DechertOnPoint

October 2007 / Issue 24

A legal update from Dechert's Antitrust Group

Ninth Circuit Defines Antitrust Standard for Bundling

The antitrust rules governing bundling, the sale of a group of products at a discount to customers purchasing the entire bundle, have long been unclear, particularly after the Third Circuit's decision in *LePage's v. 3M*. While bundling is a common practice, the circumstances in which it might carry a serious antitrust risk have never been clearly defined, and an adverse verdict, though rare, could result in exorbitant damages.

The Ninth Circuit's recent decision in the *PeaceHealth* case adopts a relatively straightforward standard toward bundling that is likely to be adopted by other courts: a bundled price is legal if, when the total discount is attributed only to the product that less diversified competitors are trying to sell separately, the resulting price is above the seller's average variable costs for that product. That is, a bundled discount is legal if an equally efficient competitor making only one or some of the bundled products could meet it without selling at a loss (i.e., a price below its average variable costs).

The *PeaceHealth* Decision

PeaceHealth neatly presented the bundling issue. Two firms operated hospitals in a relevant market: PeaceHealth, with three hospitals, and McKenzie, with only one. Both firms provided primary and secondary care, but only PeaceHealth provided tertiary care. Insurers therefore had to contract with PeaceHealth to obtain tertiary care for their insureds. PeaceHealth offered a discount to insurers that made it their only preferred provider for all three levels of hospital care.

The Ninth Circuit's Test for Anticompetitive Bundling

If you hypothetically applied the entire discount in your bundle to one of the products in that bundle, would the resulting hypothetical price be lower than your variable costs for that single product? For example, if you offer a $2 discount to customers who buy a bundle of four of your products, and you offer to sell one of those products separately for $2.50, would the imputed net price for the single product bought separately ($2.50 - $2.00 = $.50), be above your variable cost of making that product?

Questions to Consider When Designing a Bundled Sales Package

While not discussed in *PeaceHealth*, other questions may be relevant to a judicial decision, and consequently to legal advice, on bundling.

Q. Is the discount for the bundle roughly equal to what you save by selling your products in a bundle rather than separately?

The saved costs relevant to this calculation include all costs that can be attributed to making a bundled sale rather than separate sales of individual products. They include lower transactions costs (less time negotiating a sales agreement, preparing a shipment, etc.) and economies of scope (using available production facilities to make gadgets as well as widgets).

Q. What is your market share?

Like many other competitive practices, bundling is less likely to raise antitrust concern if practiced by a firm facing competitors with significant shares of the market.

Q. Do you have competitors who could not respond with their own bundled product?

Regardless of market shares, if your competitors are able to create their own bundle of products to compete against yours, there is less likely to be antitrust concern.

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McKenzie couldn't match PeaceHealth's bundled discount as it didn't offer all levels of care.

In reaching its decision, the Ninth Circuit reviewed the leading appellate decision on bundling, *LePage's v. 3M* (3d Cir. 2003), criticism and commentary related to that decision, alternative standards proposed by the parties in the *PeaceHealth* case, and the amicus briefs the court had, in an unusual step, requested from anyone interested. The court also considered the Supreme Court's discussion in *Brooke Group v. Brown & Williamson Tobacco Corp*. (1993). Although a Robinson-Patman case, that decision contained an authoritative analysis of why pricing above cost should not violate the antitrust laws.

The Ninth Circuit rejected the *LePage*'s standard as too strict, as it effectively condemned any bundled pricing by a monopolist who faced a competitor that couldn't offer a competing bundle. Such a standard provided insufficient guidance, said the court, and "could protect a less efficient competitor at the expense of consumer welfare." The court also rejected PeaceHealth's proposed standard—that a bundled price be considered legal if greater than the seller's marginal cost of producing all of the products in the bundle—as too lenient.

Instead, the court incorporated an above-cost *Brooke Group* analysis, focusing only on the seller's costs for those product(s) in the bundle that a less diversified competitor was trying to sell separately. In effect, the court factored into its analysis the fact that the seller was bundling its products in competition against a seller that could not offer equivalent bundles. The Ninth Circuit also held that the appropriate measure of cost is *average variable cost,* the average cost to the seller of producing one item, not counting its fixed costs. The court then remanded the case for consideration under this standard.

What the Decision Does and Does Not Change

Unlike the *LePage's* decision, *PeaceHealth* introduces a clear standard for evaluating bundling that has been advocated by several leading commentators, and should prove useful in future business planning since the facts of the case were straightforward, without wrinkles or unusual circumstances that might distinguish it from future cases.

PeaceHealth did not, however, move antitrust to a completely cost-focused analysis, as some advocates have urged. By limiting the cost analysis to only those products offered by less diversified competitors, the court in effect held that a bundled price can in some circumstances be illegal, even if the price is above the seller's average variable costs for all of the products in the bundle.

While *PeaceHealth* only has precedential effect in the Ninth Circuit, it addresses an issue that courts around the country have struggled with for some time, adopts a middle course among several vying alternatives, and incorporates the main element of the analysis advocated by the bipartisan Antitrust Modernization Commission, which has undertaken a comprehensive review of contemporary antitrust law. For these reasons, we believe other courts are likely to follow the Ninth Circuit's lead and adopt its approach.

The Future of Bundling

If other circuits accept the *PeaceHealth* holding, sellers facing competition from less diversified rivals will be able to offer bundled discounts at a reduced risk of antitrust challenge. Before *PeaceHealth*, any competitor faced with a significant loss of sales due to a bundled discount could consider an antitrust challenge without giving much attention to evidence of the seller's efficiency justification for the discount. Widespread adoption of the *PeaceHealth* standard will enable businesses to plan their pricing strategies with more confidence about where their antitrust risk truly rests.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/antitrust.

Jeffrey W. Brennan
Washington, D.C.
+1 202 261 3326
jeffrey.brennan@dechert.com

Stephen D. Brown
Philadelphia
+1 215 994 2240
stephen.brown@dechert.com

Peter R. Crockford
London
+44 20 7775 7506
peter.crockford@dechert.com

Paul T. Denis
Washington, D.C.
+1 202 261 3430
paul.denis@dechert.com

Rebecca P. Dick
Washington, D.C.
+1 202 261 3432
rebecca.dick@dechert.com

H. Joseph Escher III
San Francisco
+1 415 262 4545
h.joseph.escher@dechert.com

Michael D. Farber
Washington, D.C.
+1 202 261 3438
michael.farber@dechert.com

Carolyn H. Feeney
Philadelphia
+1 215 994 2247
carolyn.feeney@dechert.com

James A. Fishkin
Washington, D.C.
+1 202 261 3421
james.fishkin@dechert.com

Paul H. Friedman
Washington, D.C.
+1 202 261 3398
paul.friedman@dechert.com

George G. Gordon
Philadelphia
+1 215 994 2382
george.gordon@dechert.com

Robert C. Heim
Philadelphia
+1 215 994 2570
robert.heim@dechert.com

Kevin T. Kerns
Philadelphia
+1 215 994 2729
kevin.kerns@dechert.com

Edward L. Kling
London
+44 20 7184 7612
edward.kling@dechert.com

Christine C. Levin
Philadelphia
+1 215 994 2421
christine.levin@dechert.com

Pierre-Manuel Louis
Brussels
+32 2 535 5479
pierre.louis@dechert.com

Isabelle M. Rahman
Brussels
+32 2 535 5445
isabelle.rahman@dechert.com

Stephen A. Stack, Jr.
Philadelphia
+1 215 994 2660
stephen.stack@dechert.com

Joseph A. Tate
Philadelphia
+1 215 994 2350
joseph.tate@dechert.com

Chris Watson
London
+44 20 7184 7610
chris.watson@dechert.com

Dechert LLP
www.dechert.com

U.S.

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