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Discounted Pricing Clauses: Drafting Enforceable and Compliant Provisions After Collins

Utilizing Bundles, Minimum Requirements Clauses, and Tiered or Volume-Based Pricing Incentives

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Discounted Pricing Clauses:

Drafting Enforceable and Compliant Provisions After *Collins*

May 17, 2016

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Discounting Practices and Antitrust Liability

Types of discount pricing practices – Overview

- Bundled pricing for multiple products
- Partial exclusive dealing arrangements: Market share discounts for single products
- Most favored nation clauses
- Price discrimination

Discounts – A Potentially Thorny Antitrust Problem

Discounting – pro-competitive and efficiency-enhancing

- Market share discounts: provide discounts to smaller purchasers that otherwise would not be able to order sufficient quantities of product to qualify for strict volume discounts
- Frequent-buyer programs – generally ok
- First-dollar market share discounts, or bundled discounts – use of competing products potentially threatens ability to earn discounts – hence the potential antitrust issue

Antitrust Analysis (U.S. Federal Law)

Sherman Act Section 1: unreasonable restraint of trade

- "Rule of Reason"
  - Agreement
  - Anticompetitive effects vs. procompetitive benefits
- "*Per Se* Rule"

Sherman Act Section 2: monopolization and attempted monopolization

(Robinson-Patman Act: price discrimination)

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Antitrust Analysis (continued)

Sherman Act Section 1: exclusive dealing

- Supplier requires distributor(s) not to deal in the products of the supplier's competitors
- Key question – extent of market foreclosure
  - Other factors: length of exclusivity
- Can discounts be analyzed as exclusive dealing?
  - Yes, but
    - Foreclosure generally lower, and
    - Quantity discount typically presents a contract of "zero" duration, so less concern

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Antitrust Analysis (continued)

Sherman Act Section 1 : tying

- Agreement to sell one product (tying) only on condition that buyer also purchases a second (tied) product
- Appreciable economic power (tying product), substantial volume of commerce requirements
- Reason for analysis – ties can allow firms to leverage power and interfere with competition in the tied product market
- Discounts as tying
  - Bundle-to-bundle competition – not possible – may look like tying
  - Bundle-to-bundle competition – possible – may look more like predatory pricing analysis (under Section 2)

Antitrust Analysis (continued)

Section 2 (monopolization and attempted monopolization)

- Monopolization
  - Monopoly power (>60% market share) **Rule of Thumb!**
  - Exclusionary/predatory conduct (willful acquisition/maintenance)
  - *United States v. Grinnell Corp*., 384 U.S. 563 (1966)
- Attempted monopolization
  - Exclusionary/predatory conduct
  - Dangerous probability of success (>40% market share) **Rule of Thumb!**
  - Specific intent to monopolize
  - *Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447 (1993)

Antitrust Analysis (continued)

Exclusive dealing as Section 2 exclusionary conduct

Tying as Section 2 exclusionary conduct

Price predation as Section 2 exclusionary conduct

- Below-cost sales
- Dangerous probability of recouping investment in below-cost prices
- *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.,* 509 U.S. 209 (1993)

Collins and the Discount Attribution Test

***Collins Inkjet Corp. v. Eastman Kodak Co*., 781 F.3d 264 (6th Cir. March 16, 2015)**

Kodak sold refurbished printer components and ink

Collins sold ink (only)

Kodak discounted print heads for customers that also buy Kodak ink

Section 1 tying claim; district court granted preliminary injunction – would "all rational buyers" switch to Kodak ink?

On appeal, Sixth Circuit affirmed, but clarified test for "non-explicit tying via differential pricing"

Collins and the Discount Attribution Test (continued)

In the Court's view, differential pricing becomes equivalent to an unlawful tying arrangement when the price discount, <u>as applied to the original price of the second (or "tied") product, in effect lowers the price of the tied product below the seller's cost</u>. "[D]ifferential pricing . . . is unlawful only if it might [force] a more efficient competitor out of business."

Collins and the Discount Attribution Test (continued)

The below-cost test is required because

- “differential pricing, unlike other forms of indirect coercion, can be employed legitimately without illegal anticompetitive influence from the defendant’s control over the tying product market . . . . [I]f the defendant merely offers a discount on the tying good to buyers who also purchase the tied good, then buyers are only ‘forced’ to buy the tied good elsewhere at a price low enough to offset the forgone discount for the tying product. The defendant uses its market power over the tying good to shift the discount from the tied good to the tying good, but this in itself does not ‘force’ buyers to purchase the tied product any more than a discount on the tied product would.”

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Other Cases

***LePage's Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003) (*en banc*), *cert. denied*, 542 U.S. 953 (2004)**

- 3M – 90% market share – transparent tape
- Multi-tiered rebate structure – bundled rebates

  The size of the rebate was linked to the number of product lines in which targets were met, and the number of targets met by the buyer determined the rebate it would receive on all of its purchases. If a customer failed to meet the target for any one product, its failure would cause it to lose the rebate across the line. In some cases, these rebates to a particular customer were as much as half of LePage's entire prior tape sales to that customer.

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Other Cases (continued)

LePage's

- Court analyzed bundled discounts as tying or exclusive dealing, not as predatory pricing
- The court did not require LePage's to prove either it or a hypothetical equally efficient competitor would not meet the discounts without pricing below cost. Rather, the court endorsed the trial court's jury instruction that conduct that "has made it very difficult or impossible for competitors to engage in fair competition" is actionable under Section 2. *Id*. at 168. "[A] monopolist will be found to violate Section 2 of the Sherman Act if it engages in exclusionary or predatory conduct without a valid business justification." *Id*. at 152.

Other Cases (continued)

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

- The Third Circuit limited the reasoning in *LePage's* "to cases in which a single-product producer is excluded through a bundled rebate program offered by a producer of multiple products, which conditions the rebates on purchases across multiple different product lines." *Id*. at 274 n. 11.

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Other Cases (continued)

***Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883 (9th Cir. 2008)**

- Rejected *LePage's* approach
- The Ninth Circuit specifically adopted a discount attribution standard where, when the full amount of the defendant's discount on the bundled offering is allocated to the competitive product, and if the resulting price is above defendant's incremental cost to produce the competitive product (to be precise, its average variable cost), the arrangement is not exclusionary. *See id*. at 906-10. The Ninth Circuit refused to adopt an aggregate discount rule, *i.e.*, a rule that would compare total bundle costs to total bundle prices. *See PeaceHealth*, 515 F.3d at 904.
- Ninth Circuit adopted different approach to tying claim – rather than applying a cost-based screen, the court focused on "coercion," and turned to anecdotal evidence

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Other Cases (continued)

***Vesta Corp. v. Amdocs Management Ltd*., 2015 WL 5178073 (D. Or. Sep. 3, 2015)**

•Complaint did not adequately allege below-cost pricing after allocation of discount. Following *PeaceHealth*

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Contract Drafting and Antitrust Compliance

Do you have market power (or are you approaching market power) in any market for goods (or services) you are selling? If the answer is no, then there is likely little reason to think that any bundled discount is going to be problematic.

If you have – or are close to having – market power for at least one product or service, then you should make sure at least the following is true:

- If you are competing bundle-to-bundle with competitors, you should ensure that the total price of the bundle is above the total cost after taking into account any and all discounts.
- If you are selling a bundle and competing with a firm that sells only one product or service in the bundle, then you should ensure that the price of the competing product or service is above cost after allocating discounts to that product or service.

Contract Drafting and Antitrust Compliance (continued)

While the above steps are necessary, they may not be sufficient in jurisdictions that look to "coercion" or an exclusive dealing-type analysis – for example, in the Third Circuit.

In those jurisdictions, it's difficult to come up with a simple rule that will ensure compliance. Instead, there is a fluid analysis that looks to whether bundled discounts make it difficult or essentially impossible for a competitor to compete.

Therefore, if you're doing business in those jurisdictions, you may need to conduct a fact-specific analysis of your discounting practices – which may also entail making some educated guesses about your competitors' ability to continue to compete.

Partial Exclusive Dealing: Market Share Discount Program

Under a partial exclusive dealing arrangement, a manufacturer establishes its discount program to provide an incentive for a customer to source all of its needs for a particular product from the manufacturer. The most common form of discounting for this purpose is the market share discount.

A market share discount program provides the customer with a discount in proportion to the percentage of the customer's purchases for a given product sourced exclusively from the manufacturer.

Market Share Discounts

***Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000)**

A manufacturer of marine engines, Brunswick Boat, offered boat builders discounts if they agreed to purchase a certain percentage of their engine requirements from Brunswick. A builder received a 1% discount if it purchased at least 60% of its engine requirements from Brunswick, 2% if it purchased 65%, and 3% if it purchased at least 70%.

Brunswick had a 50-75% share of the stern drive market, depending on the year. The discounts were not tied to any long-term commitment from the customer, and evidence showed that builders bought from other manufacturers when they could get better discounts. There was no evidence that the program had foreclosed a substantial share of the stern drive market. There was no evidence that the discounted prices were not above Brunswick's average variable costs; hence there was no predatory pricing.

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Market Share Discount (continued)

***Eisai, Inc. v. Sanofi Aventis U.S., LLC*, 2016 U.S. App. LEXIS 8148 (3d Cir. May 4, 2016)**

A manufacturer of anticoagulant drugs, Sanofi Aventis (Sanofi), offered discounts to a hospital based on the volume of the hospital's purchases of its requirements for low molecular weight heparin (LMWH) from Sanofi. It received a 1% discount if it bought 75% of its needs from Sanofi. As the percentage of its purchases increased, the percentage of discount increased, as a function of the percentage and volume of purchases. In 2008, discounts ranged from 9% to 30% for an individual hospital. Multi-hospital systems were eligible for deeper discounts. Sanofi had 81.5% to 92.3% of the LMWH market. Eisai had the second largest market share, at 4.3% to 8.2%.

The evidence did not show any substantial foreclosure resulting from the discount program. Nothing suggested that "an equally efficient competitor was unable to compete with Sanofi," and customers had the ability to switch to competing products. In dictum, the court rejected Sanofi's argument that the price-cost test should be applied, holding that pricing did not predominate over other means of exclusivity.

Market Share Discounts (continued)

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

Eaton Corp. had monopoly power in the market for heavy-duty truck transmissions. In its long-term agreements with OEM's, Eaton provided for discounts in relation to the percentage of the OEM's requirements that it purchased from Eaton. Freightliner, for example, received a rebate if it purchased 92% or more of its requirements from Eaton. A competing manufacturer, ZF Meritor, sued Eaton for monopolization.

The court rejected application of the price-cost test, because there was evidence that price was not the sole vehicle of exclusion. The long-term agreements had a number of anticompetitive provisions in addition to market share discounts, and they imposed a *de facto* purchase requirement of 90% for at least 5 years on each OEM. The conduct foreclosed a substantial share of the market.

Contract Drafting and Antitrust Compliance

Exclusive dealing arrangements are evaluated under the rule of reason. Unless a firm has market power, agreement with a customer that the customer will not buy from the firm's competitor poses no antitrust risk. In the absence of market power, there can be no significant foreclosure. A market share discount program, as a partial exclusive dealing arrangement, is subject to the same analysis.

Contract Drafting and Antitrust Compliance (continued)

Market share discount programs have been found unlawful when used by a firm with monopoly power to foreclose competitors from access to the market. The discount program in *Eisai* was unobjectionable because a hospital could switch to a competing product without incurring costs other than loss of the discount. In contrast, in *ZF Meritor* an OEM's failure to achieve a market penetration target gave Eaton the right to terminate the supply relationship and to require repayment of all contractual savings.

Most Favored Nation Clauses

A most favored nation clause (also called a most favored customer clause or most favored licensee clause) is a contract provision in which a seller (or licensor) agrees to give the buyer (or licensee) the best terms it makes available to any other buyer (or licensee).

Whether an MFN is pro-competitive or anti-competitive depends in part on whether the parties to the MFN have market power. An MFN could not lessen competition unless it affects the prices of products in markets in which buyers or sellers, either individually or collectively, have market power.

Again, the traditional rule of thumb is that ~65% market share is enough for market power. Below that threshold, an MFN clause becomes much less subject to attack.

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Most Favored Nation Clauses (continued)

The major pro-competitive effect of an MFN is obvious: it tends to lower cost for the buyer who employs the MFN. Most MFNs are pro-competitive.

On the other hand, MFNs can lessen price competition. For example, if a larger buyer imposes an MFN, sellers may decide not to discount pricing to other buyers to avoid the effect of the MFN. That decision can, in turn, harm smaller buyers and ultimately consumers. In other words, the concern is that through vertical agreements, a larger buyer can effectively suppress horizontal competition.

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Contract Drafting and Antitrust Compliance

Do you have market power (or are you approaching market power) in any market for goods (or services) you are buying? If the answer is no, then there is likely little reason to think that any MFN is going to be problematic.

If you have buy-side power, are you utilizing an MFN across-the-board, or only as a one-off? If only as a one-off – where there is no substantial market effect – then the MFN is also likely not to be problematic.

If you have – or are close to having – market power for at least one product or service, and you are using or contemplated MFNs for most or all of your suppliers, then you should make sure at least the following is true:

- You should consider whether the MFN will prevent a substantial number of suppliers from contracting with other (smaller) buyers who may purchase at lower prices. If it is likely to do so, then the pro-competitive benefits and anti-competitive effects of the MFN should be carefully weighed.

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Price Discrimination

<u>Price discrimination</u>: Sale by a manufacturer of a good to Dealer A at a net price that is higher than the net price for the same good sold by the manufacturer at or about the same time to Dealer B, where Dealers A and B are competing to sell the good to the same customer or customers:

- Two sales by manufacturer at or about the same time in interstate commerce
- Of goods of like grade and quality
- To competing buyers for resale
- At different prices

Section 2(a) of Robinson-Patman Act (15 U.S.C. § 13(a)).

Price Discrimination (continued)

Justifications for discrimination or defenses against a discrimination claim under Section 2(a):

- Meeting competition (Section 2(b))
- Cost justification (Section 2(a))
- Functional discounts
- Changing conditions (Section 2(a))

Price Discrimination (continued)

There can be no recovery for unlawful price discrimination unless it has injured or threatens to injure competition.

- In a secondary-line case, injury is presumed from substantial price difference over time. (*FTC v. Morton Salt Co.*, 334 U.S. 37 (1948).)
- Damages are the profits lost by the disfavored customer as a result of the discrimination. The amount of the discrimination is not the measure of damages. A plaintiff must show that, as a result of the discrimination, (a) the favored customer was able to lower its prices and thereby divert sales away from the plaintiff or (b) it had to lower its prices to an unprofitable level in order to compete against the favored customer's lower prices. *E.g., United Magazine Co. v. Murdoch Magazines Distribution, Inc.*, 393 F. Supp. 2d 199, 210 (S.D.N.Y. 2005), *aff'd*, 279 F. App'x 14 (2d Cir. 2008).

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Promotional Allowance Discrimination

Section 2(d) of the Robinson-Patman Act prohibits discrimination in the payment of promotional allowances to competing resellers of goods unless the allowances are functionally available to the resellers on proportionally equal terms. (15 U.S.C. § 13(d).)

FTC's *Fred Meyer Guides* (16 C.F.R. § § 240.1 to .15) provide useful direction on interpretation of Section 2(d).

The meeting competition defense is available to justify a claim of wrongful allowances under Section 2(d), but cost justification and changing conditions defenses are not.

Contract Drafting and Antitrust Compliance

A manufacturer can charge different prices to competing resellers, but a discount must be justifiable under one of the specific defenses – meeting competition, cost justification, changing conditions, performance of services by the reseller. For cost justification, the savings to the manufacturer must be quantifiable and equal to the discount. For a functional discount, the discount should equal the savings realized by the manufacturer from not having to perform the services itself. A discount given to meet a competitive bid should be sufficient to equal, but not beat, the bid.

Contract Drafting and Antitrust Compliance (continued)

Volume discounts are among the most problematic under the Robinson-Patman Act. They need to be functionally available to competing resellers. If they are pegged to specific dollar amounts, the discount schedule should be structured so even comparatively small dealers will be able to reach the deepest discount level.

Eligibility for a promotional allowance, which will have the effect of reducing a reseller’s costs, should be tied to percentages, not dollar volume. For example, to qualify for an allowance equal to 1% of the reseller’s annual sales, its year-to-date purchases must equal at least 110% of YTD purchases in the previous year.

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