CONDITIONAL DISCOUNTS AND THE LAW OF EXCLUSIVE DEALING

Derek W. Moore & Joshua D. Wright[*]

INTRODUCTION

The appropriate antitrust analysis of conditional discounts remains a subject of considerable debate.[1] Conditional discounting is a broad category of business practices by which a seller agrees to lower its price if the buyer agrees to certain conditions. Examples include volume discounts, by which a seller lowers its per-unit price if the buyer agrees to purchase a certain number of units from the seller, and market-share discounts, by which a seller lowers its per-unit price if the buyer agrees to buy at least a certain percentage of its requirements from the seller.

Discounting is not the only way a seller may compensate a buyer for agreeing to certain conditions. The seller may also make an up-front payment to the buyer in exchange for the buyer's agreement to purchase all or a fixed percentage of its requirements from the seller. This payment can be made in cash or in kind, such as an attractive display case that the buyer can use to display the seller's products at the point of sale. Or the seller could make payments to the buyer in exchange for the buyer's commitment to devote a certain amount of shelf space to the seller's products.

The debate surrounding how the law ought to treat conditional "discounts" stems largely from the fact that certain discounting practices resemble both conduct that the antitrust laws have analyzed under the "predation" rubric and conduct that the antitrust laws have analyzed under the

---

[*] Mr. Moore is Attorney Advisor to the Office of Policy Planning at the Federal Trade Commission; Mr. Wright is a former Commissioner of the Federal Trade Commission and Professor of Law at George Mason University School of Law. We thank Benjamin Klein, Bruce Kobayashi, Steve Salop, and Joanna Tsai for helpful comments and discussions, and Andrew Barna for valuable research assistance.

[1] *Compare* ZF Meritor, LLC v. Eaton Corp., 696 F.3d 254 (3d Cir. 2012) (majority opinion), *with id.* at 303 (Greenberg, J., dissenting), *and* Brief for Eighteen Scholars as Amici Curiae in Support of Petitioner, Eaton Corp. v. ZF Meritor, LLC, No. 12-1045 (U.S. Mar. 28, 2013), 2013 WL 1309073. *See also* Daniel A. Crane, *Bargaining Over Loyalty*, 92 TEX. L. REV. 253 (2013); Herbert Hovenkamp, *Discounts and Exclusions*, 2006 UTAH L. REV. 841; Jonathan M. Jacobson, *A Note on Loyalty Discounts*, ANTITRUST SOURCE, June 2010, at 1, 3-6; Benjamin Klein & Andres Lerner, *The Economics of Alternative Antitrust Standards for Loyalty Contracts*, ANTITRUST L.J. (forthcoming 2016) (manuscript at 1) (on file with authors); Robert H. Lande, *Should Predatory Pricing Rules Immunize Exclusionary Discounts?*, 2006 UTAH L. REV. 863, 864-65 (2006); Steven C. Salop, *Exclusionary Conduct, Effect on Consumers, and the Flawed Profit-Sacrifice Standard*, 73 ANTITRUST L.J. 311, 315-17 (2006).

"exclusion" rubric.[2] Predation occurs when a seller prices its goods below cost, with the aim to drive competitor(s) out of the market and to recoup its "investment" in predation in later time periods when it is able to charge a monopoly price in the absence of competition. Exclusion, by contrast, occurs when a seller raises its rival's costs by foreclosing competitor(s) from key channels of distribution by using contractual arrangements with distributors to prevent the rival seller(s) from achieving minimum efficient scale ("MES"). A market-share discount may resemble predation because the seller is discounting its price in the face of competition from a rival. A market-share discount may resemble exclusion because, if the discount is triggered at a high enough percentage of the buyer's requirements, then a rival seller may be foreclosed from distributing its products through that buyer and may fail to reach MES.

The critical question, then, is whether the law should analyze conditional discounts as price predation, exclusive dealing, or some hybrid combination of the two. This question is critical because the law applies different standards to predation and exclusion. A predation claim requires a plaintiff to allege and prove that the defendant has priced its goods below some measure of cost. The obvious question then becomes what role a price-cost test comparing the price paid by the supplier, net of any discounts to its incremental costs, should play in a proper analysis of conditional-discount claims. The answer to the second question is clear if one concludes that the price-predation framework is the appropriate analytical framework to assess conditional discounts. In that case, the price-cost test articulated in *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*[3] provides a safe harbor for above-cost conditional discounts.[4]

The answer is less obvious—or at least up for debate—if one concludes that the exclusive-dealing framework is a better fit for analyzing conditional discounts. In this case, some argue that a price-cost test should still play a role—and an important role at that. Some prominent antitrust scholars (and courts) have endorsed the view that above-cost conditional discounts cannot constitute exclusionary conduct within an exclusive-dealing framework because they are not capable of excluding equally efficient rivals.[5] This view implies that a price-cost test can be used to establish a safe harbor for conditional discounts that are above cost. Others concluding that the exclusive-dealing framework is a superior fit for analyzing con-

---

2 Steven C. Salop, Professor, Georgetown University Law Center, Presentation at the DOJ/FTC Workshop on Conditional Pricing Practices (June 23, 2014); *see also* Sean P. Gates, *Antitrust by Analogy: Developing Rules for Loyalty Rebates and Bundled Discounts*, 79 ANTITRUST L.J. 99, 101 (2013).

3 509 U.S. 209 (1993).

4 *Id.* at 223. For an explanation of the various ways to measure discounts, see Bruce H. Kobayashi, *The Law and Economics of Predatory Pricing*, in ANTITRUST LAW AND ECONOMICS 116, 145-46 (Keith N. Hylton ed., 2009).

5 Brief for Eighteen Scholars as Amici Curiae in Support of Petitioner, *supra* note 1, at 14; Crane, *supra* note 1, at 300; Klein & Lerner, *supra* note 1.

ditional discounts, including the authors, have argued that a price-cost test should play no role in that analysis and point to the much closer analytical fit between the raising rivals' costs ("RRC") theories of harm in conditional discount cases and the law analyzing exclusive dealing and related practices.[6]

The Third Circuit's recent decision in *ZF Meritor, LLC v. Eaton Corp.*[7] highlights the tension between following the exclusive-dealing approach and the predation approach.[8] In *ZF Meritor*, an upstart competitor in the market for heavy-duty-truck transmissions sued that market's leading supplier, challenging that the leading firm's market-share discounts violated the antitrust laws.[9] Specifically, the upstart challenged the incumbent's "long-term agreements" with truck manufacturers, which discounted the price of transmissions if the truck manufacturers purchased 70-90 percent of their transmission requirements from the incumbent.[10] The Third Circuit decided not to apply a price-cost screen to analyze competitive effects, reasoning that such a screen is appropriate only "when price is the clearly predominant mechanism of exclusion."[11] In dissent, Judge Morton Greenberg supported using a price-cost screen because above-cost pricing is "generally [] not anticompetitive" and courts must "tread lightly" when reviewing claims that discounted prices harm competition.[12]

The debate between predation and exclusion does not occur in a vacuum. Antitrust analysis of all vertical agreements has evolved considerably since the Supreme Court's watershed decision in *Continental T.V., Inc. v.*

---

6 Joshua D. Wright, Comm'r, Fed. Trade Comm'n, Remarks at the Bates White 10th Annual Antitrust Conference: Simple but Wrong or Complex but More Accurate? The Case for an Exclusive Dealing-Based Approach to Evaluating Loyalty Discounts (June 3, 2013), http://www.ftc.gov/speeches/wright/130603bateswhite.pdf; *see also* Salop, *supra* note 1.

7 696 F.3d 254 (3d Cir. 2012).

8 Some courts have analyzed loyalty discounting using both exclusive-dealing precedent and a price-cost test. *See* NicSand, Inc. v. 3M Co., 507 F.3d 442, 447-48, 455 (6th Cir. 2007); Concord Boat Corp. v. Brunswick Corp., 207 F.3d 1039, 1062-63 (8th Cir. 2000) (using the rule of reason to evaluate claim under Section 1 of the Sherman Act and *Brooke Group* test to evaluate claim under Section 2 of the Sherman Act); Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227 (1st Cir. 1983). Other courts have analyzed loyalty-discounting programs under the rule of reason only. *See, e.g.*, Conwood Co., L.P. v. U.S. Tobacco Co., 290 F.3d 768, 795 (6th Cir. 2002); R.J. Reynolds Tobacco Co. v. Philip Morris Inc., 199 F. Supp. 2d 362 (M.D.N.C. 2002), *aff'd per curiam*, 67 F. App'x 810 (4th Cir. 2003). Still, other courts have analyzed loyalty discounts using a price-cost test. *See, e.g.*, Virgin Atl. Airways Ltd. v. British Airways PLC, 257 F.3d 256, 266 (2d Cir. 2001) (using *Brooke Group* test where plaintiff had alleged below-cost pricing). Finally, courts have also applied a version of a price-cost test in the context of a challenge to a *bundled* discounting program. *See*, *e.g.*, Cascade Health Solutions v. PeaceHealth, 515 F.3d 883, 909 (9th Cir. 2008).

9 *ZF Meritor*, 696 F.3d at 267-68.

10 *Id.* at 265.

11 *Id.* at 275.

12 *Id.* at 320.

GTE Sylvania Inc.[13] in 1977. During that time, antitrust analysis of vertical arrangements has undergone two major changes. The first is greater focus upon the competitive effects of the challenged business practice rather than upon various noneconomic considerations, such as how the practice affects small businesses. In focusing upon economic effects, the Court's task has become to discern the underlying economic logic of the restraint at issue. The second change, somewhat related to the first, is a reduced focus upon formal distinctions that distract from the relevant economic-welfare analysis, especially distinctions between price and nonprice conduct.[14]

This Article argues that exclusive dealing provides a superior framework for analyzing conditional discounts and should be used to determine the legality of any conditional-discount claim in which the plaintiff alleges that the underlying conduct is exclusionary because it forecloses rivals from access to a critical input and thus deprives a rival of the opportunity to compete for MES.[15] In other words, all claims challenging conditional discounts and proffering a theory of harm within the RRC framework are best analyzed within the legal framework applied to assess the legality of exclusive-dealing arrangements.

The basis for this claim is relatively simple. There are two economic paradigms to analyze anticompetitive conduct that is not the product of collusion among competitors: predation and exclusion. Each represents a distinct—though related—mechanism by which a firm might acquire or maintain market power and harm consumers by harming rivals. The theoretical mechanisms of competitive harm in each paradigm are distinct. The conditions required for these theories to apply also differ—thus, it is not surprising that their empirical relevance in the real world differs. The efficiencies associated with each form of conduct are also distinct. Thus, the legal framework designed to identify anticompetitive instances of each must differ. But which economic paradigm should apply to the legal standard applicable to conditional discounts?

Most modern cases involving conditional discounts are based upon theories of economic harm grounded in the RRC framework. In this situation, a plaintiff alleges that the conditional discount is anticompetitive because it deprives a rival from the opportunity to compete for distribution (or customers) sufficient to achieve MES, thus raising the rival's costs relative to the costs faced by the defendant, and results in the acquisition or mainte-

---

13 433 U.S. 36 (1977).

14 *See infra* Parts III.A, C.

15 *See generally*, Thomas G. Krattenmaker & Stephen C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 YALE L.J. 209, 234-38 (1986); Salop, *supra* note 1; Steven C. Salop & David T. Scheffman, *Raising Rivals' Costs*, 73 AM. ECON. REV. 267 (1983). For a review on the treatment of these claims, see Alden F. Abbott & Joshua D. Wright, *Antitrust Analysis of Tying Arrangements and Exclusive Dealing*, *in* ANTITRUST LAW AND ECONOMICS 183 (Keith N. Hylton ed., 2010).

nance of market power that the defendant would not have possessed without the practice.[16] Because the relevant economics for understanding these claims involves the economics of exclusion, the legal framework best suited to analyze conditional discounts is the one most closely aligned to the economics of exclusion. The relevant economics includes not only the theoretical literature describing the conditions under which it may be profitable for a firm with market power to use conditional discounts to raise rivals' costs, but also the empirical literature testing those models with real-world data.[17] Incorporating the appropriate empirical evidence is of paramount importance given the focus in modern antitrust upon assessing competitive effects.

As this Article will demonstrate, price-cost tests applied to predatory pricing are not a good match for the economics of exclusion.[18] A price below cost is neither necessary nor sufficient for exclusion. A firm with market power can raise rivals' costs without pricing its goods below cost. Nor does the fact that a firm is pricing below cost mean that the firm is foreclosing rivals from key channels of distribution. The approach taken in exclusive-dealing cases—focusing on whether the exclusivity provisions allow the defendant to acquire or maintain market power by assessing foreclosure, duration of the contract, entry conditions, and competitive effects—is much more closely aligned with the economics of conditional discounts. Some have argued that price-cost tests should be imported into the conventional exclusive-dealing analysis.[19] This Article demonstrates that this view is also incorrect for the same basic reason: a price below cost is neither a necessary nor sufficient condition for a conditional discount within the RRC framework.

The authors do not believe that conditional discounts are often anticompetitive. Thus, a bright-line test such as that offered by *Brooke Group* or even per se legality might have some benefits from an error-cost perspective. Plaintiffs rarely prevail under *Brooke Group*'s aggregate-discount price-cost test.[20] Thus, false positives would be relatively rare if *Brooke Group* applies to claims challenging conditional discounts sounding in exclusion as well as predation. On the other hand, it is not clear, and perhaps unlikely, that the price-cost test applied to conditional discounts would be

---

16 Understandably, a plaintiff might, and is entitled to, allege that a conditional discount violates the antitrust laws because it results in predation rather than exclusion. Nevertheless, in recent years, most allegations of anticompetitive harm arising from conditional discounts appear to involve exclusion rather than predation. This Article focuses upon the question of whether the case law traditionally associated with exclusive-dealing cases or the case law associated with predatory pricing is better suited to evaluating exclusion claims involving conditional discounts.

17 James C. Cooper, et al., *Vertical Antitrust Policy as a Problem of Inference*, 23 INT'L J. INDUS. ORG. 639, 659 (2005).

18 *See supra* Part IV.

19 Hovenkamp, *supra* note 1, at 854.

20 Kobayashi, *supra* note 4.

the aggregate discount rule articulated in *Brooke Group*. Rather, scholars, commentators, and courts appear to have embraced a price-cost test based upon discount attribution, by which the whole of the defendant's discount is attributed only to a subset of goods sold, making it far more likely that a discount would be deemed to be below cost. Accordingly, embracing a discount-attribution test for challenges to conditional discounting would allow for a greater number of successful claims and would be more difficult to administer than the traditional *Brooke Group* test. For these reasons, the consumer-welfare benefits from a bright-line rule are likely to be lower under a discount-attribution rule.

This Article argues that rigorous application of the exclusive-dealing framework is superior to any available price-cost test. This is primarily because the exclusive-dealing framework is much more likely accurately to distinguish procompetitive from anticompetitive conditional discounts. Further, importing a price-cost test to analyze claims sounding in exclusion rather than predation inserts intellectual distance between antitrust economics and the correct legal standard—rather than more closely aligning industrial-organization economics and antitrust law, as has been the overwhelming and beneficial trend over the past fifty years. Indeed, applying a price-cost test to any conduct that can be characterized as a "discount" is an example of a formalistic distinction without a difference that has been largely eradicated in antitrust law in recent decades.

Before turning to the appropriate legal standard, this Article begins by elucidating the relevant economics of conditional discounts and establishing that the economics of exclusion rather than of predation offers the relevant paradigm for assessing antitrust claims involving conditional discounts. It then demonstrates that prices below cost—whether the discount is applied to all units or a subset of units deemed to be contestable—are neither necessary nor sufficient to establish competitive harm within the RRC framework.

I. THE ECONOMICS OF CONDITIONAL DISCOUNTS

This Article begins by briefly reviewing the economics of exclusion, focusing upon the relevant anticompetitive theories of harm involving conditional discounts rather than their potential competitive virtues. In the case of conditional discounts as price predation, the competitive benefits of lower prices for consumers are well understood and intuitively obvious.[21] To the extent conditional discounts exhibit the economic characteristics of exclusive-dealing contracts or partial exclusive-dealing contracts, there is a substantial literature discussing the various ways in which such contracts

---

21 Salop, *supra* note 1, at 337.

can align incentives between vertically related firms,[22] prevent different forms of free-riding,[23] and the empirical evidence that exclusive contracts frequently enhance economic welfare.[24]

A. *Two Paradigms of Exclusionary Conduct: Raising Rivals' Costs and Price Predation*

There are two paradigms of exclusionary conduct potentially applicable to conditional discounts: exclusion and predation.[25] The economic forces at work in each paradigm, and thus the conditions that must be satisfied in order for each anticompetitive strategy to be profitable in equilibrium, are distinct.

Price predation is one economic mechanism that can be used to exclude rivals and to potentially create market power, and can occur when a monopolist prices below marginal cost. While there are many variations on the basic theme, the core of the price-predation mechanism of exclusion is that it can result in the monopolist maintaining or acquiring market power if and only if it forces rivals or potential entrants to sacrifice profits in order to compete with the dominant firm, and ultimately to exit the market, thus removing a competitive constraint imposed by the rival firm.

The second, and distinct, economic mechanism a monopolist or dominant firm can use to maintain or acquire market power is exclusion. To be clear, when this Article refers to exclusion, it refers to the myriad of methods that a dominant firm might use to raise its rivals' costs. While there are some important similarities, the RRC mechanism creates market power differently than the price-predation mechanism. In short, the essence of the RRC mechanism is that the monopolist engages in conduct that forecloses the rival or potential entrant's ability to compete for access to a critical input (usually distribution), thus forcing the rival to operate at higher marginal costs, reducing the competitive constraint imposed by the rival, and allowing the monopolist to gain power over price.

---

22 Benjamin Klein, *Exclusive Dealing as Competition for Distribution "On The Merits,"* 12 GEO. MASON L. REV. 119, 155-56 (2003); Benjamin Klein & Kevin M. Murphy, *Exclusive Dealing Intensifies Competition for Distribution*, 75 ANTITRUST L.J. 433, 434-36 (2008); Benjamin Klein & Andres V. Lerner, *The Expanded Economics of Free-Riding: How Exclusive Dealing Prevents Free-Riding and Creates Undivided Loyalty*, 74 ANTITRUST L.J. 473, 476 (2007).

23 Howard P. Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1, 5 (1982); Klein & Lerner, *supra* note 22.

24 Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, *in* HANDBOOK OF ANTITRUST ECONOMICS (Paolo Buccirossi, ed., 2008); Cooper, *supra* note 17.

25 Joshua D. Wright, *Moving Beyond Naïve Foreclosure Analysis*, 19 GEO. MASON L. REV. 1163 (2012); Salop, *supra* note 2.

Next, this Article elaborates upon each economic mechanism of harm and also highlights some of the key similarities and differences between them to provide the analytical basis for our central claims: (1) that conditional-discount claims usually implicate RRC concerns; and (2) exclusive-dealing law provides a superior and more accurate legal framework for identifying conditional discounts that are likely to generate competitive concerns under the RRC rubric.

1. The Economics of Price Predation

There are several broadly employed definitions of price predation. Professor Bruce Kobayashi defines predatory pricing as "a specific form of exclusionary pricing conduct in which the predatory firm sacrifices short term profits in order to achieve long term gains."[26] Dr. David Scheffman provides the broadest available definition of predation: "any action taken by a firm with market power which causes a rival to exit and in doing so reduces social welfare."[27]

The economics literature on price predation is broad and general, in large part because of the myriad of pricing schemes that can result in prices below cost. Price-predation strategies can vary both by the type of price (e.g., linear or nonlinear pricing) as well as the number of markets at issue (e.g., single market versus discounts across multiple product markets). The most comprehensive treatment of the economics of price predation describes in detail the vast game theory literature that arose in response to early Chicago School writings by then-Professors Robert Bork,[28] Frank Easterbrook,[29] and Professor John McGee,[30] and in particular, those that expressed skepticism concerning the likelihood of price predation. The proliferation of price-predation models arose to provide a logically consistent and analytically coherent account of the specific conditions that must hold in order for the price-predation mechanism to succeed—that is, for price predation to result in the exit of the rival and the creation of market power.

Following Professor Kobayashi, it is useful to categorize price-predation models into three broad categories: asymmetric financial-

---

26 Kobayashi, *supra* note 4, at 116.

27 David T. Scheffman, *Comments on An Economic Definition of Predatory Product Innovation*, *in* STRATEGY, PREDATION AND ANTITRUST ANALYSIS 397, 400 (Steven C. Salop ed., 1981).

28 ROBERT BORK, THE ANTITRUST PARADOX (1978).

29 Frank H. Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. CHI. L. REV. 263 (1981).

30 John S. McGee, *Predatory Price Cutting: The Standard Oil (N.J.) Case*, 1 J.L. & ECON. 137 (1958) [hereinafter McGee, *Price Cutting*]; John S. McGee, *Ocean Freight Rate Conferences and the American Merchant Marine*, 27 U. CHI. L. REV. 191 (1960); John S. McGee, *Government Intervention in the Spanish Sugar Industry*, 7 J.L. & ECON. 121 (1964); John S. McGee, *Predatory Pricing Revisited*, 23 J.L. & ECON. 289 (1980).

constraint models, reputation-based models, and signaling models.[31] This Article briefly describes each of these price-predation mechanisms here, referring the reader to the literature for details.

Asymmetric financial-constraint models invoke the "deep pocket" mechanism of predation. The basic notion, familiar to most antitrust students, is that the monopolist outlasts the potential entrant because it has greater resources.[32] These models typically assume the rival or potential entrant is financially constrained. Many scholars have pointed out the analytical difficulties of maintaining price predation in equilibrium against an equally efficient rival.[33]

A second class of price-predation strategies rely upon reputation-based mechanisms to allow the monopolist to credibly commit to low prices in a manner sufficient to induce exit and allow the monopolist to gain market power.[34] The monopolist, through repeat interaction in the same market over time or in multiple product markets simultaneously or over time, develops a reputation for predation. This reputation increases rivals' or potential entrants' beliefs about the probability of facing predation upon entry.

A third set of price-predation models involves the dominant firm setting a low price that signals valuable information to rivals and potential entrants—generally that the incumbent has low costs. Because the potential entrant is uncertain about market conditions, the low price serves as a negative signal and the potential entrant believes that it is more profitable to exit than to enter.[35]

For now, this Article ignores the vast literature focusing upon the optimal legal rule for price predation,[36] as well as the various empirical studies on the incidence of successful predation.[37] However, it agrees with the general consensus that "strategic theory has shown that predation can be ra-

---

31 Kobayashi, *supra* note 4, at 119; *see also* Janusz A. Ordover & Garth Saloner, *Predation, Monopolization and Antitrust*, *in* 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 538, 546 (Richard Schmalensee & Robert D. Willig eds., 1998).

32 Easterbrook, *supra* note 29, at 265.

33 Easterbrook, *supra* note 29; McGee, *Price Cutting*, *supra* note 30; Kobayashi, *supra* note 4; George J. Stigler, *Imperfections in the Capital Market*, 75 J. POL. ECON. 287 (1967).

34 Paul Milgrom & John Roberts, *Predation, Reputation, and Entry Deterrence*, 27 J. ECON. THEORY 280, 281 (1982) is the most well-known of these models. For discussion, see Kobayashi, *supra* note 4, at 121-22.

35 There are also models of predation that do not rely upon asymmetric information. *See* Kobayashi, *supra* note 4, at 124.

36 *See* Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975); Bruce H. Kobayashi, *Does Economics Provide a Reliable Guide to Regulating Commodity Bundling Firms? A Survey of the Economic Literature*, 1 J. COMPETITION L. & ECON. 707 (2005); Janusz A. Ordover & Robert D. Willig, *An Economic Definition to Predation: Pricing and Product Innovation*, 91 YALE L.J. 8 (1981); Oliver E. Williamson, *Predatory Pricing: A Strategic and Welfare Analysis*, 87 YALE L.J. 284 (1978).

37 *See* Kobayashi, *supra* note 36.

tional, and empirical studies have presented evidence consistent with successful predation."[38]

This Article's focus is to highlight the key economic characteristics of price predation as a form of potentially exclusionary conduct. A successful, anticompetitive price-predation strategy must satisfy a number of key conditions: (1) a monopolist or dominant firm must offer its product for sale at a discounted price; (2) that results in short-term profit sacrifice for the monopolist; (3) induces rivals to exit; and (4) relaxes the competitive constraints imposed upon the monopolist, granting it power over price. As this Article will show, these conditions characterize an economic theory of antitrust harm that is qualitatively different than the RRC mechanism, introduced below.

2. The Economics of Anticompetitive Exclusion

There are two distinct economic mechanisms characterizing conduct that constitutes unlawful "exclusionary conduct": predation, discussed above, and exclusion. The "exclusion" mechanism generally refers to the set of strategies that a monopolist or dominant firm can employ to potentially deprive a rival from competing for MES, thus raising its costs and reducing the competitive constraint imposed by the rival upon the monopolist.[39] Ultimately, this results in the monopolist acquiring market power and reducing consumer welfare.[40]

As is the case with the price-predation literature, there are myriad economic models describing competitive concerns with conditional discounts in various settings.[41] In nearly all of these models, RRC is the mechanism of potential exclusion that arises from competition with conditional discounts. While this Article acknowledges the handful of exceptions considering the use of conditional discounts to harm competition without RRC, courts and agencies have generally ignored these accounts of conditional discounts, and there is no empirical evidence supporting their policy relevance.

A brief sketch of modern RRC theories involving allegedly exclusionary agreements illuminates the difference between older foreclosure arguments and the RRC paradigm.[42] The most common scenario of relevance to

---

38 Kobayashi, *supra* note 4, at 150.

39 Salop, *supra* note 1, at 311.

40 Klein, *supra* note 22; Krattenmaker & Salop, *supra* note 15, at 223-24.

41 For details, one may consult the many works surveying this literature. *See, e.g.*, HANDBOOK OF ANTITRUST ECONOMICS (Paolo Buccirossi, ed., 2008); Patrick Rey & Jean Tirole, *A Primer on Foreclosure*, *in* 3 HANDBOOK OF INDUSTRIAL ORGANIZATION (Mark Armstrong & Rob Porter, eds., 2007); Abbott & Wright, *supra* note 15.

42 Wright, *supra* note 25, at 1168-70 & nn.28-36. For an excellent summary of the theoretical literature on vertical restraints and integration, see Daniel P. O'Brien, *The Antitrust Treatment of Verti-*

antitrust involving exclusionary contracts concerns an upstream supplier, S, entering into an exclusive-dealing contract with retailers, R, who in turn sell the product to final consumers. The potentially anticompetitive motivation associated with these contracts is related to the limitation they place upon R's ability to sell rival products to final consumers. The possibility of anticompetitive exclusion deriving from these types of contracts generally emerges only if S is able to foreclose rival suppliers from a large-enough fraction of the market to deprive S's rivals of the opportunity to achieve MES.

The well-known critique of this line of reasoning comes from the Chicago School argument that R will not have the incentive to agree to contracts that facilitate monopolization upstream because they will then suffer the consequences of facing that monopolist in their chain of distribution.[43] As a general matter, one can think of this criticism as drawing the analogy to a conspiracy among retailers, R, organized by the monopolist, S, to exclude S's rivals from access to distribution. Like any other conspiracy, it is generally the case that each retailer has the incentive to deviate and remain outside the agreement by contracting with S's rivals and expanding its own output at the expense of rival retailers. In other words, retailers have the incentive to avoid entering agreements that will ultimately harm them, and S will generally not be able to compensate retailers enough to alter this incentive and persuade them to enter into the anticompetitive exclusive contract. The critique goes on to argue that observed exclusionary distribution contracts must be motivated by efficiencies rather than by anticompetitive effects.[44]

The economics literature has grown in recent years to include a series of theoretical models contemplating scenarios in which S can sufficiently compensate R to join and remain within the conspiracy—therefore accomplishing an anticompetitive purpose.[45] These anticompetitive theories of exclusive dealing generally assume that S supplies a product that is essential to R's viability and that there are substantial economies of scale in manufacturing.

One such theory considers the case where the monopolist, S, adopts exclusive contracts, rather than merely collecting its monopoly profit from the sale of the essential product, and relies upon the existence of dynamic economies of scale, such as network effects. Under this dynamic theory of exclusion, S's exclusive contracts prevent S's rivals, or potential entrants that might develop into future rivals, from competing—in order to protect future market power. Because S's rivals must operate at a cost disadvantage

---

cal Restraints: Beyond the Possibility Theorems, *in* THE PROS AND CONS OF VERTICAL RESTRAINTS 40 (2008).

43 Abbott & Wright, *supra* note 15, at 23.

44 BORK, *supra* note 28.

45 Abbott & Wright, *supra* note 15, at 24.

that drives them out and prevents entry, S is able to increase the duration and scope of its market power.

A second set of models explores the possibility that coordination problems between buyers prevent the foiling of S's anticompetitive use of exclusive-dealing contracts. There is a substantial industrial-organization literature analyzing the conditions under which these types of coordination problems between buyers generate the possibility of anticompetitive exclusion. The central logic of these models is that the potential entrant (or current rival) must attract a sufficient mass of retailers to cover its fixed costs of entry, but S's exclusive contracts with retailers prevent the potential entrant from doing so.[46] Significant economies of scale in distribution militate against exclusion because, in that case, a potential entrant may need to attract only a single buyer in order to achieve MES. Similar logic suggests that a small number of buyers will be able to coordinate in order to support the excluded rival. Further, the exclusionary equilibrium in this model appears relatively fragile because an alternative equilibrium in which buyers reject exclusivity also exists. The most recent strand of this literature examines the relationship between downstream competition and exclusion.[47]

Many economic models rely upon RRC or a similar mechanism to illustrate the potential for profitable exclusion. A handful of conditions are common to most if not all of these RRC-based models: (1) vertical contracts are generally assumed not to generate efficiencies; (2) economies of scale or scope are required; and (3) a rival must be substantially foreclosed from a critical input in order to achieve exclusion.[48]

There appears to be substantial agreement that "the potential anticompetitive effects of a loyalty discount contract are the same as an exclusive dealing contract, namely the foreclosure of competition by contractually restricting the ability of rivals to compete for sales."[49] There have been three types of responses to this generally accepted economic insight into the appropriate legal standard to evaluate loyalty discounts. The first type adopts the position that, while loyalty discounts involve exclusion rather than predation, a price below marginal cost is a necessary condition of both anticompetitive mechanisms, and thus a safe harbor for prices above cost is appropriate no matter the allegedly harmful conduct.[50] The second is a variant of the first, arguing that a price-cost test is an appropriate threshold test required to establish whether a loyalty discount amounts to de facto exclusive dealing, and thus should be evaluated under exclusive-dealing law.[51]

---

46 *Id.* at 25.

47 *Id.*

48 *Id.* at 2.

49 Klein & Lerner, *supra* note 1, at 33; *see also* Gates, *supra* note 2, at 104; Jacobson, *supra* note 1; Salop, *supra* note 1.

50 Daniel A. Crane, *The Paradox of Predatory Pricing*, 91 CORNELL L. REV. 1, 59 (2005).

51 Klein & Lerner, *supra* note 1.

Under this second approach, a loyalty discount that is below cost—applying a discount-attribution test evaluating net prices when the discount is attributed only to those sales determined "contestable"—would next be analyzed under exclusive-dealing law. The third approach, endorsed here, is to apply exclusive-dealing-type legal analysis to any claim in which the plaintiff alleges that a loyalty discount excludes or forecloses a rival.[52]

B. *Net Prices Below Marginal Cost Are Not Necessary for Exclusion*

A key economic question informing the appropriate legal standard for exclusion is whether a price net of conditional discounts that is below marginal cost is *necessary* for exclusion. An affirmative answer implies that a price-cost test may usefully identify not only plausible predation claims but also plausible exclusion claims. In other words, a net price above cost would imply that neither predation nor anticompetitive exclusion was possible. Unfortunately, as the discussion of the relevant predation and exclusion literatures illustrates, the exclusion mechanism is not always dependent upon price below cost.

It is important to recognize that, from an economic perspective, the RRC literature rejects the notion that a price net of discount that is less than cost—that is, a discounted price that generates profit sacrifice—is neither necessary nor sufficient to establish competitive harm in RRC models. The RRC literature is rife with examples of small and above-cost discounts, conditioned upon exclusivity or partial exclusivity, generating anticompetitive exclusion.[53] Similarly, large discounts involving net prices below marginal cost are not sufficient to generate anticompetitive exclusion in many economic models.

A simple example illustrates the point that a price below cost is not necessary for anticompetitive exclusion using conditional discounts. Consider the case of a monopolist and its rival (or a potential entrant) bidding for exclusive contracts—that is, competing for distribution—by offering conditional discounts to a retailer. Professor Steven Salop and others have argued that competition for exclusive arrangements—including using conditional discounts—may not generate competitive outcomes in some circumstances because the monopolist is competing to maintain the monopoly rate of return against a rival or potential entrant who will earn the competitive rate of return if it prevails.[54] Thus, if the potential entrant is deterred

---

52 *See* Abbott & Wright, *supra* note 15, at 6-7.

53 *See, e.g.*, John Simpson & Abraham L. Wickelgren, *Naked Exclusion, Efficient Breach, and Downstream Competition*, 97 AM. ECON. REV. 1305, 1306-07 (2007); John Simpson & Abraham L. Wickelgren, Exclusive Dealing and Entry, When Buyers Compete: Comment 1-3 (June 2005) (unpublished manuscript) (on file with George Mason Law Review).

54 Salop, *supra* note 1, at 357 n.180.

from competing or competing vigorously in such a bidding war, it is possible that a conditional discount might generate anticompetitive exclusion by raising rivals' costs and allowing the monopolist to acquire power over price without a net price below costs.[55]

This issue raises the more general but important economic question about identifying loyalty-discount programs that might pass a discount-attribution test but yet anticompetitively exclude rivals. Professor Benjamin Klein argues that the discount-attribution test is superior by analogizing the risk of an anticompetitive loyalty discount to that of anticompetitive, noncontingent predatory pricing. That is, despite the fact that it is well understood in the noncontingent-predation setting that, in some circumstances, prices above marginal cost might result in anticompetitive exclusion of *less efficient competitors*, Professor Klein and Dr. Andres Lerner correctly observe that "there are serious difficulties, however, in using antitrust law to require a firm that is pricing above its cost to increase its prices in order to protect high cost firms to encourage entry."[56] Thus, for Klein and Lerner, a safe harbor for discounts that pass the discount-attribution test is appropriate—despite some risk of competitive harm—for the same reasons as a safe harbor for noncontingent prices above cost.

There are many problems in extending the noncontingent-pricing analogy to the case of loyalty discounts—most importantly, the fundamental economic forces at work and their competitive implications are quite different. In the latter case, the allegation is that the defendant is using the discount to restrict its rival's access to a critical input. In that case, the competitive inferences that can be drawn from observing below-cost prices on "contestable sales" in the context of an allegation that the discount is conditioned upon restricting a rival's access to a critical input for distribution are not the same for several reasons.

The first is that the RRC literature demonstrates that a conditional discount can exclude an *equally* efficient firm, not simply less efficient ones, for the reasons described above. Second, this approach ignores the economic importance of the condition itself. Consider the following example. Suppose a firm engages in unitary, noncontingent above-cost pricing. Suppose further that a plaintiff specifically alleges that the pricing scheme is "exclusionary." Without a requirement that prices be below cost, is there a real threat that a court will require the firm to increase prices that are already above cost? This Article contends that this threat is nonexistent because a plaintiff in such a case must tell a plausible exclusion story.[57] A unitary, noncontingent price has no direct impact on distribution, shelf space, or any other potentially critical input. A true predation case that ought to fail—one

---

55 This Article reserves its discussion of practical issues with identifying below-cost prices in the context of conditional discounts, and in particular, what volume of sales to attribute the discount over.

56 Klein & Lerner, *supra* note 1, at 43.

57 Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 556 (2007).

involving unitary, noncontingent prices above cost—cannot succeed if mislabeled as an exclusion case because the other necessary components to a meritorious exclusion story simply will not be there. The traditional economic objection to looking for, and potentially condemning, "true" predation cases notwithstanding that prices are above cost is that there are no tools to separate "good" unitary, noncontingent above-cost discounts from "bad" unitary, noncontingent above-cost discounts. When the discounts are contingent on market share or shelf-space requirements, however, these tools are available.

The third is that the discount-attribution approach, while purporting to avoid using the antitrust laws as a planning mechanism used to protect particular chosen rivals until they become equally efficient, places far-greater reliance upon courts and agencies to determine precisely what sales are contestable for the purposes of a discount-attribution analysis.[58] There is a substantial risk that sales that are deemed "incontestable" to rivals by courts and agencies—that is, sales for which rivals apparently do not have the ability to compete—simply because the defendant has been successful in procuring them by way of "competition on the merits" and the normal competitive process. The contestability approach invites courts and judges to undo the outcomes of the normal competitive process by deeming the spoils granted to its victors in the form of sales to be "incontestable."

II. CONDITIONAL DISCOUNTS AND THE LAW

This Article now turns to analyzing case law in which a plaintiff has challenged a conditional-pricing program as unlawful under the antitrust laws. It first discusses generally the law of predatory pricing and the law of exclusive dealing, as these two distinct legal regimes supply the candidate frameworks for analyzing conditional-pricing claims. Next, it reviews the case law to assess how courts have analyzed claims challenging loyalty discounts in the past. Finally, it discusses the authors' view of the optimal legal approach.

Though it may seem like the obvious approach, this Article argues that the legal rule to be applied should depend upon the theory of harm put forward by the plaintiff. That is, if the plaintiff alleges that the defendant's discounting program is predatory, then the plaintiff has invoked the economic theory of predation and the legal rules associated with predatory conduct should govern the claim. However, if the plaintiff alleges that the defendant's discounting program is exclusionary, in that it forecloses rivals' access to distribution and raises their costs, then the plaintiff has invoked the economic theory of exclusion, and the legal rules associated with exclusionary conduct should govern the claim.

---

58 Klein & Lerner, *supra* note 1, at 43.

This approach has the advantage of directing courts to focus upon the alleged economic theory of harm and not upon whether the challenged conduct involves "discounting," "price," or other factors that are unhelpful in determining whether the conduct is exclusionary or predatory and harms competition. Of course, most antitrust challenges to a monopolist's loyalty discounting are likely to invoke the economic theory of exclusion rather than of predation. Nevertheless, courts and enforcement agencies are likely to minimize errors—both false positives and false negatives—if there is a tight fit between the economic theory of harm and the legal rule applied.

A. *Exclusion and Predation: Two Different Legal Standards*

The recent split decision by the Third Circuit in *ZF Meritor* reflects the longstanding debate regarding whether an antitrust challenge to loyalty discounts ought to be governed by the law of predation—implicating some version of a price-cost test—or the law of exclusion and, thus, the rule of reason.[59] The relevant aspects of the case involve claims by ZF Meritor against Eaton Corporation related to practices in the market for heavy-duty-truck transmissions in North America. According to the court, Eaton had been the only supplier of heavy-duty-truck transmissions from the 1950s until 1989, when Meritor entered the market.[60] In 1999, Meritor held about a 17 percent market share and had plans to expand through a joint venture with a large German company, ZF Freidrichshafen, that had not yet entered the North American market.[61] The plan was for the joint venture to adapt and introduce ZF's twelve-speed, two-pedal transmission to North America and differentiate itself from Eaton, which did not have a two-pedal transmission at the time.[62]

ZF Meritor claimed that competitive efforts were undermined by Eaton's exclusive-contracting practices.[63] Eaton entered into what the court termed "long-term agreements" with each of the four direct purchasers of heavy-duty-truck transmissions that conditioned rebates from Eaton on whether the buyers purchased a specified percentage of their requirements from Eaton.[64] The four agreements varied in their terms, but several included up-front payments from Eaton and set the market-share requirement from 70 percent to above 90 percent.[65] Between 1999 and 2005, ZF Meritor's market share dropped from 19 percent to 4 percent. Also during this

---

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

60 *Id.* at 264.

61 *Id.* at 265.

62 *Id.*

63 *Id.* at 264-65.

64 *Id.* at 265-66.

65 ZF Meritor, LLC v. Eaton Corp., 696 F.3d 254, 265-66 (3d Cir. 2012).

period, however, a severe downturn in the heavy-duty-truck market caused demand to plummet by as much as 50 percent.[66] Nevertheless, the joint venture fell apart, and—believing that a market share above 10 percent was necessary for long-term viability—ZF Meritor exited the market in 2007.[67]

As in most cases involving allegations of anticompetitive conduct by a firm with monopoly power, at first glance, the effect of the conduct is no more consistent with competition on the merits than it is with exclusionary and anticompetitive consequences. One view of the case is that Eaton responded to increased competitive pressure by ZF Meritor and developed a successful discounting program to attract original equipment manufacturers ("OEMs"), resulting in ZF Meritor's reduced competitive significance and ultimate exit from the market. Another view is that Eaton contractually induced OEMs to deal with it exclusively—or almost exclusively—with the purpose and effect of preventing ZF Meritor from maintaining MES, leading to ZF Meritor's exit from the business and allowing Eaton to earn monopoly rents and harm consumers.[68]

Eaton argued that ZF Meritor's claim was about discounted pricing, therefore requiring allegations and proof that Eaton's prices were below some relevant measure of cost to satisfy the Supreme Court's *Brooke Group* test.[69] The Third Circuit rejected the application of the *Brooke Group* test, holding that that test is appropriate "when price is the clearly predominant mechanism of exclusion."[70] According to the court, the relevant question in deciding whether to require evidence of below-cost pricing is whether "pricing itself operat[es] as the exclusionary tool."[71] In deciding not to apply the *Brooke Group* test, the court identified three features of Eaton's agreements with OEMs that allowed it to conclude that price was not the predominant mechanism of exclusion in Eaton's contracts: (1)

---

66 *Id.* at 265.

67 *Id.* at 267.

68 Whether one is inclined to believe the pro- or anticompetitive explanation for a given example of allegedly exclusionary conduct often depends upon one's prior beliefs. *Cf.* DAVID FOSTER WALLACE, THIS IS WATER: SOME THOUGHTS, DELIVERED ON A SIGNIFICANT OCCASION, ABOUT LIVING A COMPASSIONATE LIFE 17-23 (2009) ("There are these two guys sitting together in a bar in the remote Alaskan wilderness. One of the guys is religious, the other's an atheist, and they're arguing about the existence of God . . . . And the atheist says, 'Look, it's not like I don't have actual reasons for not believing in God. It's not like I haven't ever experimented with the whole God-and-prayer thing. Just last month, I got caught away from the camp in that terrible blizzard, and I couldn't see a thing, and I was totally lost, and it was fifty below, and so I did, I tried it: I fell to my knees in the snow and cried out, 'God, if there is a God, I'm lost in this blizzard, and I'm gonna die if you don't help me!' And now, in the bar, the religious guy looks at the atheist all puzzled: 'Well then, you must believe now,' he says. 'After all, here you are, alive.' The atheist rolls his eyes like the religious guy is a total simp: 'No, man, all that happened was that a couple Eskimos just happened to come wandering by and showed me the way back to the camp.'").

69 Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993).

70 *ZF Meritor*, 696 F.3d at 275.

71 *Id.*

Eaton's position as a supplier of a necessary input for heavy-duty-truck OEMs; (2) the five-year duration of the agreements; and (3) the fact that some of Eaton's agreements required OEMs to remove ZF Meritor's products from the OEMs' data books, which were a source that truck buyers used to customize their purchases from OEMs.[72]

Judge Greenberg—who also dissented from the Third Circuit's en banc decision on bundled discounts in *LePage's Inc. v. 3M*[73]—disagreed with the court's decision to reject a price-cost test in favor of applying the rule of reason.[74] In particular, Judge Greenberg cited the "fundamental . . . principle that above-cost pricing practices, even those embodied in discount and rebate programs . . . generally are not anticompetitive," and, therefore, courts must "tread lightly" when asked to condemn such pricing practices.[75] Ultimately, he concluded that a price-cost test "should apply and be given persuasive effect regardless of whether a plaintiff identifies non-price elements of a defendant's conduct that it alleges were anticompetitive."[76]

The first major opportunity to interpret the Third Circuit's opinion in *ZF Meritor* arose in a district court decision, *Eisai Inc. v. Sanofi-Aventis U.S., LLC*.[77] The plaintiff and defendant in *Eisai* were rival manufacturers of pharmaceuticals used to treat blood clots for patients with deep vein thrombosis.[78] Plaintiff Eisai challenged Sanofi's hybrid market-share/volume discounts, by which the price a purchaser paid depended upon the total volume of purchases made from Sanofi as well as the percentage of its requirements the purchaser bought from Sanofi.[79] The available discounts ranged from 1 percent to 30 percent, with the 30 percent discount available to customers that purchased more than $1.2 million and 90 percent of their requirements from Sanofi.[80] Eisai characterized Sanofi's discounts as "*de facto* exclusive-dealing" and challenged them under the antitrust laws.[81] The parties disputed whether the price-cost test applied to Sanofi's discounting program and, based upon the standard set forth in *ZF Meritor*, whether price was the predominant mechanism of exclusion.[82]

In granting Sanofi's motion for summary judgment, the court held that the price-cost test applied because "price is the predominant mechanism of exclusion" and that "nothing more" was happening in the case other than

---

72 *Id.* at 277-78.
73 324 F.3d 141 (3d Cir. 2003) (en banc).
74 *ZF Meritor*, 696 F.3d at 311-12.
75 *Id.* at 320.
76 *Id.* at 324.
77 No. 08-4168 (MLC), 2014 WL 1343254 (D.N.J. Mar. 28, 2014).
78 *Id.* at *1.
79 *Id.*
80 *Id.* at *4.
81 *Id.* at *12.
82 No. 08-4168 (MLC), 2014 WL 1343254, at *12 (D.N.J. Mar. 28, 2014).

customers choosing Sanofi's products because of its discounting.[83] Notably, the court rejected Eisai's contention that a price-cost test applied because Sanofi "bundled contestable and incontestable demand" for its product.[84] The court rejected outright any distinction between contestable and incontestable components of demand on the ground that, "[s]eemingly, the incontestable demand relating to these unique indications is attributable to the inherent properties of the product at issue, and thus competition on the merits."[85]

This Article now turns to the law of exclusive dealing and the law of predatory pricing, as well as their doctrinal evolutions over the past century.

1. Exclusive Dealing

Exclusive-dealing arrangements were typically upheld both in cases brought under the common law and in cases brought under the Sherman Act,[86] until the Clayton Act[87] was passed in 1914.[88] After the passage of the Clayton Act, however, plaintiffs began to use Section 3 of that statute[89] to prosecute exclusive-dealing arrangements, and courts began to interpret the Sherman Act more broadly to prohibit certain exclusive-dealing arrangements.[90] As courts have become more accepting of the precompetitive virtues of exclusive-dealing arrangements, it has become more difficult for a plaintiff to win a case, in part because a plaintiff must *always* establish that

---

83 *Id.* at *26, *36 (citing NicSand, Inc. v. 3M Co., 507 F.3d 442, 452 (6th Cir. 2007)).

84 *Id*. at *26-27. Eisai apparently did not argue that Sanofi's prices were below cost if the discount was not attributed entirely to the contestable portion of demand. One potential reason for this is that the average variable cost of producing the pharmaceuticals at issue was low, making profit margins exceedingly high and limiting the plaintiff's ability to demonstrate below-cost pricing even if Sanofi's discounts were attributed to a small subset of purchases.

85 *Id.* at *27.

86 Jonathan M. Jacobson, *Exclusive Dealing, "Foreclosure," and Consumer Harm*, 70 ANTITRUST L.J. 311, 312.

87 *Id.*

88 11 HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1800c (3d ed. 2011) (quoting Whitwell v. Continental Tobacco Co., 125 F. 454 (8th Cir. 1903) (approving tobacco company's granting of rebates to dealers who did not sell competing brands); Mogul Steamship Co. v. McGregor, Gow & Co., [1892] A.C. 25 (H.L.) (appeal taken from Eng.) (approving shipping association's granting of rebates to any merchant agreeing to ship tea exclusively on association ships)).

89 *See* 15 U.S.C. § 15 (1914).

90 United States v. Am. Can Co., 230 F. 859, 901 (D. Md. 1916) (holding an exclusive-dealing arrangement unlawful under the Sherman Act); Jacobson, *supra* note 86, at 317 ("Passage of the Clayton Act did in fact result, almost immediately, in more and successful challenges to exclusive dealing arrangements.").

the exclusive-dealing arrangement harms competition as understood under the familiar antitrust rule of reason.[91]

In 1949, in *Standard Oil Co. v. United States*,[92] the Supreme Court introduced quantitative "foreclosure" analysis into the law of exclusive dealing.[93] A rival is said to be "foreclosed" from access to a distributor if the distributor has committed to deal exclusively with a specific supplier. The Court held that all that was necessary for there to be a violation of Section 3 of the Clayton Act was "proof that competition has been foreclosed in a substantial share of the line of commerce affected."[94] However, what constitutes a "substantial share" of the line of commerce occupied courts' attention for much of the last half of the twentieth century.[95]

The last time the Court squarely considered an exclusive-dealing claim was in 1961, in *Tampa Electric Co. v. Nashville Coal Co.*,[96] where it upheld a twenty-year exclusive arrangement that the Court determined foreclosed only a very small percentage of the market.[97] The Court essentially repeated the same standard, announcing that "the competition foreclosed by the contract must be found to constitute a substantial share of the relevant market."[98] Providing some guidance to lower courts, the Court stated that,

> "[t]o determine substantiality in a given case, it is necessary to weigh the probable effect of the contract on the relevant area of effective competition, taking into account the relative strength of the parties, the proportionate volume of commerce involved in relation to the total volume of commerce in the relevant market area, and the probable immediate and future effects which pre-emption of that share of the market might have on effective competition therein."[99]

Recognizing a trend that courts had been "employ[ing] a fuller rule-of-reason analysis" in exclusive-dealing cases, in 1982 the FTC held in *In re Beltone Electronics Corp.*[100] that exclusive dealing ought to be governed by the same legal standard—the rule of reason—that the Supreme Court had applied to all nonprice, vertical restraints five years earlier in *GTE Sylvania*:

---

91 Jacobson, *supra* note 86, at 323 (More recent exclusive-dealing cases have "reduced the focus on foreclosure and placed greater emphasis on the need to prove market power and actual consumer harm."); *cf.* Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 224-25 (1993) (finding injury to a competitor is "of no moment to the antitrust laws if competition is not injured . . . . Even an act of pure malice by one business competitor against another does not, without more, state a claim under the federal antitrust laws.").

92 337 U.S. 293 (1949).

93 *See id.* at 314.

94 *Id.*

95 *See* Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320 (1961).

96 365 U.S. 320 (1961).

97 *Id.* at 334-35.

98 *Id.* at 328.

99 *Id.* at 329.

100 100 F.T.C. 68, 197, 204 (1982).

"a proper analysis of exclusive dealing arrangements should take into account market definition, the amount of foreclosure in the relevant markets, the duration of the contracts, the extent to which entry is deterred, and the reasonable justifications, if any, for the exclusivity."[101] Judge Richard Posner offers a modern statement of the general rule:

> First [the plaintiff] must prove that [the challenged restraint] is likely to keep at least one significant competitor of the defendant from doing business in a relevant market. If there is no exclusion of a significant competitor, the agreement cannot possibly harm competition. Second, [the plaintiff] must prove that the probable (not certain) effect of the exclusion will be to raise prices above (and therefore reduce output below) the competitive level, or otherwise injure competition; he must show in other words that the anticompetitive effects (if any) of the exclusion outweigh any benefits to competition from it.[102]

The best and most straightforward way to establish harm to competition is direct evidence that the exclusive-dealing arrangement caused prices to rise and output to fall relative to a but-for world in which the defendant did not employ exclusive-dealing contracts. Courts in exclusive-dealing cases have also held that a plaintiff may prove its case indirectly by considering various observable market factors that allow a court to infer whether an anticompetitive effect is likely to have occurred in the market at issue.[103]

Categories of indirect evidence include an estimate of the significance of market foreclosure caused by the exclusive-dealing arrangement[104] and the duration and terminability of the exclusive-dealing arrangement.[105] Many courts have held that exclusive-dealing contracts of one year or less

---

101 *Id.* at 204.

102 Roland Machinery Co. v. Dresser Indus., Inc., 749 F.2d 380, 394 (7th Cir. 1984).

103 *See, e.g.*, United States v. Dentsply Int'l, Inc., 399 F.3d 181, 191 (3d Cir. 2005) ("The record of long duration of the exclusionary tactics and anecdotal evidence of their efficacy make it clear that power existed and was used effectively.").

104 *See, e.g.*, Ryko Mfg. Co. v. Eden Servs., 823 F.2d 1215, 1233 (8th Cir. 1987) ("[W]here, as here, the foreclosure rate is neither substantial nor even apparent, the plaintiff must demonstrate that other factors in the market exacerbate the detrimental effect of the challenged restraints."); *Beltone*, 100 F.T.C. at 92 (noting that foreclosure is "only one of several variables to be weighed in the rule-of-reason analysis now applied to all nonprice vertical restraints . . ."); *cf. Microsoft Corp.*, 253 F.3d at 69 ("[T]he requirement of a significant degree of foreclosure serves a useful screening function."). The law is clear that market foreclosure is but one of several factors relevant to a court's analysis. This is because it can be difficult to separate foreclosure that is caused by the exclusive-dealing arrangement—the foreclosure the antitrust laws are concerned with—from the consequences of actual competition. *See* Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 236 (1st Cir. 1983) (Breyer, J.) ("[V]irtually every contract to buy 'forecloses' or 'excludes' alternative sellers from *some* portion of the market, namely the portion consisting of what was bought.").

105 Omega Envtl., Inc. v. Gilbarco, Inc., 127 F.3d 1157, 1163 (9th Cir. 1997) ("[T]he short duration and easy terminability of [certain] agreements negate substantially their potential to foreclose competition."); *see also* W. Parcel Express v. United Parcel Serv. Of Am., Inc., 190 F.3d 974, 976 (9th Cir. 1999) (holding that "termination provisions that allowed a customer to terminate the contract for any reason with very little notice" were relevant to upholding agreements).

are presumptively legal.[106] Others have observed that short duration and easy terminability do not preclude liability for exclusive dealing in all cases.[107] Other factors relevant to the analysis include whether the exclusivity is required of end users or distributor intermediaries;[108] whether distributors are a significant gateway to end users;[109] and evidence of the ease of entry.[110]

2. Predatory Pricing

Predatory pricing, like exclusive dealing, has been prosecuted under multiple antitrust statutes, including Section 2 of the Sherman Act as unlawful monopolization[111] and the Robinson-Patman Act as unlawful price discrimination.[112]

Early predatory-pricing jurisprudence permitted claims to succeed when the discounting harmed a rival and the discounter had "predatory" intent.[113] The law was hospitable to predatory-pricing claims until the 1980s

---

106 *See, e.g.*, Concord Boat Corp. v. Brunswick Corp., 207 F.3d 1039, 1059 (8th Cir. 2000); CDC Techs., Inc. v. IDEXX Lab., Inc., 186 F.3d 74, 81 (2d Cir. 1999); Thompson Everett, Inc. v. Nat'l Cable Adver., 57 F.3d 1317, 1326 (4th Cir. 1995); Omega; U.S. Healthcare, Inc. v. Healthsource, Inc., 986 F.2d 589, 596 (1st Cir. 1993); Roland Machinery Co. v. Dresser Indus., 749 F.2d 380, 395 (7th Cir. 1984).

107 *See Dentsply Int'l, Inc.*, 399 F.3d at 193 ("Although the parties to the sales transactions consider the exclusionary arrangements to be agreements, they are technically only a series of independent sales. Dentsply sells teeth to the dealers on an individual transaction basis and essentially the arrangement is 'at-will.' Nevertheless, the economic elements involved—the large share of the market held by Dentsply and its conduct excluding competing manufacturers—realistically make the arrangements here as effective as those in written contracts.").

108 *See* Omega Envtl., Inc. v. Gilbarco, Inc., 127 F.3d 1157, 1162-63 (9th Cir. 1997) ("[E]xclusive dealing arrangements imposed on distributors rather than end-users are generally less cause for anticompetitive concern . . . . If competitors can reach the ultimate consumers of the product by employing existing or potential alternative channels of distribution, it is unclear whether such restrictions foreclose from competition *any* part of the relevant market."); *Ryko*, 823 F.2d at 1235 (stating that a plaintiff faces higher burden of proving harm to competition "[w]here the exclusive dealing restraint operates at the distributor level, rather than at the consumer level").

109 *See* ZF Meritor, LLC v. Eaton Corp., 696 F.3d 254, 287 (3d Cir. 2012) ("[T]he mere existence of potential alternative avenues of distribution, without an assessment of their overall significance to the market, is insufficient to demonstrate that [the competitor's] opportunities to compete were not foreclosed." (internal quotation marks omitted)).

110 *See Omega*, 127 F.3d at 1164; 2B PHILLIP E. AREEDA ET AL., ANTITRUST LAW ¶ 422e3 (3d ed. 2006) ("Entry while alleged exclusionary conduct is underway may suggest both that entry is easy and that the defendant's conduct is not really predatory at all."); *cf.* Allen-Myland, Inc. v. IBM Corp., 33 F.3d 194, 209 (3d Cir. 1994) ("[T]he ease or difficulty with which competitors enter the market is an important factor in determining whether the defendant has true market power—the power to raise prices.").

111 15 U.S.C. § 2 (2012).

112 15 U.S.C. § 13 (2012).

113 3A Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law ¶ 726 (3d ed. 2006).

because, as one commentator puts it, "[t]he traditional fear was predatory prices locally would be 'subsidized' by higher prices elsewhere" and a larger company operating in multiple geographic markets could drive smaller, local-only competitors out of business through low pricing.[114] In *Utah Pie Co. v. Continental Baking Co.*,[115] the Supreme Court determined that local price cutting by three national firms violated the Robinson-Patman Act, in part because it found evidence of predatory intent.[116]

The Court's decision in *Utah Pie* was roundly criticized, and numerous academic efforts to rationalize the law of predatory pricing followed.[117] The most influential of these was Professors Philip Areeda and Donald Turner's seminal 1975 article proposing that a plaintiff be required to show that the predator's prices were below average variable costs for a predatory-pricing claim to succeed.[118] In the wake of Areeda and Turner's proposal, a number of commentators suggested various measures of cost to use depending upon the level of market output, but there was general agreement that a plaintiff needed to show below-cost pricing of some form to state a viable claim.[119]

In *Brooke Group*, the Supreme Court rationalized the law of predatory pricing by requiring a plaintiff alleging a predatory-pricing claim under either the Sherman Act or the Robinson-Patman Act to establish that the defendant's prices are below an appropriate measure of cost.[120] The Court did not definitively establish the appropriate measure of cost to use in all predation cases but conclusively recognized "the notion that above-cost prices that are below general market levels or the costs of a firm's competitors [do not] inflict injury to competition cognizable under the antitrust laws."[121] Further, the Court held that a plaintiff must also show that the predator had a reasonable prospect or a dangerous probability of recouping its investment in below-cost prices, establishing another significant burden

---

114 *Id.* ¶ 745f; *see also id.* ¶ 723a (citing Reynolds Metal Co. v. FTC, 309 F.2d 223, 229-30 (D.C. Cir. 1962); Foremost Dairies, Inc., 60 F.T.C. 944, 1083-84 (1962)).

115 386 U.S. 685 (1967).

116 *Id.* at 702-03.

117 *See* 3A AREEDA & HOVENKAMP, *supra* note 113, ¶ 720c; BORK, *supra* note 28, at 386-87; RICHARD A. POSNER, ANTITRUST LAW 193-94 (2d ed. 2001); LAWRENCE A. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST 687 (1977); Ward S. Bowman, *Restraint of Trade by the Supreme Court: The* Utah Pie *Case*, 77 YALE L.J. 70 (1967).

118 Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697, 716-17 (1975).

119 *See* Kobayashi, *supra* note 4, at 26-27 (citing Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697, 733 (1975); William J. Baumol, *Predation and the Logic of the Average Variable Cost Test*, 39 J.L. & ECON. 49, 72 (1996); Richard O. Zerbe, Jr. & Donald S. Cooper, *An Empirical and Theoretical Comparison of Alternative Predation Rules*, 61 TEX. L. REV. 655, 715 (1983)).

120 Brooke Group Ltd. V. Brown & Williamson Tobacco Corp., 509 U.S. 209, 222-23 (1993).

121 *Id.* at 223.

for a plaintiff pursuing a predatory-pricing claim.[122] Since the Court's decision in *Brooke Group*, antitrust plaintiffs have had very limited success in bringing successful predatory-pricing claims.[123]

The law varies considerably among the circuits regarding the appropriate measure of cost to apply when determining whether a given case of low pricing is predatory.[124] Some courts have adopted "average variable cost"—the measure advocated by Areeda and Turner—as the appropriate measure of cost,[125] whereas others have allowed for the possibility that prices below "average total cost" can be predatory even if above average variable cost.[126] Still others have followed the Supreme Court's lead in declining to adopt an appropriate measure of cost for all cases.[127]

III. LEGAL ANALYSIS OF LOYALTY DISCOUNTS

The Third Circuit's decision in *ZF Meritor* and the district court's decision in *Eisai* are not the first times that a court has confronted the issue of how to analyze a claim that loyalty discounts have harmed competition.[128] A review of the cases reveals that courts do not apply a specific conduct-based

---

122 *Id.* at 224.

123 Kobayashi, *supra* note 4, at 45; Patrick Bolton et al., *Predatory Pricing: Strategic Theory and Legal Policy*, 88 GEO. L.J. 2239 (2000); Michael L. Denger & John A. Herfort, *Predatory Pricing Claims after* Brooke Group, 62 ANTITRUST L.J. 541(1994); C. Scott Hemphill, *The Role of Recoupment in Predatory Pricing Analyses*, 53 STAN. L. REV. 1581 (2001); Richard Zerbe & Michael Mumford, *Does Predatory Pricing Exist? Economic Theory and the Courts after* Brooke Group, 41 ANTITRUST BULL. 949-85 (1996)).

124 AMERICAN BAR ASSOCIATION, ANTITRUST LAW DEVELOPMENTS 276-81 (6th ed., 2007).

125 *See, e.g.*, Stearns Airport Equipment Co. v. FMC Corp., 170 F.3d 518 (5th Cir. 1999); Tri-State Rubbish, Inc. v. Waste Mgmt., Inc., 998 F.2d 1073 (1st Cir. 1993); Kelco Disposal, Inc. v. Browning-Ferris Indus. of Vermont, Inc., 845 F.2d 404 (2d Cir. 1988).

126 *See, e.g.*, McGahee v. N. Propane Gas, 858 F.2d 1487 (11th Cir. 1988); William Inglis & Sons Baking Co. v. ITT Cont'l Baking Co., 668 F.2d 1014 (9th Cir. 1982).

127 *See, e.g.*, Multistate Legal Studies, Inc. v. Harcourt Brace Jovanovich Legal and Prof'l Publ'ns, Inc., 63 F.3d 1540 (10th Cir. 1995); Advo, Inc. v. Philadelphia Newspapers, Inc., 51 F.3d 1191 (3d Cir. 1995).

128 Some courts have analyzed loyalty discounting using both exclusive-dealing precedent and a price-cost test. *See* NicSand, Inc. v. 3M Co., 507 F.3d 442, 447-48, 455 (6th Cir. 2007); Concord Boat Corp. v. Brunswick Corp., 207 F.3d 1039, 1061-63 (8th Cir. 2000); Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227 (1st Cir. 1983). Other courts have analyzed loyalty-discounting programs under the rule of reason only. *See, e.g.*, Conwood Co., L.P. v. U.S. Tobacco Co., 290 F.3d 768 (6th Cir. 2002); R.J. Reynolds Tobacco Co. v. Philip Morris Inc., 199 F. Supp. 2d 362 (M.D.N.C. 2002) *aff'd per curiam*, 67 F. App'x 810 (4th Cir. 2003). Still, other courts have analyzed loyalty discounts using a price-cost test. *See, e.g.*, Virgin Atl. Airways Ltd. v. British Airways PLC, 257 F.3d 256 (2d Cir. 2001). Finally, courts have also applied a version of a price-cost test in the context of a challenge to a *bundled* discounting program. *See*, *e.g.*, Cascade Health Solutions v. PeaceHealth, 515 F.3d 883, 909 (9th Cir. 2008).

rule for all antitrust claims involving loyalty discounts.[129] Rather, in choosing whether to analyze loyalty discounts under the exclusion or predation rubrics, courts have tended to base their analyses upon the theory of harm asserted by the plaintiff. In other words, if the plaintiff asserts that the defendant's loyalty discounting amounts to predation, a court is likely to apply some form of a price-cost test as elucidated in *Brooke Group*.[130] If, on the other hand, the plaintiff asserts that the defendant's loyalty discounting amounts to unlawful exclusion, a court is likely to apply the rule of reason as elucidated in *Tampa Electric*.[131] This Article agrees that this approach makes sense as a general matter. In all antitrust cases, the plaintiff's task is to articulate a coherent theory of economic harm. The rule of law to be applied in any given case depends upon the theory of harm. Because loyalty discounting can be a mechanism for both predation and exclusion, assigning a legal rule based only upon the conduct—loyalty discounts—does not make sense.

Several cases illustrate the fact that in analyzing an antitrust challenge to a loyalty-discount program, courts apply a rule consistent with the plaintiff's economic theory of harm. In some cases, the rule chosen—either a price-cost test or the rule of reason—may depend in part upon whether the plaintiff pleads its case as monopolization under Section 2 of the Sherman Act,[132] a violation of Section 1 of the Sherman Act,[133] or a violation under the Robinson-Patman Act.[134] This Article's view, consistent with the growing trend in antitrust jurisprudence that has eradicated legal distinctions between the same theories of harm pursued under different statutes, is that the particular statutory claim does not matter, but the theory of harm does.[135]

The first and perhaps most surprising case to consider is *Brooke Group* itself. Although that case is well known for establishing the general ap-

129 *See supra* note 128.

130 *See* Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993).

131 *See* Tampa Elec. Co. v. Nashville Coal Co., 365 U.S. 320 (1961).

132 15 U.S.C. § 2 (2012).

133 15 U.S.C. § 1 (2012).

134 15 U.S.C. §§ 13a, 13b, 21 (2012).

135 *See Brooke Group,* 509 U.S. at 221 ("As the law has been explored since *Utah Pie,* it has become evident that primary-line competitive injury under the Robinson-Patman Act is of the same general character as the injury inflicted by predatory pricing schemes actionable under § 2 of the Sherman Act."); *see also* United States v. Microsoft Corp., 253 F.3d 34, 70 (D.C. Cir. 2001) (en banc) (per curiam) ("The basic prudential concerns relevant to §§ 1 and 2 are admittedly the same: exclusive contracts are commonplace—particularly in the field of distribution—in our competitive, market economy, and imposing upon a firm with market power the risk of an antitrust suit every time it enters into such a contract, no matter how small the effect, would create an unacceptable and unjustified burden upon any such firm. At the same time, however, we agree with plaintiffs that a monopolist's use of exclusive contracts, in certain circumstances, may give rise to a § 2 violation even though the contracts foreclose less than the roughly 40% or 50% share usually required in order to establish a § 1 violation."), *aff'd in part*, *rev'd in part*, 373 F.3d 1199 (D.C. Cir. 2004), *aff'd*, 731 F.3d 1064 (10th Cir. 2013).

proach to all predatory-pricing cases—the "classic" version of predatory pricing involves a simple unconditional price reduction, not a discount that is conditioned on some behavior by the buyer—in fact, the case involved loyalty discounts.[136] The Court described defendant Brown & Williamson's pricing approach as follows:

> At the retail level, the suggested list price of Brown & Williamson's black and whites was the same as Liggett's, but *Brown & Williamson's volume discounts to wholesalers were larger. Brown & Williamson's rebate structure also encompassed a greater number of volume categories than Liggett's, with the highest categories carrying special rebates for orders of very substantial size*.[137]

It is clear that the plaintiff's, Liggett's, theory was that Brown & Williamson was engaged in predatory pricing:

> Liggett claimed that Brown & Williamson's discriminatory volume rebates were integral to a scheme of predatory pricing, in which Brown & Williamson reduced its net prices for generic cigarettes below average variable costs. According to Liggett, these below-cost prices were not promotional but were intended to pressure it to raise its list prices on generic cigarettes, so that the percentage price difference between generic and branded cigarettes would narrow.[138]

Not surprisingly, given Liggett's theory of harm, the Court applied a price-cost test advocated by legal and economic commentators designed specifically for predatory-pricing claims.[139]

Other courts evaluating challenges to loyalty-discounting programs have analyzed the discounting both as predation and as exclusion.[140] One notable example is the Eighth Circuit's decision in *Concord Boat Corp. v. Brunswick Corp.*[141] There, Brunswick, the defendant, had a share of around 75 percent in the market for stern-drive-boat engines.[142] From 1984 to 1997, it offered various market-share discounts to its boat-manufacturer customers.[143] One iteration of its approach provided boat manufacturers with three

---

136 *Brooke Group*, 509 U.S. at 212.

137 *Id.* at 215 (emphasis added).

138 *Id.* at 217; *id.* at 216 ("Liggett contends that by the end of the rebate war, Brown & Williamson was selling its black and whites at a loss."); *id.* at 220 ("Liggett contends that Brown & Williamson's discriminatory volume rebates to wholesalers threatened substantial competitive injury by furthering a predatory pricing scheme designed to purge competition from the economy segment of the cigarette market. This type of injury, which harms direct competitors of the discriminating seller, is known as primary-line injury.").

139 *Id*. at 230-32.

140 Concord Boat Corp. v. Brunswick Corp., 207 F.3d 1039, 1060-63 (8th Cir. 2000); Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 232-38 (1st Cir. 1983).

141 207 F.3d 1039 (8th Cir. 2000).

142 *Id.* at 1044.

143 *Id.*

different discount levels: 3 percent off if the customer bought 80 percent of their requirements from it; 2 percent off if the customer bought 70 percent; and 1 percent off if the customer bought 60 percent.[144] The plaintiffs alleged that "Brunswick had used its market share discounts, volume discounts, and long term discounts and contracts, coupled with the market power it had achieved in purchasing Bayliner and Sea Ray, to restrain trade and monopolize the market in violation of Sections 1 and 2 of the Sherman Act."[145] The boat builders argued that "Brunswick's monopolization of the market enabled it to charge supracompetitive high prices for their engines, which drove other engine manufacturers out of business."[146]

The court analyzed the claim under Section 1 as exclusive dealing, relying on *Tampa Electric*, noting that "Section 1 claims that allege only de facto exclusive dealing may be viable" and that "[t]he principle criteria used to evaluate the reasonableness of a contractual arrangement include the extent to which competition has been foreclosed in a substantial share of the relevant market, the duration of any exclusive arrangement, and the height of entry barriers."[147] The court ultimately rejected the plaintiff's exclusion claim, holding that it "failed to produce sufficient evidence to demonstrate that Brunswick had foreclosed a substantial share of the stern drive engine market through anticompetitive conduct. They also did not demonstrate that Brunswick's discount program was in any way exclusive."[148] With regard to the plaintiff's allegations of monopolization under Section 2, the court analyzed the claim as predatory pricing, noting that, "[b]ecause cutting prices in order to increase business often is the very essence of competition, which antitrust laws were designed to encourage, it 'is beyond the practical ability of a judicial tribunal to control above cost discounting without courting intolerable risks of chilling legitimate price cutting.'"[149] The court rejected the Section 2 claim on the ground that "[n]o one argues in this case that Brunswick's discounts drove the engine price below cost."[150]

Another court has considered an antitrust challenge to loyalty discounts under the exclusive-dealing framework, without considering whether the discounting resulted in below-cost pricing or any other form of predation.[151] In *R.J. Reynolds Tobacco Co. v. Philip Morris Inc.*,[152] the leading

---

144 *Id.*

145 *Id.* at 1045.

146 Concord Boat Corp. v. Brunswick Corp., 207 F.3d 1039, 1046 (8th Cir. 2000).

147 *Id.* at 1058-59.

148 *Id.* at 1059.

149 *Id.* at 1061 (quoting Brooke Group Ltd. V. Brown & Williamson Tobacco Corp., 509 U.S. 209, 223 (1993)).

150 *Id.* at 1062.

151 R.J. Reynolds Tobacco Co. v. Phillip Morris Inc., 199 F. Supp. 2d 362, 396-97 (M.D.N.C. 2002), *aff'd*, 67 F. App'x 810 (4th Cir. 2003).

152 *Id.*

cigarette manufacturer, Philip Morris, introduced a program that provided its retailers with various options regarding the price and mechanism for distributing Philip Morris's products.[153] Philip Morris's "Retail Leaders" program offered four different "participation" levels for retailers.[154] At each level, Philip Morris would offer retailers certain discounts and promotional materials, such as an "industry fixture" designed to hold and display products at the point of sale in exchange for the retailer's commitment to devote a certain percentage of its total display space for cigarettes to Philip Morris's products.[155] As the share the retailer promised to Philip Morris increased, the wholesale price for Philip Morris's products decreased.[156] Philip Morris's competitors challenged Philip Morris's conduct under Sections 1 and 2 of the Sherman Act.[157] The court granted Philip Morris's motion for summary judgment, holding that Philip Morris did not have market power and that the Retail Leaders program did not foreclose competitors from a substantial share of the market.[158]

Notwithstanding the Eight Circuit's conjecture in *Concord Boat* that "it is beyond the practical ability of a judicial tribunal to control above cost discounting without courting intolerable risks of chilling legitimate price cutting,"[159] the very same panel in the very same case analyzed the very same conduct as exclusive dealing, the law of which does not require a plaintiff to establish below-cost pricing.[160] Indeed, *Concord Boat* is an example of a case in which a judicial tribunal was able to consider whether a large-share firm's above-cost discounting led to the exclusion of its competitors. The fact of the matter is that there is nothing unusual about a court considering the competitive merits of above-cost discounting. In *Standard Fashion Co. v. Magrane-Houston Co.*,[161] decided by the Supreme Court in 1922, the Court considered an exclusive-dealing claim that involved a discount: "Petitioner agreed to sell to respondent Standard Patterns *at a discount of 50% from retail prices* . . . . Respondent agreed not to . . . sell or permit to be sold on its premises during the term of the contract any other make of patterns."[162]

153 *Id.* at 370-71.

154 *Id.*

155 *Id.* at 369-71.

156 R.J. Reynolds Tobacco Co. v. Phillip Morris Inc., 199 F. Supp. 2d 362, 369-70 (M.D.N.C. 2002), *aff'd*, 67 F. App'x 810 (4th Cir. 2003).

157 *Id.* at 396-97.

158 *Id.*

159 Concord Boat Corp. v. Brunswick Corp., 207 F.3d 1039, 1061 (8th Cir. 2000) (quoting Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 223 (1993)) (internal quotation marks omitted).

160 *Id.* at 1062-63.

161 258 U.S. 346 (1922).

162 *Id.* at 351-52 (emphasis added).

Although the Supreme Court has not squarely addressed exclusive dealing since *Tampa Electric*, the Third Circuit in *United States v. Dentsply International, Inc.*[163] evaluated a claim of unlawful exclusive dealing put forward by the Department of Justice under the rule of reason, notwithstanding that the defendant-manufacturer provided rebates to its customers: "In the 1990's Dentsply implemented aggressive sales campaigns, including efforts to promote its teeth in dental schools, *providing rebates for laboratories' increased usage*, and deploying a sales force dedicated to teeth, rather than the entire product mix. Its chief competitors did not as actively promote their products."[164] Several other cases analyzed as "exclusive-dealing" claims involved discounting or price reductions in one form or another.[165]

These cases illustrate the point that it is not remotely unusual for a court to consider the competitive impact of above-cost discounting. To the extent that an exclusive arrangement involves some sort of payment from the party to the agreement that is demanding exclusivity—and there is reason to believe that such a payment will always occur—courts are perfectly capable of using the tools elucidated in exclusive-dealing cases to ascertain the competitive impact of the defendant's conduct.[166] As explained, these tools include direct evidence of competitive impact, contract duration, the presence of alternative channels of distribution, entry, and various other relevant factors.[167]

IV. THE LAW OF EXCLUSIVE DEALING SHOULD APPLY TO CLAIMS THAT LOYALTY DISCOUNTS FORECLOSE OR EXCLUDE COMPETITORS

Although antitrust plaintiffs have challenged loyalty discounts as both predatory and exclusionary, this Article argues that most future plaintiffs will pursue an exclusion theory rather than a predation theory of harm. In-

---

163 399 F.3d 181 (3d Cir. 2005).

164 *Id.* at 185 (emphasis added).

165 *See* ZF Meritor, LLC v. Eaton Corp., 696 F.3d 254, 254, 265 (3d Cir. 2012); U.S. Healthcare, Inc. v. Healthsource, Inc., 986 F.2d 589, 592 (1st Cir. 1993) (addressing a challenged contract that "provided for *an increase in the standard monthly capitation* paid to each primary care physician . . . if the doctor agreed . . . not to serve as a participating physician for any other HMO plan" (emphasis added)); R.J. Reynolds Tobacco Co. v. Philip Morris Inc., 199 F. Supp. 2d 362, 362, 369-70 (M.D.N.C. 2002), *aff'd*, 67 F. App'x 810 (4th Cir. 2003).

166 *See* BORK, *supra* note 28, at 309.

167 *See supra* text accompanying notes 103-110.

deed, although there are exceptions,[168] most post-*Brooke Group* plaintiffs argue that a loyalty-discounting program is exclusionary.[169]

There appears to be no controversy regarding the legal rule to apply when a plaintiff claims a loyalty-discount program is predatory. In such a case, the test elucidated in *Brooke Group* will apply, with the court selecting the appropriate measure of cost and considering the defendant's prospects for recoupment.[170] In this context, a court would have no need to assess issues specifically relevant to exclusive-dealing claims, such as any direct evidence of anticompetitive effects, the presence of alternative channels of distribution, the duration of the contracts, and other factors. This Article agrees that the price-cost test is the most appropriate legal rule to use when a plaintiff challenges a loyalty-discount program as predatory.

There is controversy, however, regarding the best rule to apply when a plaintiff challenges a loyalty-discount program as exclusionary.[171] Some have argued that a price-cost test ought to play a role in the analysis even though the test was specifically developed to handle claims of predation and not exclusion.[172] The primary normative argument supporting the price-cost test is that the

> function of the price-cost test is to ensure that less efficient firms who lose sales because customers prefer their rival's offerings are not able to turn their defeat in the market into an antitrust claim. If a seller offers aggressive but above-cost prices, equally efficient rivals will not be excluded from matching and hence attracting customers.[173]

Although immunizing conduct that is likely to be procompetitive from antitrust challenge is a laudable benefit of the price-cost test, this Article argues that the rule of reason ought to apply to exclusion claims for several reasons.

First, it is virtually always better to adopt a legal test that comports with economic reality, and the rule of reason developed to assess the competitive impact of exclusion claims comports with the economic theory of harm in exclusion cases far better than a price-cost test does. Second, an

---

168 Virgin Atl. Airways, Ltd. v. British Airways PLC, 257 F.3d 256, 259 (2d Cir. 2001); Concord Boat Corp. v. Brunswick Corp., 207 F.3d 1039, 1060-61 (8th Cir. 2000).

169 *ZF Meritor*, 696 F.3d at 268-69; Eisai Inc. v. Sanofi-Aventis U.S., LLC, No. 08-4168, 2014 WL 1343254, at *12 (D.N.J. Mar. 28, 2014); *R.J. Reynolds Tobacco Co.*, 199 F. Supp. 2d at 386-87.

170 Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 224-26 (1993).

171 Brief for Eighteen Scholars as Amici Curiae in Support of Petitioner, *supra* note 1, at 7-8; Crane, *supra* note 1, at 264-65; Gates, *supra* note 2, at 99-101; Hovenkamp, *supra* note 1, at 841-44; Willard K. Tom et al., *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 ANTITRUST L.J. 615, 615-16 (2000).

172 Brief for Eighteen Scholars as Amici Curiae in Support of Petitioner, *supra* note 1, at 5-7; 3B PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 768b4 (3d ed. 2008); Crane, *supra* note 1, at 270-71.

173 Brief for Eighteen Scholars as Amici Curiae in Support of Petitioner, *supra* note 1, at 14.

economically rational price-cost test is not necessarily easier for a court to administer than the rule of reason. Third, applying a price-cost test only when "price is the predominant mechanism of exclusion," as the court in *ZF Meritor* counsels, repeats an error that the Supreme Court eradicated from antitrust law when it decided that price and nonprice vertical restraints are to be governed by the same standard in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*[174] This Article next discusses each of these reasons in turn.

A. *Legal Rules Should Comport with Economic Reality*

Since the mid-1970s, the Supreme Court has systematically reworked its antitrust jurisprudence to reflect the teachings of modern industrial-organization economics.[175] The trend has been for the legal rule chosen to govern a particular business practice to reflect the underlying economic effect of the chosen practice.[176] In other words, the legal regime has grown closer to, rather than moved away from, economic reality. Indeed, this trend can be seen in the reduction in scope of the per se rule: "the range of conduct deemed unlawful *per se* [has] narrowed markedly as economic analysis displaced free-ranging considerations of political economy in giving meaning to the Sherman Act."[177]

The primary reason the Court has altered the legal regime to reflect economic learning is that it is virtually always better to adopt a legal test that comports with economic reality. In a world in which courts are unable to distinguish between pro- and anticompetitive conduct perfectly in all cases, the antitrust regime will produce errors. The antitrust system—like most other legal systems—should be designed to minimize the sum of the costs of legal errors plus the costs of administering the system.[178] Legal errors can be divided broadly into two categories. The first is false positives, where a court incorrectly condemns procompetitive conduct as unlawful. The second is false negatives, where a court incorrectly permits anticompetitive conduct.

Although some have argued that antitrust courts ought to be primarily concerned with a legal regime that produces false positives because "the economic system corrects monopoly more readily than it corrects judicial

---

174 551 U.S. 877 (2007).

175 Leah Brannon & Douglas H. Ginsburg, *Antitrust Decisions of the U.S. Supreme Court, 1967 to 2007*, COMPETITION POL'Y INT'L, Autumn 2007, at 3.

176 *Id.* at 21-22.

177 Douglas H. Ginsburg & Derek W. Moore, *The Future of Behavioral Economics in Antitrust Jurisprudence*, COMPETITION POL'Y INT'L, Spring 2010, at 92 (emphasis added).

178 Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 4 (1984); *see also* Geoffrey A. Manne & Joshua D. Wright, *Innovation and the Limits of Antitrust*, 6 J. COMPETITION L. & ECON. 153, 156-57 (2010).

errors,"[179] a legal regime that applies a rule to govern business conduct that does not reflect economic reality is likely to produce both types of errors. As this Article has explained, a price below cost is neither necessary nor sufficient for a loyalty-discounting program to harm competition.[180] Requiring courts to ask a question that bears no relation to the underlying economic problem posed by the challenged business conduct is an invitation for the courts to commit error. Only if a price-cost test reduces the cost of administering the system dramatically—which, this Article argues, it does not[181]—would a test that invites error be superior to one that reflects economic reality.

One need only consider how putative antitrust defendants would react if a price-cost screen applies to a claim that loyalty discounts harm competition but the rule of reason applies to "true" exclusive-dealing claims. As this Article has explained, "traditional" exclusive dealing, where a manufacturer and its distributor agree that the distributor will buy all of its requirements from the manufacturer, is simply a special case of loyalty discounting.[182] Rather than set the maximum-discount trigger at a subset of all the distributor's requirements (e.g., 60 percent, 70 percent, etc.), in a "pure" case of exclusive dealing, the manufacturer simply sets the maximum-discount trigger at 100 percent of the distributor's requirements.

If the legal rule that applies when the maximum-discount trigger is set at 100 percent is different from the legal rule that applies when the maximum-discount trigger is set at all other possible percentages, and the rule that applies at 100 percent is less favorable than the rule that applies at all other possible percentages, then putative defendants will undoubtedly react accordingly. Assuming that a plaintiff's prospects for victory are better when pursuing a case under the rule of reason than under the price-cost test, then presumably, firms worried about antitrust liability would recharacterize "pure" exclusive dealing as a form of loyalty discounting. Instead of a manufacturer paying a distributor a lump sum in exchange for the distributor agreeing to buy 100 percent of its requirements from the manufacturer, the manufacturer will offer it a "discount" or a "rebate" if the distributor buys 99 percent of its requirements from it.

The example of "pure" exclusive dealing—a lump-sum payment in exchange for 100 percent exclusivity—is economically indistinguishable from the example in which the manufacturer offers a discount if the distributor buys 99 percent of its requirements from the manufacturer, regardless of whether the manufacturer is seeking to create a more efficient distribution chain—the "procompetitive" explanation—or is seeking to create or maintain a monopoly position—the "anticompetitive" explanation. If the

179 Easterbrook, *supra* note 178, at 15.
180 *See supra* Part I.B.
181 *See infra* Part IV.B.
182 *See supra* Part II.B.

manufacturer is seeking to use exclusive dealing to incentivize dealers to promote the manufacturer's product, then a market-share discount triggered at 99 percent is likely to function just as well as "pure" exclusive dealing. It is highly unlikely that a dealer's ability to sell a very small share of the manufacturer's rivals' products will have a significant impact on the dealer's incentive to promote the manufacturer's brand, given that the vast majority of the dealer's sales within a category will consist of one brand. Moreover, if a manufacturer could use "pure" exclusive-dealing arrangements to foreclose competing suppliers from access to a sufficient amount of distribution to prevent those suppliers from achieving MES, then that same manufacturer could achieve virtually the same outcome by using a market-share discount triggered at 99 percent. If a legal rule more lenient to defendants applied to the market-share discount, then all defendants would use the market-share discount as a substitute for "pure" exclusive dealing.

One potential criticism of this admittedly stylized example is that no court would see a plausible distinction between "pure" exclusive dealing and a market-share discount where the discount occurs when the distributor purchases 99 percent of its requirement from the manufacturer. Although that may be true, this criticism raises the question of how a court is to distinguish between a market-share-discount trigger that is "too close" to 100 percent—tantamount to pure exclusive dealing—and one that is "not too close" when deciding whether to apply the rule of reason or a price-cost test. Is it 90 percent? 80 percent? The firm's market share? In truth, it would be impossible for a court or policymakers to identify ex ante a market-share threshold above which a market-share discount is tantamount to exclusive dealing. This is because every industry is different, and the competitive problem posed by both exclusive-dealing and market-share discounts depends upon the discounter's rivals being unable to access sufficient distribution to achieve MES—and there is no reason to believe MES is consistent across industries. Moreover, a rule establishing a price-cost test for market-share discounts that are triggered at or below the discounting firm's market share[183] and using the rule of reason for market-share discounts that are triggered above market share would deter firms from using market-share discounts to increase their share—precisely their intended purpose.

Antitrust has a long and storied history of drawing legal distinctions that do not reflect economic reality. In *United States v. Arnold, Schwinn & Co.*,[184] the Supreme Court famously held that it was per se illegal for a manufacturer to impose exclusive-dealer territories to facilitate distribution of its products.[185] In so concluding, the Court emphasized that the per se

183 *Cf.* R.J. Reynolds Tobacco Co. v. Philip Morris Inc., 199 F. Supp. 2d 362, 396 (M.D.N.C. 2002), *aff'd per curiam*, 67 F. App'x 810 (4th Cir. 2003).

184 388 U.S. 365 (1967), *overruled by* Cont'l T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977).

185 *Id.* at 379.

rule would apply only when the manufacturer transferred title of its products to distributors: "We conclude that the proper application of § 1 of the Sherman Act to this problem requires differentiation between the situation *where the manufacturer parts with title*, dominion, or risk with respect to the article, and where he completely retains ownership and risk of loss."[186] For the purpose of distinguishing between pro- and anticompetitive uses of a manufacturer's use of exclusive-distributor territories—the primary substantive function of the antitrust laws—whether the manufacturer transfers title is a distinction without a difference. In assessing whether an exclusive distributorship harms competition, the relevant question is whether the vertical arrangement somehow prevents the manufacturer's rivals from achieving MES.

It is difficult to see how a manufacturer's use of exclusive territories harms competition in this way, which is why plaintiffs have had very limited success in pursuing such claims post-*Sylvania*.[187] Nevertheless, it is nearly impossible to surmise how whether the manufacturer transfers title of its product to its dealers bears any relevance to whether the distribution arrangement will result in competitive harm. A manufacturer might choose to transfer (or not to transfer) title based upon a myriad of considerations specific to the manufacturer's business interests. In the modern economy, it appears that most sophisticated supply chains involve the transfer of title rather than consignment sales. A legal rule that taxes transferring title, such as a rule that says exclusive territories are per se illegal when the manufacturer transfers title but not when the manufacturer retains title, will not only result in fewer exclusive-territory arrangements—the ill sought to be condemned by the per se rule—but also fewer arrangements where the manufacturer transfers title. Under the rule in *Schwinn*, a manufacturer that seeks to achieve the *procompetitive* virtues of exclusive-territory arrangements—such as inducing dealers to devote resources to promoting the manufacturer's product without fear that dealers in the same territories will take sales away by not engaging in costly promotion and undercutting price—must arrange its business dealings so that title is not transferred from manufacturer to dealer. This "tax" on title transfer will necessarily result in a less efficient distribution chain if the only reason manufacturers choose not to transfer title is to comply with the rule in *Schwinn*.[188]

---

186 *Schwinn*, 388 U.S. at 378-79 (emphasis added). This distinction between vertical arrangements in which the manufacturer transfers title and ones in which it does not has its roots in *United States v. General Electric Co.*, 272 U.S. 476, 494 (1926), which held that a manufacturer may impose resale-price requirements on its dealers if there is a consignment relationship between manufacturer and dealer, rather than a sale relationship.

187 *See* HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE 486 (3d ed. 2005); Douglas H. Ginsburg, *Vertical Restraints: De Facto Legality Under the Rule of Reason*, 60 ANTITRUST L.J. 67, 76 (1991).

188 *See* POSNER, *supra* note 117, at 178-88.

This latter point is made more vivid by examining another similar context—the longstanding ban on resale price maintenance. In 1911, the Supreme Court held in *Dr. Miles Medical Co. v. John D. Park & Sons Co.*[189] that a manufacturer may not set the minimum price at which a dealer may resell its products.[190] Eight years later, the Court created an enormous exception to its ban on resale price maintenance in *United States v. Colgate & Co.*[191] In *Colgate*, the Court held that, although a manufacturer may not reach an *agreement* with a dealer by setting minimum resale prices, a manufacturer may publish a list of suggested retail prices and terminate its relationship with a dealer that fails to adhere to the published list of prices.[192] The principle underlying the Court's reasoning is that the antitrust laws do "not restrict the long recognized right of trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal. And, of course, he may announce in advance the circumstances under which he will refuse to sell."[193]

Here again, the Court emphasized a distinction in fact that has limited relevance to assessing the competitive consequences of the challenged behavior. To the extent resale price maintenance harms competition, it is likely because resale price maintenance facilitates horizontal price fixing at either the manufacturer or the dealer links in the distribution chain.[194] It is difficult to determine exactly how prohibiting agreements between manufacturers and dealers on resale prices but allowing manufacturers to terminate price-cutting dealers relates in any way to the issue of horizontal collusion at the manufacturer or dealer levels of the supply chain. Indeed, requiring manufacturers to *publicize* a list of suggested resale prices to permit the manufacturer to terminate a noncomplying dealer may have the effect of *facilitating* coordinated behavior when compared to the outlawed alternative of private resale-price agreements between individual manufacturers and individual dealers.[195]

Nevertheless, when *Dr. Miles* was good law, a manufacturer wishing to achieve the procompetitive virtues of prohibiting dealers from reselling

---

189 220 U.S. 373 (1911), *overruled by* Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007).

190 *Id.* at 405.

191 250 U.S. 300 (1919).

192 *Id.* at 305-07.

193 *Id.* at 307.

194 *Leegin*, 551 U.S. at 892-93 ("Resale price maintenance could assist the cartel in identifying price-cutting manufacturers who benefit from the lower prices they offer. Resale price maintenance, furthermore, could discourage a manufacturer from cutting prices to retailers with the concomitant benefit of cheaper prices to consumers. . . . Vertical price restraints also might be used to organize cartels at the retailer level." (citations omitted) (internal quotation marks omitted)).

195 *Cf.* U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES § 7 (2010), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104, *available at* http://www.justice.gov/atr/public/guidelines/hmg-2010.html.

its product below a set resale price[196] had to forego direct contractual arrangements regarding resale-price terms and all the rights and remedies accompanying contract law to make sure that courts could not infer a resale-price agreement. It is clear that many manufacturers sought to approximate what they were forbidden from achieving via contract through other, presumably less efficient, dealer arrangements, as there was substantial litigation over the contours of the so-called *Colgate* doctrine.[197] Here again, the Supreme Court's acceptance of a distinction—*agreeing* on resale prices rather than *announcing* resale prices and terminating noncompliant dealers—that bears no relationship to distinguishing examples of resale price maintenance that harm competition from those that do not—shaped the way manufacturers structured their relationships with distributors. Courts should avoid repeating this same mistake in the context of loyalty discounts.

B. *An Economically Rational Price-Cost Test Is Difficult to Administer*

Some have argued that the price-cost test elucidated in *Brooke Group* needs modification to account for the richer economic issues accompanying loyalty discounts compared to ordinary discounts that do not depend upon the portion of its requirements that the buyer must devote to a particular seller in order to obtain the discount.[198] The Antitrust Division of the Department of Justice has opined that, to assess whether a market-share discounting program is "above cost," "the entire discount should be attributed . . . to the [customers] that [the discounter] would actually be at risk of losing if [a customer] were to choose nonexclusivity (the 'contestable volume')."[199]

The logic in attributing the discount only to a subset of sold units rather than to the entire volume of sold units is necessary if customers "must carry a certain percentage of the leading firm's products."[200] In other words,

---

196 Lester Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86 (1960); Klein & Murphy, *supra* note 22.

197 *See* Monsanto Co. v. Spray-Rite Service Corp., 465 U.S. 752, 759 (1984) ("In substance, the Court of Appeals held that an antitrust plaintiff can survive a motion for a directed verdict if it shows that a manufacturer terminated a price-cutting distributor in response to or following complaints by other distributors. This view brought the Seventh Circuit into direct conflict with a number of other Courts of Appeals. We granted certiorari to resolve the conflict.").

198 *See* Lande, *supra* note 1, at 878-80 (explaining that attributing the entire discount to the "marginal" units would make economic sense, but that "a predatory pricing test—even one as theoretically sound as the one proposed in this Section—would as a practical matter snare the parties into the expensive, unpredictable, daunting quagmire").

199 Competitive Impact Statement at 14-15, United States v. United Reg'l Health Care Sys., No. 7:11-cv-00030 (N.D. Tex. Feb. 25, 2011).

200 U.S. DEP'T OF JUSTICE, COMPETITION AND MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT 107 (2008) (quoting Ron Stern, Vice President & Senior Competition Counsel, Gen. Electric Co., Business Testimony at the Sherman Act Section 2 Joint Hearing 106 (Feb.

in some markets, not all sales are "contestable." That is, some inframarginal customers are going to buy the leading firm's products even if a challenger firm offers a lower price. In such a circumstance, the leading firm could structure the discount "to induce purchasers to buy all or nearly all needs beyond that 'uncontestable' percentage from the leading firm."[201] Furthermore, "if the financial benefits of a market-share discount are effectively concentrated on the decision whether to buy a relatively small number of marginal units, even prices that technically are 'above cost' on average effectively may be below cost as to those marginal units."[202]

Arguments that support attributing market-share discounts only to the contestable portion of market demand have some underlying economic logic. However, the basic observation that informs this rationale is the "general agreement that a monopolist's above cost (on all units) single-product loyalty discounts can be anticompetitive."[203] Thus, the effort to divine a discount-attribution test reflects the fact that whether the discounted price is below cost bears little relationship to whether the discounting harms competition. Instead of modifying a price-cost test to assess more accurately the competitive impact of loyalty discounts, proponents of a price-cost test should ask the threshold question of why a price-cost test is in any way relevant to the question courts must answer: do the discounts harm competition?

A potential response relates to the broad rationale that underlies the Supreme Court's decision to adopt a price-cost test in *Brooke Group*:

> As a general rule, the exclusionary effect of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator, and so represents competition on the merits, or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting.[204]

Put more succinctly, "cutting prices in order to increase business is often the very essence of competition" and the antitrust laws should avoid rules that "chill the very conduct the antitrust laws are designed to protect."[205] In other words, some version of a price-cost test is desirable because it is "clear" or easy to administer—it is within "the practical ability of a judicial tribunal"—and because price cutting is an activity the antitrust laws should protect, not condemn. An economically rational price-cost test to evaluate loyalty discounts fails on both fronts.

13, 2007), https://www.ftc.gov/sites/default/files/documents/public_events/section-2-sherman-act-single-firm-conduct-related-competition/07.02.13_chicago_final70213ftc.pdf) (internal quotation marks omitted), http://www.justice.gov/sites/default/files/atr/legacy/2009/05/11/236681.pdf.

201 *Id.*

202 Tom et al., *supra* note 171, at 636.

203 U.S. DEP'T OF JUSTICE, *supra* note 200, at 107.

204 Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 223 (1993).

205 Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 594 (1986).

First, defining the contestable portion of market demand is, as one commenter has observed an "expensive, unpredictable, daunting quagmire."[206] Although it may be simple to conclude in most cases that customers in a given market will make some percentage of their purchases from the leading firm even in the face of discounts from an equally efficient rival, identifying the precise percentage of the leading firm's products that customers "must carry" is a much more difficult proposition.[207] And identifying the contestable portion of market demand with some precision is absolutely necessary for a price-cost test to function in this context. If the loyalty discounts render prices below cost without attributing the discounts only to the contestable portion of demand, then a discount-attribution test is unnecessary—the discounts are predatory under the well-accepted standard established in *Brooke Group*. It follows, then, that whether a price-cost test yields a conclusion that prices are above or below cost depends upon the size of the contestable portion of demand. Defining the contestable portion of market demand is, therefore, likely to be outcome determinative. Unlike in the context of applying a discount-attribution test to bundled discounts or rebates,[208] where customers' purchases of the different products within the bundle can provide a useful guide about how precisely to attribute the discounts for purposes of a discount-attribution test, there is no obvious guide in the context of single-product discounts.

Furthermore, what constitutes the contestable portion of market demand is likely to vary across markets and industries. One potential solution would be to equate the noncontestable portion of demand to the leading firm's market share. That is, if the leading firm has a 60 percent market share, then 40 percent of the market is contestable and any loyalty discounts offered by the leading firm must be attributed to 40 percent of the market to assess whether they are below cost. This approach has the advantage of reducing a plaintiff's litigation burden, in that proof of the leading firm's market share will do double duty in both establishing market power and defining the contestable portion of market demand. However, there is no reason to equate the contestable portion of market demand with the share of the market not occupied by the leading firm. Applying such a blanket rule would deter leading firms from competing to increase market share, which is not something the antitrust laws ought to do. Moreover, there is no reason to equate market share with contestability. In most markets, the challenger firms do not view the leading firm's market share as incontestable (i.e., competing only with one another for the residual).

Another option might be to define the contestable portion of market demand to relate to the leading firm's discount levels. If, for example, the

---

206 Lande, *supra* note 1, at 880.

207 *See generally* John A. Quelch & David Harding, *Brands Versus Private Labels: Fighting to Win*, HARV. BUS. REV., Jan.–Feb. 1996, at 99.

208 *See* Cascade Health Solutions v. PeaceHealth, 515 F.3d 883, 906 (2007).

leading firm offers a discount if buyers purchase 80 percent of their requirements from the seller, then the contestable portion of market demand would be the 20 percent residual. This approach would be nonsensical for two reasons. First, many examples of market-share discounts involve multiple discount levels. In *Concord Boat*, for example, the leading firm offered three different discount levels: 3 percent off if the customer bought 80 percent of their requirements from it; 2 percent off if the customer bought 70 percent; and 1 percent off if the customer bought 60 percent.[209] If the primary guide to establishing the contestable portion of market demand is the leading firm's chosen discount trigger, then how is a court to choose if there are multiple discount triggers? Second, the economic basis for defining contestable and noncontestable portions of market demand is that customers "must carry" some amount of the leading firm's products because the customers want access to those products. How much a distributor "must carry" of the leading firm's products to satisfy this demand does not depend upon how the leading firm chooses to structure its discounts.

If courts apply an economically rational price-cost test to assess whether loyalty discounts can violate the antitrust laws, then the issue of defining the contestable portion of market demand will dominate virtually all cases in which loyalty discounts are challenged. This is because the issue will be outcome determinative in almost all cases. A plaintiff can easily satisfy a motion to dismiss by claiming that price is below cost for the small contestable portion of demand in a given market. Moreover, there are no broad principles regarding the contestable portion of demand in different markets to guide courts. Contestability is likely to be an issue that is determined differently case-by-case. This is not to say that the size of the contestable portion of market demand is more difficult to determine than other factors germane to a typical analysis under the rule of reason. However, it is not at all clear that determining the contestable portion of demand would be less difficult, which would be a necessary element if adopting a price-cost test is to be justified on the ground that it is easy to administer.

Moreover, one related argument in favor of applying a price-cost screen is that it is easier to counsel a client not to price goods below cost than it is to counsel it not to violate the rule of reason. Although a client may understand the general prohibition against below-cost predatory pricing, if the price-cost test is modified to attribute any discount to only the contestable subset of sales, a client is going to have a much more difficult time keeping prices above cost. This practice will prove even more difficult if counsel is unable to provide any firm guidance on how a court is going to define the contestable portion of sales.

Nevertheless, adopting a price-cost test could still be justified on error-cost grounds if only a very small number of loyalty discounts are likely to

209 Concord Boat Corp. v. Brunswick Corp., 207 F.3d 1039, 1044 (8th Cir. 2000).

result in competitive harm and the price-cost test reduces the number of false positives. Although the vast majority of loyalty-discounting programs are unlikely to present a close antitrust question, it is doubtful whether a price-cost test modified to account for contestable and noncontestable portions of market demand will dramatically reduce the number of successful claims challenging the discounts. Nevertheless, given the poor track record of plaintiffs pursuing predatory-pricing claims under the *Brooke Group* test,[210] there will likely be some support for a price-cost test in this context because a price-cost test will make loyalty discounts effectively legal per se. This Article argues that it would be an undeniable mistake to inject an economically irrelevant screen into the law just to make a plaintiff's job more difficult. If the incidence of anticompetitive loyalty discounts is sufficiently low, then a rule of per se legality would be more defensible than requiring plaintiffs to jump through an additional hoop merely to reduce the probability of their success.

C. *The Price/Nonprice Distinction Is Unhelpful*

In *ZF Meritor*, the Third Circuit did not hold that the rule of reason governed all antitrust challenges to a loyalty-discount program or that a price-cost screen applied in all cases. Rather, the court held that the price-cost test applies only "when price is clearly the predominant mechanism of exclusion" and "pricing itself operat[es] as the exclusionary tool."[211] Putting aside the threshold question of how exactly a court is to determine when price or something else operates as the exclusionary tool, the Third Circuit's approach reflects an outmoded analysis that the Supreme Court has worked hard to eradicate from antitrust law.

In the context of horizontal restraints of trade, the law has long recognized that an agreement between competitors not to compete, whether the agreement fixes price or some other element of dealing that impacts price or output, is per se illegal if it is not ancillary to some other legitimate business arrangement.[212] The reason is that price is but one of several terms relevant to any business arrangement. In the sale of goods, a buyer and a seller not only agree to the price, but also to terms related to delivery, warranty, as well as a myriad of other factors that may differ substantially across industries. If one term is adjusted to meet the buyer's demands, then another

---

210 *See* Kobayashi, *supra* note 36 (citing Bolton, Broadley & Riordan, *Predatory Pricing: Strategic Theory and Legal Policy*, 88 GEO. L.J. 2239, 2241 (2000); Denger & Herfort, *supra* note 123, at 545; Hemphill, *supra* note 123, at 1585; Zerbe & Mumford, *supra* note 123, at 952).

211 ZF Meritor, LLC v. Eaton Corp., 696 F.3d 254, 275 (3d Cir. 2012).

212 12 HERBERT HOVENKAMP, ANTITRUST LAW ¶ 2000b (3d ed. 2012) (criticizing the court in *Palmer v. BRG of Georgia, Inc.*, 874 F.2d 1417, 1424 (11th Cir. 1989), *rev'd*, 498 U.S. 46 (1990), for concluding that a market-division agreement between competitors was not subject to the *per se* rule because the competitors' agreement did not "explicitly address[] the factor of price").

term—perhaps even the price term—might also be adjusted to reflect the seller's demands. In other words, everything affects everything.

With regard to horizontal restraints, the law did not recognize a distinction between price and nonprice terms of agreements among competitors. As the leading treatise puts it:

> Firms could presumably agree to insist on cash at the time of delivery but nevertheless compete vigorously on the price they charge. But to make much of this fact distorts the relative importance of the various terms of any transaction. The explicit 'price' of any good or service is a function not only of the nominal price but also for the credit terms, applicable discounts, rebates, terms of delivery, and the like. Firms might also agree about the nominal price but continue to compete by offering increasingly longer time periods before payment is due. The fact that such competition continues to exist does not serve to make the price-fixing agreement reasonable.[213]

The law of vertical restraints, on the other hand, recognized an explicit distinction between price and nonprice restraints.[214] The leading treatise also explains that "the law distinguished very sharply between price and nonprice vertical agreements, condemning the former categorically while permitting the latter unless shown to be unreasonable."[215] The Supreme Court eradicated this distinction in *Leegin* by holding that vertical price restraints are no longer governed by the per se rule and are instead governed by the rule of reason standard that also governs vertical price restraints.[216] In so holding, the Court made explicit the fact that there is no economic significance between restraints on price and restraints on other terms of dealing, regardless of whether the agreement is horizontal or vertical: "[t]he same legal standard (*per se* unlawfulness) applies to horizontal market division and horizontal price fixing because both have similar economic effect. There is likewise little economic justification for the current differential treatment of vertical price and nonprice restraints."[217]

The Third Circuit's approach in *ZF Meritor*—a price-cost screen applies only when price is the "predominant mechanism of exclusion"[218]—harkens back to the bad old days, when courts made the economic mistake of viewing the price term of an agreement as being somehow more significant from a competition perspective than the other terms in the agreement. The court provided no guidance regarding how to identify when price is the predominant mechanism of exclusion other than explaining that the case

---

213 *Id.* ¶ 2022a, at 175.

214 Cont'l T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36, 51 n.18 (1977) (holding that vertical nonprice restraints are subject to the rule of reason but noting that "[t]he *per se* illegality of price restrictions has been established firmly for many years and involves significantly different questions of analysis and policy").

215 8 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1630a (3d ed. 2010).

216 *Leegin*, 551 U.S. at 882.

217 *Id.* at 904.

218 *ZF Meritor*, 696 F.3d at 269.

against Eaton did not present a scenario in which price was the predominant mechanism.[219] The Third Circuit has not carried its burden to establish that disparate legal treatment is warranted when price, rather than some other nonprice element, is the mechanism for exclusion.[220]

CONCLUSION

The successful integration of economic analysis into antitrust law has depended critically upon the proposition that legal rules that comport more closely with economic reality are superior to those that do not. The exclusive-dealing framework comports much more closely with the RRC framework most often implicated by conditional discounts than does predatory-pricing law. Any attempts to fit a price-cost test into the legal analysis of conditional discounts are necessarily awkward because such tests were developed to evaluate the legality of a different form of anticompetitive conduct.

The false allure of the increased administrability of price-cost tests has led many scholars to argue that loyalty discounting is the exceptional case in which the antitrust laws are improved by imposing a legal framework that does not comport closely with the economic forces describing most conditional-discount-based antitrust claims. They are wrong, both because price-cost tests in the conditional-discount context require subjective, costly, and uncertain determinations of contestability and because prices below cost are not a necessary condition of the relevant anticompetitive mechanism allegedly at work in exclusion cases. Thus, predation law does not capture the relevant competitive harm. Accordingly, courts should reject price-cost tests in conditional-discount cases alleging exclusion in favor of the rule of reason framework applied in exclusive-dealing cases.

---

219 *Id.*

220 *Cf.* 8 AREEDA & HOVENKAMP, *supra* note 215, ¶ 1630c ("The administrative problem for businesspersons and courts in living with the disparate treatment of price and nonprice restraints counts against disparate legal treatment unless the case for such treatment is clear.").