating cost across multi-product bundled discounts. As a result, the Ninth Circuit adopted the measure of cost recently proposed by the Antitrust Modernization Commission, referred to as the "discount attribution standard." Under this standard, all that a discounting vendor must know not to violate the law is within its grasp. Given that the motivation for the bundled discount is presumed to be competition in the competing product -- *i.e.*, a vendor would not normally discount products over which it already exercises market power -- the full amount of the discounts in the bundle is allocated to the competitive product(s) only. If the resulting price of the competitive product(s), net of the aggregate bundled discount, is below the defendant's incremental cost to produce the competing product, the discount is likely to be exclusionary and therefore anticompetitive.

The Court summarized its holding thus:

> To prove a bundled discount was exclusionary or predatory for purposes of monopolization or attempted monopolization claim under Section 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 products below its average variable cost of producing them.

Resolving concerns regarding earlier precedents, the Ninth Circuit's standard: (1) provides a measure of certainty and predictability because it is based on a defendant's own costs and discounts; and (2) protects against a defendant's ability to leverage market power over a non-competing product to create market power over a competing product, but (3) makes a defendant's bundled discounts lawful unless the discounts have the potential to exclude hypothetically equally efficient producers of competitive products within the bundle. The solution of the Ninth Circuit may not be perfect, but it is objective and ascertainable; it protects competition, not competitors; and it rewards efficiency and productivity -- both on the part of single product suppliers facing predatory bundled discounts, and of efficient suppliers of multiple products seeking to compete based on the breadth of their full portfolios.

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[4] See Weyerhauser Co. v. Ross Simmons Hardwood Lumber Co., 127 S. Ct. 1069 (2007); Brooke Group v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 113 S. Ct. 2578 (1993).

[5] Ortho Diagnostic System, Inc. v. Abbott, 920 F. Supp 455 (S.D.N.Y. 1996).

The standard announced by the Ninth Circuit is not, however, simple: as is the case in any below cost pricing case, establishing true marginal cost can be difficult and may not remain constant over a long period of time. Marginal cost, in the antitrust sense, is not found in or easily derived from standard business accounting measures. Moreover, in cases where there is more than one competing product or service in a bundled discount package, it may also be practically difficult for vendors to attribute their aggregate discounts across the competing products for purposes of gauging the antitrust character of such discounts in advance of adoption. Our clients and friends would be well-advised to consider the antitrust implications of any multi-product distribution or pricing plans as part of planning any such programs as well as the regular course of managing their businesses.

Contact your Butzel Long attorney, or a member of Butzel Long's Antitrust Practice listed below, for more information regarding the antitrust implications of bundled discounts, or application of the U.S. antitrust laws generally.

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