

A Preservation Safe Harbor in e-Discovery

Editor's Note: Standards relating to production of electronic discovery have become important concerns in antitrust matters, where e-mails and other electronic records can shine a powerful light on the competitive nature of company decisions. As the Federal Trade Commission announced in December 2002, "in some cases the search of even a small portion of the parties' archive and backup systems produces valuable information that is helpful to the staff's investigation." Statement of the Federal Trade Commission's Bureau of Competition on Guidelines for Merger Investigations, <http://www.ftc.gov/os/2002/12/bcguidelines021211.htm>. At the same time, the Commission recognized "problems posed by searching archive and backup systems." To balance the need for information with the cost of production of that information, the Commission proposed that merging parties negotiate with staff for limitations on Second Requests relating to search-terms, time periods, or specified personnel. Such self-imposed balancing is practical within the context of a Second Request negotiation during a merger investigation.

In the litigation context, however, this balancing often occurs at the judicial level. The issue of standards related to electronic discovery in antitrust litigation formally arose as long ago as 1995, in *In re Brand Name Prescription Drugs Antitrust Litigation*, 1995 U.S. Dist. LEXIS 8281 (N.D. Ill. June 15, 1995). In that case, the court found that the defendant bore the ultimate responsibility for production of its own electronic documents in discovery and that the plaintiff "should not be forced to bear a burden caused by [defendant's] choice of electronic storage." The court mitigated this burden, however, by assigning various costs of production to the plaintiff and by requiring the parties to consult and agree upon limitations to the production scope.

In the following article, Thomas Allman examines the current balancing considerations related to electronic discovery employed in *Zubulake v. UBS Warburg LLC and Rowe Entertainment, Inc. v. William Morris Agency, Inc.*, two opinions that substantially refine the standard expressed in *In re Brand Name Prescription Drugs Antitrust Litigation*. Allman also goes beyond the case law and proposes a blueprint for areas still left unresolved, even by these most recent cases.

—MICHAEL R. BARNETT

Thomas Y. Allman

Much has been written recently about the possible abuse of electronic discovery by parties who have little or no incentive to minimize their demands for electronic data. Indeed, anecdotal concerns over this issue dominate discussions among counsel for producing parties. One proposed solution is adoption in the *Federal Rules of Civil Procedure* of the principle established by the Texas Supreme Court, under which the initial production obligations of a producing party extend only to electronic material which is specifically sought and which is readily available in the ordinary course of business.¹ If sufficient necessity is shown for more heroic efforts, the party seeking discovery must pay for the costs, arguably including the attorney privilege review costs. Recent discussions with Texas counsel from the corporate community indicate that this has essentially cured the problem in state court.

The Federal Rules Advisory Committee, through its Discovery Subcommittee, is well aware of the Texas principle, and has been asked to consider measures of a similar nature. I have advo-

■ **Thomas Y. Allman** is Senior Vice President, Secretary, & General Counsel of BASF Corporation.

¹ See TEX. R. CIV. P. 196.4.

cated such an approach,² although in my view the cost shifting should be discretionary but not mandatory. Others have opined that the federal courts already have ample authority to issue orders under Rule 26(b) reducing undue burdens associated with electronic discovery.

Increased Predictability from the Courts Regarding Electronic Discovery

Two recent opinions from the Southern District of New York suggest possible formulations of the proportionality considerations set forth in Rule 26(b) for use in the cost-shifting context.³ Rather than simply grant or deny requests for protective orders, those courts carefully listed the factors that made it more or less fair to have the requesting party absorb the additional costs attributable to an otherwise appropriate request.⁴ Both cases clearly illustrate the significant power of a court to shift discovery costs despite the normal presumption that each party should bear its own costs.⁵ The key point, however, was the adoption of a subtle but important improvement in the Texas rule. Electronic materials not reasonably available to producing parties in the ordinary course of business—such as backup media—should be ordered to be produced only after a careful analysis of cost sharing to the requesting party. A common sense approach adopted by some courts uses the results of sampling techniques to first determine whether production is warranted.⁶ If it is, the sharing or shifting of costs to the requesting party often results.⁷

The *Zubulake* decision also acknowledged the role of the Sedona Conference in producing practical guidance. The Sedona Conference, an ad hoc collaborative effort of a variety of representatives primarily from the defense bar, produced a paper in March 2003 with an abundant analysis of electronic discovery issues and certain suggested principles to guide their resolution.⁸ One key point related to the accessibility of materials sought in discovery and considerations of cost-sharing.⁹ Unlike the *Sedona Principles*, the *Zubulake* court suggests a hierarchy of factors to be considered in the exercise of discretion once the threshold issue of accessibility is resolved.

² See Thomas Y. Allman, *The Need for Federal Standards Regarding Electronic Discovery*, 68 DEF. COUNS. J. 206 (2001).

³ See *Zubulake v. UBS Warburg LLC*, No. 02 Civ. 1243, 2003 U.S. Dist. LEXIS 7939, *17–*21, *36–*49 (S.D.N.Y. May 13, 2003); *Rowe Entm't, Inc. v. William Morris Agency, Inc.*, 205 F.R.D. 421, 429–32 (S.D.N.Y. 2002).

⁴ The seven factors discussed by the courts are as follows:

1. The extent to which the request is specifically tailored to discover relevant information;
2. The availability of such information from other sources;
3. The total cost of production, compared to the amount in controversy;
4. The total cost of production, compared to the resources available to each party;
5. The relative ability of each party to control costs and its incentive to do so;
6. The importance of the issues at stake in the litigation; and
7. The relative benefits to the parties of obtaining the information.

Zubulake at *43 (discussing *Rowe Entm't, Inc.*, 205 F.R.D. at 429–32).

⁵ See *Oppenheimer Fund, Inc. v. Sanders*, 437 U.S. 340, 358 (1978) (“Under [the discovery] rules, the presumption is that the responding party must bear the expense of complying with discovery requests. . . .”).

⁶ See, e.g., *McPeck v. Ashcroft*, 202 F.R.D. 31, 34–35 (D.D.C. 2001); *McPeck v. Ashcroft*, 212 F.R.D. 33, 34 (D.D.C. 2003); *Zubulake*, at *46–*49.

⁷ See, e.g., *Murphy Oil U.S.A., Inc. v. Fluor Daniel, Inc.*, 52 Fed. R. Serv. 3d (Callaghan) 168, 176–77 (E.D. La. 2002); *Rowe*, 205 F.R.D. at 433.

⁸ See THE SEDONA CONFERENCE, THE SEDONA PRINCIPLES: BEST PRACTICES RECOMMENDATIONS & PRINCIPLES FOR ADDRESSING ELECTRONIC DOCUMENT PRODUCTION (March 2003) [hereinafter SEDONA PRINCIPLES], available at http://www.thesedonaconference.org/publications_html.

⁹ See *id.* at 18–24.

Some years of experimentation still lie ahead of us in agreeing upon and applying the “cost-shifting factors” that are most appropriate, if indeed that can be determined in advance. It may well be that each case is so fact-specific that generalities will not prove useful, but the underlying considerations are now clear and they make sense. By emphasizing “accessibility” as the key distinction in electronic discovery, the opportunity now exists to tackle the other important issues.

Some years of experimentation still lie ahead of us in agreeing upon and applying the “cost-shifting factors” that are most appropriate, if indeed that can be determined in advance. It may well be that each case is so fact-specific that generalities will not prove useful, but the underlying considerations are now clear and they make sense. By emphasizing “accessibility” as the key distinction in electronic discovery, the opportunity now exists to tackle the other important issues.

A Remaining Area of Uncertainty in Need of a Standard

One related area that can now be addressed is backup systems. Backup systems periodically copy the contents of the company’s computer systems to a series of tapes, so that in the event of a catastrophic system failure, the company may restore its computer systems. These tapes are routinely recycled for reuse and are not retained. It can and has been argued that the ongoing process of recycling of tapes necessarily constitutes “spoliation” of evidence in a specific case. Federal case law has not properly developed answers to questions such as whether a producing party may commit “spoliation” by maintaining reasonable existing business practices in the face of preservation obligations. Likewise, this question has divided the practical from the academic commentators.¹⁰

Halting the practice of recycling backup tapes is impractical in many instances. Once tapes from an e-mail server are set aside for one case, the same tapes are logically available for review in the context of other subsequently filed cases involving the same servers—potentially resulting in an administrative nightmare. For an entity facing hundreds of suits, this effectively means that no backup systems can ever be purged. Moreover, some backup systems are partially or fully automatic, and interrupting the established automatic processes can be difficult and labor intensive. Finally, halting reuse of backup tapes could require the purchase of unlimited numbers of extra tapes as well as burdensome arrangements for storage and access to the tapes that are no longer being recycled. The costs and burdens of tracking the tapes would convert a disaster recovery system into an extraordinarily expensive and unwarranted record retention program.

Given these substantial costs and difficulties, it is unrealistic to expect that halting of rotation of all backup tapes should be a routine response to the filing of litigation. A far better approach is to acknowledge that determined efforts to identify and collect electronic materials from readily accessible sources represent an effective substitute for the preservation of backup media.¹¹

Even more is at stake, though, than addressing the effect of undue burdens during production of electronic records. A recent opinion from the Second Circuit holds that in cases of breach of discovery obligations, sanctions can issue where the breach occurred not only through bad intent,

¹⁰ Compare *id.* at 18 (“However, the obligation to preserve relevant evidence is generally understood to require on the part of the producing party only reasonable efforts to identify and manage the relevant information readily available to it. Satisfying this obligation must be balanced against the right of a party to continue to manage its electronic information in the best interest of the enterprise even though some electronic information is necessarily overwritten on a routine basis through applications of various computer systems. If such overwriting is incidental to the operation of the systems, it should be permitted to continue after the commencement of litigation.”) with 7 MOORE’S FEDERAL PRACTICE, § 37A.12[5][e] (Matthew Bender 3d ed., 2003) (“The routine recycling of magnetic tapes that may contain relevant evidence should be immediately halted on commencement of litigation.”).

¹¹ See, e.g., Lisa M. Arent, Robert D. Brownstone & William A. Fenwick, *Essay: Ediscovery: Preserving, Requesting & Producing Electronic Information*, 19 SANTA CLARA COMPUTER & HIGH TECH. L.J. 131, 175 (2002) (“[Where] volume of back-ups may be very large given the size of the company. . . . a strategy entailing an ongoing thorough search for, and preservation of, pertinent electronic data. . . . could minimize or eliminate the need for discovery of back-up tapes.”).

but also through mere negligence.¹² Such sanctions may include monetary fines, adverse instructions to the jury, or, in extreme cases, default judgments.¹³ Sanctions, such as adverse jury instructions, may have case-altering effects far out of proportion to the seriousness of the alleged conduct. If a company fails to halt routine recycling of backup tapes as unnecessary in a context where the court ultimately disagrees with the decision, the party may be in the position of having to make the Hobson's choice between going to trial with an instruction that the jury infer that the documents on the backup tape would have been detrimental to the company, and simply settling the case. Indeed, some commentators now predict that the courts will routinely apply harsh sanctions, such as jury instructions commanding the jury to infer that destroyed documents would have been detrimental to the company even where their destruction was due to negligence.¹⁴

A Proposed Preservation Safe Harbor

In light of the uncertainties outlined above, producing parties operating large numbers of computers need to be able to rely on a more clearly defined preservation standard so that they can appropriately plan for litigation. Accordingly, now is the time to enact a Rule-based "preservation safe-harbor" applicable to the operations of business systems involving information that is not routinely accessible at the time of institution of litigation. *Zubulake* is helpful here as well: it can be seen to stand for the principle that where information is not accessible in the ordinary course of business, no automatic requirement exists to halt the ordinary treatment of such information where the systems are operated in good faith for business purposes.

Thus, Rule 37 of the Federal Rules of Civil Procedure could expressly provide that a responding party need not automatically suspend or alter the operation in good faith of electronic backup or other routine disaster recovery or business systems absent a preservation order based on a clear showing of need justifying the expense and disruption inherent in such an order. This would allow the producing party to explain to the court or magistrate the alternative methods and assurances already in place to produce the evidence sought and the burdens of such an order. Such a preservation order should not issue unless the requesting party met the standards for injunctive relief because an order of this nature is, arguably, injunctive in nature.¹⁵

Moreover, given the well-documented varieties of electronic data available in even the ordinary case, Rule 37 should provide that a court should not enter sanctions predicated upon a failure to maintain or preserve electronic information unless a discovery request or preservation order describes with particularity the specific documents or data sought to be preserved. In that situation, entry of sanctions would require evidence that the party upon whom the request or order was served willfully failed to preserve the documents or data. Including language in Rule 37 to reflect this principle would prevent organizations from being blindsided by spoliation sanctions premised

¹² See *Residential Funding Corp. v. DeGeorge Fin. Corp.*, 306 F.3d 99, 108 (2d Cir. 2002) ("The sanction of an adverse inference may be appropriate in some cases involving the negligent destruction of evidence because each party should bear the risk of its own negligence.").

¹³ See, e.g., *Danis v. USN Communications, Inc.*, 53 Fed. R. Serv. 3d (Callaghan) 828, 835 (N.D. Ill. 2000) (fining individual defendant \$10,000 and recommending adverse inference instruction be given at trial).

¹⁴ See, e.g., Gregory P. Joseph, *Electronic Spoliation*, SH037 ALI-ABA 163 (2003).

¹⁵ See *Sedona Principles*, *supra* note 8, at 21–23 (citing *In re Potash Antitrust Litig.*, No. 3-93-197, 1994 WL 1108312, at *7–*8 (D. Minn. Dec. 5, 1994); *Humble Oil & Ref. Co. v. Harang*, 262 F. Supp. 39, 42–43 (E.D. La. 1996)).

on conduct that lacked bad intention.¹⁶ This language should be supported by a presumption that the undertaking of reasonable steps to notify custodians of electronic information of the need to preserve such information constitutes prima facie compliance with the standard of care.

Conclusion

Recent progress in solving the practical problems in the production of electronic evidence has been substantial, and the two district court opinions cited provide much needed assistance by opening the debate over cost-shifting factors informing the exercise of judicial discretion. However, the challenge of providing a balanced approach to issues involving the planning for preservation necessitates a “safe harbor” in the *Federal Rules*. Building on the principles underlying those recent cases, this is the time for the Federal Rules Advisory Committee to work towards adoption of such a measure as part of a comprehensive amendment reflecting the differences in electronic discovery. ●

¹⁶ See generally SEDONA PRINCIPLES, *supra* note 15, at 39 (“Sanctions, including spoliation findings, should only be considered by the court if, upon a showing of a clear duty to preserve, it is found that there was an intentional or reckless failure to preserve and produce relevant electronic data, and a showing of a reasonable probability that the loss of the evidence materially prejudiced the adverse party.”).

Book Review:

Searching for a Principled Order in an Ever More Complex Antitrust World

Ky P. Ewing

Competition Rules for the 21st Century: Principles from America's Experience

Kluwer Law International • 2003

Reviewed by Donald I. Baker

Ky Ewing's book, *Competition Rules for the 21st Century*, is a tour de force. It is must reading for anyone seriously interested in how competition laws could be more effectively and efficiently enforced in an ever smaller world in which competition enforcement regimes proliferate and competitive (and anticompetitive) effects reverberate.

The book seeks to push an increasingly numerous competition community in the direction of a coherent focus based on a rigorous factual analysis and a standard of consumer welfare. It cautions against embracing some of the more exuberant and populist elements of the American past. It expresses concerns about antitrust mandarins telling enterprises, courts, and each other what is good for the world.

Part of what makes the book so good is the painstaking assembly of ideas and statistics. The President of Harvard and the EU Commissioner of Competition are quoted on the same page in support of sensitivity to innovation and dynamic markets. Passages like these make the book a brief writer's bonanza.

The statistics cover such interesting subjects as the percentage of GDP spent on antitrust enforcement in various countries, and the proportion of national antitrust budgets spent on merger enforcement vs. cartel enforcement. Who would have guessed that Panama had the highest proportion of GDP on antitrust enforcement? Or that France would top the league on anti-cartel enforcement as a dominant priority? Not so surprisingly, we find that the United States has as many personnel devoted to antitrust enforcement as the next three teams in the antitrust enforcement league combined—EU, Japan, and Australia.

Ky Ewing advocates ten principles that he argues should govern antitrust enforcement anywhere (listed as eight principles on an erroneous page 225):

1. A focused purpose for enforcement.
2. Rigorous factual examination.
3. Rigorous evaluation of the competitive process with an eye to the nature of the particular competitive circumstances involved, innovation, potential competitive risks, and time dimensions.
4. Balancing of good and bad effects, and long- and short-term interests, with the costs of government intervention.
5. Avoidance of presumptions (particularly presumptions of anticompetitive effect) in lieu of inquiry.

■ **Donald I. Baker**

is a Partner, Baker & Miller, PLLC, Washington, D.C. He is Advisor to the ICN Working Group on Merger Notification and Procedures, and former Assistant Attorney General in charge of the Antitrust Division, U.S. Department of Justice.

6. Non-discrimination.
7. Transparency.
8. Accountability.
9. Minimalist intervention.
10. Humility.

These principles are important and correct, and worth emphasizing; but I would add two more which I think are at least as important:

11. Intellectual honesty and imagination, and
12. Political courage.

The last two can determine how effective a competition agency is in its own political environment and markets—which is for me more important than its standing in the Premier League of Competition Enforcement.

*We have a few areas—
including mergers—
where we probably
have too much antitrust
enforcement in the
world, and Ewing finds
these areas especially
worrisome.*

We have a few areas—including mergers—where we probably have too much antitrust enforcement in the world, and Ewing finds these areas especially worrisome. His discussion of duplication and overlap in merger enforcement is worthy of attention by those in charge of agencies that are making the commitments of limited resources to particular transactions or sectors. To the extent that the enforcement agencies can make efficiency-based allocations of responsibilities for dealing with the same cartel, monopolistic abuse, or merger, everybody is better off. Both the private parties and the agencies can save resources.

But that is only part of what antitrust enforcement in a global economy is all about. I find it to be entirely appropriate for the European Commission—or even a smaller and less important agency—to take a different view of the Microsoft monopoly and appropriate relief differently from the U.S. Justice Department or to take a different view of the Boeing-McDonnell acquisition than the FTC did. But there is a risk that Ewing points out clearly:

The danger to the international trading system, then, is not so much the cost to companies of complying, but the very real possibility of attempts by one nation or another to thwart efficiency-enhancing mergers or acquisitions that will impact consumer welfare around the world. (page 196).

The same point would apply equally to monopolization and abuse of dominance cases under Section 2 of the Sherman Act or Article 82 of the Treaty of Rome. Given this potential for global consumer loss from excessive or insufficient enforcement, it becomes a particularly important obligation on each enforcement authority to make clear why it decided to act or decline to act and what it believes the appropriate rules are.

It often seems that the international differences in approach come from unstated assumptions. For example, modern U.S. antimerger enforcement tends to rest on the assumption that a merger is likely to be efficiency-enhancing to some degree, just because the companies want the transaction. Meanwhile, the EC assumption seems to be more neutral, and thus they are just a little less likely to see a downside risk in blocking a transaction that has some competitive problems. For me, it is very hard to fault the EC position—given the serious number of mergers that do not work out and the “buying binge” strategies of stock market manipulators like WorldCom. In any event, I think that these differences in assumptions would be an appropriate subject for additional exploration.

This is all part of a broader reality. The anti-merger rules of almost every jurisdiction require a predictive judgment about the likelihood and magnitude of future anticompetitive effects and efficiency gains. All this should be done in the context of a legal regime rather than a system of

bureaucratic “ad hoc-ery” or political favoritism. Contrary to Mr. Ewing’s warnings against use of presumptions (pp. 238–39), I think that some presumptions are necessary in the merger area just in order to maintain some veneer of legalism. The Merger Guidelines that have become so important in modern times are in fact a codification of presumptions—not all of which are necessarily right.

Like Mr. Ewing, I think harmonized substantive rules are important—but it is a long way from harmonized rules to *consistent decisions*. Professionals (as well as amateurs) born and educated into quite different legal and political systems are often likely to come up with different decisions in virtually identical cases. This is reality, however far it is from Mr. Ewing’s desires.

If there is any general fault with *Competition Rules for the 21st Century*, it is not what is found between the covers of the book, but what is not. The author’s basic thesis is that we need more care, coordination, and economic rationality in order to make the global market system more efficient and beneficial to consumers around the world. Ewing’s focus is almost entirely on national government competition agencies, the rules they apply and their decision-making processes. Yet, in fact, there has been an extraordinary modern history of coordination and cooperation among these agencies—as underscored by the current International Competition Network (ICN) and the growing web of antitrust cooperation agreements.

Rather, as I see it, the main sources of antitrust waste, confusion, and disharmony are coming from elsewhere, and appear to be getting worse. They deserve more attention than they seem to have received in what I hope will be referred to as the First Edition of *Competition Rules*. This would be my list of candidates for greater attention:

Devolution (or Subsidiarity) in Europe. The EU has, in its new “Modernization” program, pushed a lot of new authority down on the national authorities and courts of Member States—including new Member States with no tradition of competition and limited numbers of personnel with any training or experience in how markets work. If anything short of great legal confusion occurs in the next few years, it will be a miracle.

Federalism in the United States. A perceived vacuum in federal antitrust enforcement during the Reagan Administration generated a strong opportunity for state attorneys general and legislators to move into what had been essentially a federal preserve. Thus, the states now review and challenge mergers that have passed muster or been ignored at the federal review level (and at the very least state investigators can become a complicating factor in DOJ or FTC merger investigations).

Private Litigation. Hard-pressed foreign competition agencies are increasingly advocating variations on an American staple—the private antitrust case. Thus, class action cases are now authorized in the major Canadian provinces, and new rights of private recovery are being authorized in the UK and other EU Member States. Meanwhile, the United States remains a beacon for potential plaintiffs because of the treble damage bounty system (which, ironically, Congress copied from the English Statute of Monopolies of 1620); and thus disputes abound over which foreign purchasers can seek the U.S. bounties rather than have to resort to their home courts for the perhaps less generous remedies under their own laws. It is interesting that the two U.S. international jurisdiction cases mentioned in the book are both private actions—one by several state attorneys general against the Lloyds’ underwriters and the other by the British target of a hostile takeover by a South African conglomerate.¹ Such “private attorneys general” are under no obligation to—and

¹ *Hartford Fire Ins. Co. v. California*, 509 U.S. 764 (1993); *Consolidated Goldfields, PLC v. Antol Am. Corp. of South Africa*, 698 F. Supp. 487 (S.D.N.Y. 1988) (discussed at pp. 209–11).

don't—follow Ewing's helpful section on how to "Avoid Enforcement Conflicts (Nexus, Comity and Abstention)" (pp. 208–14).

Over-Exuberant Assertions of Jurisdiction. This subject has long pitted the United States against the world, and ultimately resulted in a series of "blocking statutes" aimed at U.S. plaintiffs being enacted by normally friendly countries, such as Australia, Canada, and the UK. In modern times, the worst jurisdictional abusers have been countries that have asserted *national* jurisdiction based on *worldwide* turnover, even where the local nexus was virtually non-existent. Brazil has been the biggest and hence most notorious of these jurisdictions; and yet there is nothing by way of text or statistics on Brazil in the book (probably because the Brazilian agency did not repond to an American Bar Association questionnaire on which Mr. Ewing relies for a lot of his data).

The competition

agencies surely do not

have all the answers,

but they probably have

more principled

answers than most

(or even all) of their

political opponents.

Political Uncertainties. In each national government, the competition agency is only a small part (sometimes a very small part) of the domestic political system—and the competition agency is usually engaged in ongoing bureaucratic battles with constituency-serving ministries engaged in trying to maximize the welfare of politically favored groups. Brussels is a little different because competition is so central to the EU's mission, but DG Competition's battles with constituency-directorates and national governments are a fundamental reality in the Union. Dealing with such opponents requires brains and courage; and, because I think that the intra-governmental battles over trade rules and subsidies are important, I would recommend a little less humility on the part of the competition agencies than Mr. Ewing seems to urge (at pp 242–43). The competition agencies surely do not have all the answers, but they probably have more principled answers than most (or even all) of their political opponents. I realize that strength and success on the political side of the competition process may cause occasional excess activism on the enforcement side, but it is a risk that I would be willing to run. Anyway, more discussion of the political dynamics would seem useful in this book—because it is probably politics that is the biggest threat to the rules-based competition law system that Mr. Ewing so clearly advocates.

Much has been achieved and much still remains to be done in the area of competition law and enforcement. This readable and insightful work can contribute to the ongoing dialogue, but it is too good to be read by only a few cognoscenti from the international antitrust network. To the extent that *Competition Rules for the 21st Century* influences actors in the agencies, courthouses, and corridors of power around the world, it could make a positive difference to consumers and dynamic enterprises almost everywhere. ●

Brown Bag Program

A New Wave of Robinson-Patman Act Section 2(c) Litigation: Anti-Brokerage Claims in the Franchise Supply Context

An ABA Section of Antitrust Law “Brown Bag” Conference Call, held November 12, 2002, co-sponsored by the Section’s Robinson-Patman Act and Corporate Counsel Committees.

MODERATORS



Brian R. Henry
Competition Counsel for Coca-Cola Company, and Vice-Chair, ABA Section of Antitrust Law Corporate Counseling Committee

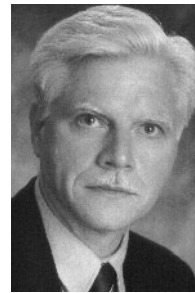


Margaret M. Zwisler
Partner, Howrey Simon, Arnold & White, and Chair, ABA Section of Antitrust Law Robinson-Patman Act Committee

PARTICIPANTS



Donald S. Clark
Secretary, Federal Trade Commission



W. Michael Garner
Partner, Dady & Garner, P.A.



Alicia L. Downey
Partner, Bingham McCutchen LLP

Editor’s Note: This program traces recent, innovative applications of Section 2(c) of the Robinson-Patman Act¹ in lawsuits that challenge supply practices in the hotel industry and in franchise relationships. Section 2(c) prohibits

any person engaged in commerce . . . to pay or grant, or to receive or accept, anything of value as a commission, brokerage or other compensation, or any allowance or discount in lieu thereof, except for services rendered in connection with the sale or purchase of goods, wares or merchandise, either to the other party to such transaction or to an agent, representative, or other intermediary. . . .

The first wave of these cases involves hotels. Many hotel owners contract out the operation of their properties to well-known managers, such as ITT Sheraton and Marriott. The management agreements typically provide that the operator will charge all operating costs to the owner and receive a management fee. The recent cases brought by the hotel owners assert that the operators received undisclosed rebates, or “sponsorship funds,” from vendors in connection with purchases of supplies the operators charged to the owners. The hotel owners assert that operators’ retention of these payments violates their fiduciary duties to the owners and, in addition, that the payments violate Section 2(c) of the Robinson-Patman Act as a “kickback” paid to the operators.

In the first of the hotel cases to go to trial, 2660 Woodley Road Joint Venture v. ITT Sheraton Corp.,² a jury agreed with the owner. The jury’s verdict awarded the owner about \$10 million in compensatory damages and \$39 million in punitive damages on the breach

¹ 15 U.S.C. § 13(c).

² 2002 U.S. Dist. LEXIS 439, 2002-1 Trade Cas. (CCH) ¶ 73,601 (D. Del. Jan. 10, 2002).

of fiduciary duty claims, and an additional \$750,000 in compensatory damages for the Section 2(c) violation, which was subject to trebling under the Clayton Act. The trial court issued a ruling on January 10, 2002, that denied the defendant's motion for judgment *n.o.v* or a new trial on any of the claims but reduced the punitive damages award to approximately \$17 million. Shortly after that ruling, many more cases were filed challenging hotel operators' practices.³

Building on the hotel cases, a second wave of cases has been initiated by franchisees in the fast-food industry against their franchisors. Typically, a fast-food franchisor will either designate approved suppliers of foodstuffs or paper goods, from whom franchisees must make purchases, or will purchase and supply these items itself. When the franchisors make these designations or make the purchases, they sometimes receive fees from the suppliers.

An association of Blimpies' franchisees initiated an arbitration proceeding against their franchisor, contending that the franchisor's receipt of such payments, among other things, violates Section 2(c) and raised their costs of supplies.⁴ A group of franchisees of the "Huddle House" restaurant chain brought suit against their franchisor on the same theory.⁵

In the recent past, franchisees challenging such arrangements as unlawful tie-in sales had, for the most part, had their challenges rebuffed.⁶ Have franchisees found a better mousetrap in Section 2(c)?

Donald S. Clark, Secretary of the Federal Trade Commission, started the program with an overview and history of Section 2(c). W. Michael Garner, who represents the Blimpies franchisees in their 2(c) arbitration, addressed the types of arrangements that franchisees would seek to challenge. Alicia L. Downey, who frequently defends franchisors, analyzed defenses likely to be available to franchisors in these actions.

—MATTHEW MOLOSHOK

MARGARET ZWISLER: Welcome to our Brown Bag on Section 2(c) of the Robinson-Patman Act. Section 2(c) of the Robinson-Patman Act has been used very little over the years. Recently, however, both practitioners and the courts have been grappling with new applications of this provision to some common business practices in the franchise and distribution context. Even the *New York Times* in late September 2002 ran an article about a case between Marriott and some of its hotel owners in which Section 2(c) is one of the fundamental claims.⁷ Once you have been in the *New York Times* it's certainly time to address this subject. The recent interest in this kind of problem is the genesis for our program.

³ Some hotel "rebate" cases decided or pending at the time of the Brown Bag discussion included:

2600 Woodley Road Joint Venture v. ITT Sheraton Corp., 2002 U.S. Dist. LEXIS 439, 2001-1 Trade Cas. (CCH) ¶ 73,601 (D. Del. Jan. 10, 2002)

In Town Limited Partnership v. Marriott International, Inc., No. 2:02-0481 (S.D.W.V. filed May 23, 2002)

CTF Holdings, Inc. v. Marriott International, Inc., No. 02-271-SLR (D. Del. filed Apr. 12, 2002)

Flatley v. Marriott International, Inc., No. 02-11577-RCL (D. Mass. filed Aug. 5, 2002)

SHC Laguna Niguel I LLC v. Marriott International, Inc., No. BC280028 (Cal. Super. Ct. filed Aug. 20, 2002)

Copies of the complaints in these cases can be found at the ABA Section of Antitrust Law Robinson-Patman Act Committee Web page using this link: <http://www.abanet.org/antitrust/committees/rp/programs.html>.

The *Flatley* suit settled, and was dismissed voluntarily on December 24, 2002.

⁴ *The Association of Blimpie Franchisees, Inc. v. Blimpie Int'l*, AAA File No. 50 T 114 00431 02 (filed Nov. 18, 2002) The Blimpies' complaint in arbitration may be found at the Robinson-Patman Committee Web page, *see supra* note 3.

⁵ *Ash-Bash, Inc. v. Huddle House, Inc.*, Civil Action No. 02-2276 (WBH) (N.D. Ga. filed Aug. 15, 2002) The Huddlehouse complaint may be found at the Robinson-Patman Act Committee Web page, *see note 3* above.

⁶ *See, e.g.*, *Queen City Pizza, Inc. v. Domino's Pizza, Inc.*, 124 F.3d 430 (3d Cir.1997); *Little Caesar Enters., Inc. v. Smith*, 34 F. Supp. 2d 459 (E.D. Mich.,1998). *But see* *Collins v. Int'l Dairy Queen, Inc.*, 939 F. Supp. 875 (M.D. Ga.1996).

⁷ L. Browning, *May I Speak to the Manager? A Storm at Marriott*, N.Y. TIMES, Sept. 29, 2002, at Sec. 3, p. 1, col. 2.

BRIAN HENRY: Several of our committee members saw the articles on Marriott in the *New York Times* and in the *Wall Street Journal*⁸ and identified this as a potential area for a Brown Bag program. The Brown Bag format provides the opportunity to learn about a new area and raise awareness regarding a developing area. I think you will find that there are really no clear answers. Our goal today is to increase the audience's awareness of this wave of Section 2(c) cases and better inform everyone as to possible approaches to handling 2(c) issues that may arise in their daily practice.

I would like to kick the program off by introducing our panelists. Don Clark is the Secretary of the Federal Trade Commission. He has been in that post since 1988, and was involved in the FTC's *Boise Cascade* case and the *Bookseller* cases. He is going to start the program by providing some background on the origins of the Robinson-Patman Act and particularly the elements of a 2(c) claim. Then Michael Garner, a partner at Dady & Garner in Minneapolis, Minnesota, will provide some background on the franchisee perspective of a Section 2(c) case. Michael's practice fundamentally involves franchisees and distributors filing suits against franchisors and he will bring that perspective and experience to his presentation today. Alicia Downey will follow. She is a partner in the Boston office of Bingham McCutchen, in its antitrust and trade regulation group. She is going to provide the defendant's response to a 2(c) claim. So our goal here is to provide the background on what 2(c) is all about; to provide a potential plaintiff's perspective in bringing a 2(c) case; and then a defendant's potential response to a 2(c) case.

DONALD CLARK: As you mentioned, I am with the Federal Trade Commission. I very much appreciate the opportunity to participate in this discussion today. I should first note, as we always have to, that the views I express are my own and do not necessarily represent the views of the Federal Trade Commission or of any members of the Commission or any members of the Commission staff. The Federal Trade Commission Act prohibits unfair methods of competition—our antitrust mission—and unfair or deceptive acts and practices—our consumer protection mission. Two laws we enforce are particularly relevant to franchise practices. The Commission is empowered to enforce the Clayton Act, including Section 2 of that statute and of course Section 2(c). Also, the Commission has adopted and enforces a trade regulation rule entitled *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*, more commonly known as the Franchise Rule.⁹

My job is to describe the historical context in which Congress created the Robinson-Patman amendments to the Clayton Act, including, in particular, Section 2(c). I think we will all recall that in 1936 Congress believed large firms could dominate markets through predation and other forms of economic warfare directed against smaller firms. And Congress felt that "power buyers" like large retailers could use their market power to extract price concessions from manufacturers and other sellers that were not available to their smaller competitors.

The major legislative purpose of the Robinson-Patman Act was to provide some measure of protection to small independent retailers and their independent suppliers from what was thought to be unfair competition from vertically integrated, multi-location chain stores. Consistent with the context in which the statute was created in 1936, the Supreme Court and the Commission have concluded that the Act's fundamental principle is to assure, to the extent reasonably practicable

⁸ See WALL ST. J., Aug. 21, 2002.

⁹ 16 C.F.R. Part 436, available at <http://www.ftc.gov/bcp/franchise/16cfr436.htm>.

and consistent with economic efficiency considerations, that firms at the same functional level would stand on equal competitive footing so far as price is concerned.

Of course, interpreting and elaborating on this basic principle is crucially important, because maximizing consumer welfare and economic efficiency in a free market economy necessarily anticipates that different firms perform differently and will fare differently. In my view, therefore, our objective should be to interpret the Robinson-Patman Act in as economically sound a fashion as possible. The Supreme Court has on several occasions stated that the Act must in fact be interpreted consistently with the broader policies of the antitrust laws, so my perspective would be that we want to ensure that Section 2(c) is enforced in a way that is as consistent as possible with the other provisions of the antitrust laws. The Supreme Court, of course, has taken a similar position with respect to Section 2(c) in the *Broch* case¹⁰ and in other cases as well.

Let me now focus more particularly on the provisions of Section 2(c). In relevant part Section 2(c) prohibits a party to a sales transaction from granting to or receiving from the other party a “commission, brokerage or other compensation or any allowance or discount in lieu thereof except for services rendered in connection with the sale or purchase of goods, wares, or merchandise.” And it goes on at some length, but that is the gist of the provision.

The circumstances that led to the inclusion of this provision in the 1936 amendments to the Clayton Act are instructive. In the 1920s and 1930s many small manufacturers and processors marketed their output through independent sales brokers. Those brokers solicited orders from potential customers, forwarded the orders to the producers/sellers, and received commissions from the sellers for their efforts. However, as competition in a variety of retail sectors developed, many large buyers began to maintain their own elaborate purchasing departments. These buyers did not need the services of a seller’s broker because they bought their merchandise directly from the producers/sellers. As a consequence, in many cases, these large buyers required the sellers either (1) to pay them the commission that would otherwise have gone to a broker or (2) to give them allowances in lieu of brokerage reflecting the savings in the cost of distribution attributable to their performing the brokerage function. That was the genesis of Section 2(c); it was designed to protect smaller sellers, in particular manufacturers and brokers, from what were thought to be unfair practices by large buyers.

With this background in mind, I think that the best enunciation of the purpose of Section 2(c) remains the Supreme Court decision in *FTC v. Henry Broch & Co.*, where the Supreme Court defined the objectives of Section 2(c) in the following way:

The Robinson-Patman Act was enacted in 1936 to curb and prohibit all devices by which large buyers gain discriminatory preferences over smaller ones by virtue of their greater purchasing power. A lengthy investigation revealed that large chain buyers were obtaining competitive advantages in several ways other than direct price concessions and were thus avoiding the impact of the Clayton Act.¹¹

The Court noted:

One of the favorite means of obtaining an indirect price concession for large buyers was by setting up “dummy” brokers who were employed by the buyer and who, in many cases, rendered no services. The large buyers demanded that the seller pay “brokerage” to these fictitious brokers who then turned it over to their employer. This practice is one of the chief targets of Section 2(c) of the Act.¹²

¹⁰ *FTC v. Henry Broch & Co.*, 363 U.S. 166 (1960).

¹¹ *Id.* at 168–69.

¹² *Id.* at 169.

... the primary goals of Section 2(c) were to eliminate the practice of dummy brokerage and, at the same time, to eliminate hidden preferences that might be masked by the brokerage function by forcing them into the open . . .

Dummy brokers were not the only means by which the Congress perceived the brokerage function to be abused, but preventing their use was, I think, the primary goal of the statute.

In short, the primary goals of Section 2(c) were to eliminate the practice of dummy brokerage and, at the same time, to eliminate hidden preferences that might be masked by the brokerage function by forcing them into the open; that is, to ensure that firms—instead of trying to hide price reductions they were offering through brokerage and other kinds of arrangements—would bring their pricing behavior out into the open so it could be evaluated under the more forgiving price discrimination provisions embodied in Sections 2(a) and 2(f) of the Robinson-Patman Act.¹³

That is the genesis of Section 2(c). The Supreme Court also, however, importantly has recognized a number of exceptions to what would otherwise be rather severe restrictions in Section 2(c). In particular, the Court placed the following limitations on the basic prohibition. First, the Court noted in the *Broch* case that if the broker had simply agreed to accept the lower commission at issue on all sales to all buyers, there plainly would be no room for finding that the price reductions were violations of Section 2(c). In other words, in *FTC v. Broch*, the problem from the Court's perspective was that Broch had used the reductions at issue to secure the business of a single buyer. On the other hand, if the same commissions had applied to all sales made by Broch, that would not have presented a problem. So, discrimination is one of the requirements that you have to find to show a 2(c) violation.

Second, the Court indicated that a “reduction in price coupled with a reduction in brokerage” did not automatically compel the conclusion that an allowance in lieu of brokerage has been granted.¹⁴ As I mentioned, one of the chief concerns was to avoid masking direct discounts through indirect brokerage reductions. The Court wanted to emphasize that the mere presence of such a reduction in price at the same time one found a reduction in commissions did not mean that a violation had occurred; it would depend on the circumstances of each case.

Third, the Court noted that the record in *Broch* contained no evidence that the buyer rendered any services to the seller or to the respondent broker, and that left the Court comfortable with finding a Section 2(c) violation. By implication, however, the Court suggested that if the buyer had rendered services to the seller or the broker then the payments might have been permissible. In fact, the Court said that if the buyer that secured the discounts at issue had actually rendered services to the seller or to the respondent broker, “[w]e would have quite a different case.”¹⁵

The *Broch* decision thus adds those three important caveats to the Section 2(c) provisions, and courts in later cases have applied them or extended them to other situations.

For example, the Fifth Circuit has added something of a cost justification defense to Section 2(c). In *Thomasville Chair Company v. FTC*, it held that allowances in lieu of brokerage are prima facie discriminatory only if they are “without justification based on actual bona fide differences in the cost of sales and resulting from the differing methods or quantities in which commodities are sold or delivered.”¹⁶ The Commission has extended these exceptions by ruling that if the buyer purchases products for its own account and then resells them to wholesalers, that may be permissible. In the *Edward Joseph Hruby* case,¹⁷ the Commission determined that while the discounts

¹³ See Herbert R. Gibson, Sr., 95 F.T.C. 553, 740, *modified*, 96 F.T.C. 126 (1980), *aff'd*, 682 F.2d 554 (5th Cir. 1982).

¹⁴ 363 U.S. at 175.

¹⁵ *Id.* at 173.

¹⁶ *Thomasville Chair Co. v. FTC*, 306 F.2d 541, 545 (5th Cir. 1952).

¹⁷ *Edward Joseph Hruby*, 61 F.T.C. 1437 (1962).

that the buyer received were equal to the usual brokerage amounts, the discounts did not violate Section 2(c) because they simply reflected a functional discount, which the buyer received because the buyer was performing significant services.

In addition, Section 2(c) expressly creates an exception for payments for services rendered. Although early cases limited the scope of this exception to payments by a seller to its broker, the Supreme Court in *FTC v. Broch* once again expressly stated that if a buyer renders any services to a seller or to the respondent broker, so that the price reduction at issue is justified by the elimination of services normally performed by the seller or its broker, that would have presented a different case. Thus, for example, a number of much more recent cases considered the situation in which a school district schedules photography sittings for its students and provides space for such sittings in exchange for a commission from the photographer on sales of photographs to the school's students. Courts confronting these situations have concluded that the commissions do not violate Section 2(c) because they fall within the services rendered exception; that is, the school district is performing services and therefore it is entitled to compensation without running afoul of Section 2(c).

Finally, of course, Section 2(c) has also been held to prohibit commercial bribery, and I think this is consistent with the more general principle that if a broker or some other entity is acting as an agent for another party but is in fact violating its fiduciary duty by taking kickbacks—commercial bribery representing probably the quintessential example of that kind of situation—then that is going to violate Section 2(c).

The final thing I wanted to mention is that Section 2(c) technically does not require a showing of injury to competition in order to establish a violation. However, Section 4 of the Clayton Act requires a private plaintiff to establish the existence of actual injury from the practice at issue in order to recover damages. Thus, as a practical matter, the plaintiff in a given case must show that it suffered injury from the allowances in lieu of brokerage or commercial bribery at issue. Typically the plaintiff would have to show it is competing with a favored participant or participants in the transaction involved. That is one last gloss on Section 2(c) which I think we want to keep in mind as we consider how the statute best should be enforced.

MICHAEL GARNER: Franchisees' interest in this type of claim arises largely as a result of a spate of recent cases that are not strictly franchise cases, and I'll describe the general fact pattern in those cases. There are number of them, and there is at least one decision in favor of the plaintiff. Those cases arise in the lodging industry. Typically, what we are seeing is that owners of a hotel property have contracted with an operator, such as a Marriott or a Sheraton, to operate the property pursuant to an operating agreement or an agency agreement. The operator in turn contracts with third parties to supply goods and perhaps services to the property—e.g., soaps, amenities, that type of thing. The plaintiffs in these cases assert that the operator has taken payments from the suppliers. Typically, what happens is that the owner is going to be paying the suppliers for the actual cost of goods or services and a payment is then going from the supplier to the operator. That was attacked under Section 2(c) in a number of cases, and there was a jury verdict that was upheld notwithstanding a motion for judgment as a matter of law, in *2660 Woodley Road Joint Venture v. Sheraton*.¹⁸

¹⁸ See *supra* note 3.

Now, that fact pattern is not terribly different from the setting that you often encounter with franchisors and franchisees. In a typical business format franchise, a franchisor licenses the trade-name, the trademark, and the system for doing business to the franchisee, and usually third parties will supply the goods that the franchisee actually sells, so that the burger franchisor will have meat suppliers that supply hamburgers, or bakers that supply the buns, or paper suppliers that supply the plates and napkins. Also, a franchisor will often operate locations of its own, what we call company-owned stores. If not side-by-side, I think it is fair to say the company-owned stores are in competition with franchisee-owned outlets.

There are a number of legal constraints on the franchisor/franchisee relationship that I think have to be taken into consideration in evaluating a 2(c) claim or any of the other claims that may arise in connection with this type of a fact pattern. One is the Lanham Act. The franchisor is licensing its name to the franchisee and it has a right to control the trademarks and the use of the trademarks and the quality of the goods and services that are used under its mark. So it has to have some type of arrangement with the supplier of the goods and services. The second consideration that you have here is something that Don mentioned, the FTC Franchise Rule, and also the law in approximately 16 states that requires a franchisor to make disclosures to prospective franchisees prior to purchase, and those include disclosures of any compensation that the franchisor receives from third party suppliers.¹⁹ And then, third, the franchisor has to be mindful of antitrust considerations other than the Robinson-Patman Act, particularly tying claims. There have been a number of cases over the years where franchisees have claimed that the franchisor has unlawfully tied the use of the trademark to particular goods or services that have to be purchased either from the franchisor or from its designated suppliers.

So we're finding, as franchisee lawyers, that franchisors are increasingly turning to their suppliers and cutting deals to obtain payments from the suppliers on account of sales that are made to franchisees.

In traditional business format franchising, the franchisor will usually derive its revenue stream from royalty payments that franchisees pay, typically a percentage of their gross sales. The franchisors in recent years, however, have begun to look to suppliers as a source of revenue. Today, when franchisors are finding that their ability to expand the number of units or their ability to increase same store sales is constrained by saturation of the market and economics and competition, the franchisors are looking elsewhere for revenues, and that leads them to look to suppliers as a source of revenue. So we're finding, as franchisee lawyers, that franchisors are increasingly turning to their suppliers and cutting deals to obtain payments from the suppliers on account of sales that are made to franchisees. These deals can come up in a number of different contexts and a number of different ways. I've got a number of hypothetical examples here.

The first fact pattern we see is where the franchisor requires the franchisee to purchase from a designated supplier, prohibits the franchisee from making purchases from any other supplier, and meanwhile the franchisor receives consideration from the supplier based on the franchisee purchases. That's one fact pattern that we see.

A second fact pattern that we see is the same as the first except that the franchisee is free to purchase from any supplier that meets the franchisor's reasonable requirements, and the franchisor has, in fact, approved such alternative supplier. So, if the franchisor is getting a payment from Pepsi but Coke is also approved and it doesn't get a payment from Coke, and the franchisee can go to Coke, that's a different situation.

¹⁹ For state laws requiring pre-sale disclosures to franchisees, see 1 W.M. GARNER, FRANCHISE AND DISTRIBUTION LAW AND PRACTICE § 5.26 (2002).

A third situation is where the franchisor requires the franchisee to purchase from designated suppliers. There is no direct payment from the supplier to the franchisor, but the supplier sells to franchisees at one price and sells the same products at a discount to the franchisor for company-owned stores.

I think that all of these fact situations have the potential to run afoul of a 2(c) claim. Whether the claim will successfully run the course is a matter we can discuss.

One thing that I noticed in reviewing the cases is that you can pretty much tell what the outcome is going to be by how the facts are described.

Certainly in the first situation, where the franchisee is locked in, you've got a pretty good claim on behalf of the franchisee. In the second situation, where the franchisee is free to purchase from any other supplier, I think somebody's going to mention the words "no antitrust injury." And in the third situation, you don't actually have a payment but you do have a discount that may be in lieu of a payment.

In real life, all of these fact patterns get complicated by a number of other factors. The franchisor may make representations to the franchisee that it will get the franchisee the best prices or reduced prices from the suppliers. There may be nondisclosures of various types under the FTC disclosure statement or the Uniform Franchise Offering Circular or "UFOC." There may be claims of fiduciary relations involved as well. We see claims arising not only under 2(c) of the Robinson-Patman Act, but also disclosure issues if the franchisor has not fully disclosed. There may be little FTC Act claims, particularly if the franchisor has not fully disclosed. There may be breach of contract claims, fraud claims, RICO claims. There could be price discrimination claims under 2(a) of the Robinson-Patman Act, and conceivably there could be tying claims that get involved in this type of fact pattern.

What are some of the issues and defenses that defendants are going to raise? First, as I mentioned earlier, they will say "no antitrust injury." One that we anticipate will be raised is a claim that services have in fact been rendered by the franchisor. That particular claim raises an interesting question on the interplay between the franchisor's duty to monitor and police the use of its trademark and whether it's actually performing services for the supplier. And sometimes we have heard franchisors say, well, we're entitled to make a profit on this and that's how we do business.

As I mentioned earlier, we do have a jury verdict in this one case, in the *Sheraton* case.²⁰ There was a jury verdict not only on the 2(c) claim but also on breach of contract claims, breach of fiduciary duty claims and certain others. There are a number of other cases that are pending as we speak. So with that introduction to the franchisee's viewpoint, I'll turn it over to Alicia.

ALICIA DOWNEY: What I'm going to try to do is address the flip side of what Michael was just talking about, specifically with reference to these recent hotel cases, some of which have only just been filed in the last six months. Others have been pending now for awhile, although there really haven't been any substantive decisions on some of the 12(b)(6) motions that have been filed in response to the 2(c) claim, at least as yet. We should be seeing them coming out within the next few months, so the legal landscape on this issue may be clearer in the very near future.

One thing that I noticed in reviewing the cases is that you can pretty much tell what the outcome is going to be by how the facts are described. The plaintiffs (and the courts in some of the cases that found their way into news reports) have defined the transactions giving rise to the 2(c) claim as being either "kickbacks," or "bribes," or "secret rebates." But the franchisor or the person being

²⁰ See *supra* note 3 and accompanying text.

accused of violating 2(c) might have called these payments “signing bonuses,” or “sponsorship funds” or “incentive programs.” How these different payments are labeled has implications not only for the litigation but also the counseling side of things. If you can connect these payments to legitimate agreements the payments are being made under—and as Michael mentioned too, if they are connected to the core franchisor function of protecting goodwill, the brand, and the trademark—and if they’re not actually called kickbacks or bribes within the company—you will have a better case going forward.

With respect to the technical elements of whether a private 2(c) claim can prevail, a couple of points have already been mentioned. In the hotel cases, the 12(b)(6) defenses have asserted, flat-out, that the plaintiffs’ claims essentially assert conduct constituting commercial bribery, rather than “dummy brokerage” conduct governed by Section 2(c). I think at this point some circuits have embraced the commercial bribery cause of action. Others have questioned it.²¹ I know here in the First Circuit, they held it up to the light but have not made a final decision yet.²² Yet that’s the threshold issue—whether Section 2(c), or some other provision of the antitrust laws, allows somebody in the hotel owner’s position to actually sue for commercial bribery.

Let’s say it does. What are they really complaining about? I think in the hotel cases you’ll see they’re really complaining that the owner didn’t get the payment. They’re the ones buying the stuff. They’re asserting that, if there are going to be payments made by vendors, the owners, not the operators, should have received the payment. So it’s really a claim more like conversion, perhaps, or breach of contract by third-party beneficiaries, to the extent that the operators were contractually bound to order supplies and then somehow kept the rebate payments for themselves. But at bottom the plaintiffs are claiming that they are the rightful recipient of the rebate. Again, there’s a basis there to question whether you’re really stating a Section 2(c) claim in that instance.

I think there have also been allusions to the fact that in the bribery context, perhaps a prerequisite is an agency or fiduciary relationship between the agent being bribed and the person on whose behalf they are supposed to be buying. A franchisor/franchisee relationship is not one that ordinarily gives rise to a fiduciary relationship and, in fact, many franchise agreements specifically disavow the existence of any such relationship. So to the extent that a fiduciary relationship is a prerequisite for a bribery claim, showing the requisite agency relationship or fiduciary duty could be a problem.

The more serious issue, and a major focus of the defenses asserted in these cases, is the “antitrust injury” requirement. It may be true that a plaintiff may not have to prove injury to competition at large to satisfy Section 2(c), but the plaintiffs are asserting their claims under the Clayton Act, and in order to get private plaintiff standing, a plaintiff needs to show the type of injury that the antitrust laws were intended to prevent. And that requires showing more than just simply not getting money to which you were allegedly entitled. The hotel cases have put this antitrust injury issue squarely before the courts. This is a threshold defense. It will be interesting to see which way the wind blows on this. It’s true that in the *2660 Woodley Road* case against ITT Sheraton, that did not seem to be an issue, but there were some interesting facts in that case that

The more serious issue, and a major focus of the defenses asserted in these cases, is the “antitrust injury” requirement.

²¹ See generally, Keller W. Allen & Meriweather D. Williams, *Commercial Bribery, Antitrust Injury and Section 2(c) of the Robinson-Patman Anti-Discrimination Act*, 26 GONZ. L. REV. 167 (1990/1991).

²² See *Augusta News Co. v. Hudson News Co.*, 269 F.3d 41 (1st Cir. 2001); *Bridges v. MacLean-Stevens Studios, Inc.*, 201 F.3d 6 (1st Cir. 2000).

may have allowed the plaintiffs to go further with the claim than perhaps some of the plaintiffs will be able to go.²³

The other issue, too, is who has standing to bring a commercial bribery claim. The common-sense thought about it is that the people who are really harmed when a buyer is bribed are the competitors of the seller, that is, the people who lost profits and lost business because they were unwilling to pay the bribe. The sellers—the competing sellers who did not pay the bribe—should be the ones who have standing to claim that they suffered antitrust injury as a result of the bribery. But in the hotel cases the plaintiffs are not those sellers. The plaintiffs are the folks who claim that they were somehow deprived of the benefit of the bribes—that is they say, in effect, that they were entitled to the bribe—or that the payments shouldn't have been made at all and that such payments unfairly increased their costs.

Another defense we see asserted in these cases is that the hotel owners agreed to allow the hotel operators to do the buying under their operating contracts. The contracts play a large role in really deciding whether a payment was wrongful or not. They're all different, and they play a major role in the case. It's not just the fact of payment that gives rise to the 2(c) violation. It has to do with all the details of parties' relationship and the procurement services that are being provided. If the contract specifically states that the hotel owner has agreed that it will make exclusive use of the operator to perform the buying function, then perhaps they've contractually agreed that there isn't going to be any competition. They can't complain of a competitive injury because they agreed at the outset that they would have only one source of goods.

The other potential defenses turn on the extent to which the payments were disclosed at the outset of the relationship as part of the system that the franchisor, or the hotel operators were operating. Where there is such disclosure then perhaps the payment is less "smelly." There is a lot of discussion in the cases about who knew what. These recent cases are based as much on allegations of hidden accounting practices and the buyer's failure to disclose, as they are on anything else.

What about cases in which the payments were in fact passed through to the plaintiffs? What damages have they suffered? I think that's a legitimate question to ask, and I think we're seeing in a couple of systems that the payments are in fact being distributed, in one form or another, to the franchisees or owners. Perhaps not as quickly or as systematically or as transparently as plaintiffs have suggested is their right, but again you'd have to question where the damage is in that case.

With respect to counseling on these issues, I think whether you are going to be working with an unhappy franchisee or the franchisor, there are likely to be a number of issues between the parties, not just the vendor payments. The 2(c) claims generally are not prosecuted alone. They come with a host of common law claims and sometimes with other federal antitrust claims. I don't see anybody thinking that the 2(c) claim is so strong that the plaintiff will present a single count complaint under Section 2(c) in this context. And there are, as I mentioned, some real threshold 12(b)(6) defenses that could well turn out to be successful in the end. But until those cases get decided and taken up on appeal, as a couple of them are right now, you have to realize that the exposure is probably pretty significant at the moment. Once it gets to a jury, if the case is pre-

With respect to counseling on these issues, I think whether you are going to be working with an unhappy franchisee or the franchisor, there are likely to be a number of issues between the parties, not just the vendor payments.

²³ *Ed. Note:* In a subsequently issued decision in one of the hotel cases under consideration, *In Town Hotels Limited Partnership v. Marriott Int'l, Inc.*, 2003 WL 536755 (S.D. W. Va. Feb. 25, 2003), the court denied the motion to dismiss, finding that antitrust injury standing requirements are met in the context of a 2(c) claim, where plaintiff alleges an injury to itself flowing from corruption of an agency relationship.

sented in the vocabulary of “kickbacks” and “bribes” and so forth, it’s going to be pretty difficult to get the claims knocked out altogether. A defense, for example, that “everybody else is doing it” or that “we’re entitled to make a profit too,” I see as being of diminished strength, at least right now.

Disclosure, though, could well be the key here, and I am talking not just about disclosure in the UFOC to potential franchisees, but also disclosure to existing franchisees. Of course that’s going to raise the other issue of whether you’ll generate complaints that you wouldn’t have otherwise had if you suddenly disclose something that perhaps was not common knowledge before with respect to receipt of vendor payments. Going forward, and with respect to existing business models, you really do have to consider whether there are services being rendered, what arguments can be made. By the same token, you also have to try to ensure that internal communications, the contract documents, the UFOC, and other disclosure documents do not undermine the argument that services of value to the franchisees or owners are being provided for these payments. Businesspeople should be counseled to avoid, for example, gleeful remarks about “getting something for nothing” or using loaded terms like “kickback.” ●

***LePage's II*: The En Banc Third Circuit Revisits 3M's Bundled Discounts and Sees Unlawful "Exclusion" Instead of Above-Cost Pricing**

David L. Meyer

In *LePage's v. 3M*, 324 F.3d 141 (3d Cir. 2002), the en banc Third Circuit joined a chorus of recent courts of appeals that have sided with plaintiffs in upholding the potential validity of their Section 2 claims.¹ If not reviewed by the Supreme Court—or affected by the outcome of the Court's pending review of the *Trinko* case—*LePage's* may well have the most far-reaching consequences of these recent decisions. It addresses a question of central importance to any firm that possesses a high share of some market: what conduct might be found unlawful under Section 2 of the Sherman Act as the "willful maintenance of monopoly power" or, in the vernacular of most recent cases, be deemed "predatory and exclusionary"?

LePage's answers this question in a way that could be read as sweeping within the ambit of Section 2 virtually any practice that causes harm to competitors. Harking back to the first half of the last century—when bigness bordered on badness²—(the decision appears to demand that a jury decide virtually every claim by a plaintiff harmed by the marketplace behavior of a firm with "monopoly" power, and offers those juries precious little guidance for distinguishing between legal competition and unlawful monopoly maintenance.

The type of behavior at issue in *LePage's* magnifies the significance of the case. With inconsequential exceptions, the case was solely about 3M's *pricing* of its products in competition with *LePage's*.³ *LePage's* labored mightily to characterize the case as involving the "exclusionary structure" of 3M's pricing—which in part involved "bundled" rebates across multiple product lines—rather than "3M's price levels,"⁴ and the court readily agreed that the case did not involve a "predatory pricing claim." 324 F.3d at 151. But there are reasons to question this characterization. For example, *LePage's* did not attempt to prove that the structure of 3M's pricing made it any harder for *LePage's* to compete than if 3M had offered equivalent rewards to customers by merely reducing the *level* of its price on the private-label tape with which *LePage's* competed.

■
David L. Meyer is a Partner in Covington & Burling, Washington, D.C. Covington represents 3M on matters unrelated to the *LePage's* case, and in which the author has not been involved.

¹ *E.g.*, *MetroNet Servs. Corp. v. US West Communications*, 2003 U.S. App. LEXIS 6007 (9th Cir. 2003) (reversing grant of summary judgment against § 2 claim); *Law Offices of Curtis V. Trinko, L.L.P. v. Bell Atl. Corp.*, 305 F.3d 89 (2d Cir. 2002) (reversing district court dismissal of Section 2 claim), *cert. granted*, 123 S. Ct. 1480 (2003); *Telecor Communications, Inc. v. Southwestern Bell Tel. Co.*, 305 F.3d 1124 (10th Cir. 2002) (affirming § 2 jury verdict); *Conwood Co., L.P. v. U.S. Tobacco Co.*, 290 F.3d 768 (6th Cir. 2002) (affirming § 2 jury verdict), *cert. denied*, 123 S. Ct. 876 (2003);

² The court of appeals treats *United States v. Aluminum Co. of America*, 148 F.2d 416 (2d Cir. 1945) (*Alcoa*), as the beginning of the "modern era" of § 2 jurisprudence, and quotes approvingly from *United States v. Swift*, 286 U.S. 106 (1932).

³ A significant portion of the court's discussion deals with 3M's alleged "exclusive dealing," but virtually all of the conduct involved the exclusionary effect of the same bundled discounts.

⁴ Brief for Appellees/Cross-Appellants at 63 (Mar. 30, 2001) (*LePage's* Brief).

*The LePage's decision
does not doom all firms
with monopoly-sized
market shares.*

The *LePage's* decision does not doom all firms with monopoly-sized market shares. They can draw some comfort from the fact that the case was decided after a jury had already concluded that 3M had unlawfully maintained its monopoly, and the court of appeals was quite reluctant to override the jury's prerogative to reach that conclusion on an extensive record covering the competitive interactions between 3M and LePage's over the course of several years.⁵ They can also hope that the rhetoric of the decision will be applied narrowly, with greatest emphasis given to the court's rejection of the (overbroad) proposition that *Brooke Group* bars all monopolization claims whenever the defendant's prices are above costs.

Moreover, there are a few concrete steps that potential defendants can take to avoid 3M's fate. They can explicitly limit their marketing programs to above-cost, unstructured discounts offered on single products, and thereby stay within the refuge of predatory pricing law. If they choose to "bundle"—or otherwise get creative in their pricing programs—they can avoid creating a record that their conduct is aimed at annihilating their smaller rivals, so as to avoid the unhappy inference that juries might draw from statements like the one in a 3M document that suggest its actions were intended to "kill" LePage's and its private-label niche. And they can be prepared to defend their pricing structure (or other potentially "injurious" competitive initiatives) by having concrete proof of the procompetitive justifications (a.k.a. "valid business reasons") for decisions to compete in ways that make life relatively more difficult for their rivals.

The Factual and Procedural Context

The factual and procedural context of the case is fairly straightforward. 3M manufactures the "Scotch" brand of tape products, which by the 1990s had come to account for over 90 percent of all sales of transparent tape in the United States. LePage's also makes transparent tape, which it sells to large retailers—like Wal-Mart, Kmart, Staples, Dollar General, CVS, and others—for resale under the retailers' "private labels" instead of the LePage's name. LePage's' private-label business was quite successful. By 1992, LePage's accounted for 88 percent of private-label tape sales in the United States, and those sales were eating into 3M's sales of Scotch-brand tape.

3M reacted in two principal ways. In 1992, 3M began selling its own version of private-label tape, bringing it into head-to-head competition with LePage's for the same large retail accounts.⁶ And in 1993, 3M launched a series of marketing programs aimed at encouraging those retailers to acquire more transparent tape—both branded and private-label—from 3M. 3M offered at least three kinds of programs: (1) volume discounts on its private-label tape; (2) rebates (called "brand mix" rebates) based on the customer's total volume of 3M tape purchases, thus encouraging customers to buy both their "Scotch" brand tape needs and their private-label tape from 3M; and (3) other rebates (part of the "executive growth" and "partnership growth" programs) that were calculated based on the customer's purchases from a range of 3M product lines, not just tape. Some of these programs were custom-tailored to specific customers, so that the level of tape purchases needed to earn maximum rebates was close to 100 percent of the customer's total purchases. And there was at least some evidence that 3M told certain customers that they could only earn

⁵ See 324 F.3d at 146 ("our review of a jury's verdict is limited to determining whether some evidence supports the jury's verdict"); see also, e.g., *id.* at 154, 163.

⁶ The court of appeals referred to "considerable evidence in the record that 3M entered the private-label market only to 'kill it.'" *Id.* at 164.

payments by shifting their business from LePage's to 3M.⁷ In addition to discount programs, 3M negotiated contracts with two smaller retailers that expressly required them to buy all of their private-label tape from 3M for a period of one year. 324 F.3d at 157.

LePage's apparently did not challenge the first type of discounts,⁸ and on that basis it contended that the case did not involve a "predatory pricing" claim. Instead, LePage's argued that 3M's "bundled" rebate programs amounted to a form of exclusive dealing arrangement that foreclosed LePage's from competing on the merits because it did not make branded tape or the other kinds of products included in 3M's programs. According to LePage's, the discounts were payments "conditioned" on exclusivity.⁹ All retailers needed to stock 3M's Scotch-brand tape, and so were already paying 3M a substantial amount of money for tape. 3M's bundled rebates acted as a credit against those purchases that customers could earn only if they shifted all or substantially all of their private-label purchases to 3M and away from LePage's.¹⁰

3M and the dissent pointed out that 3M's rebates involved rather small percentages of 3M's prices on individual products, ranging from 0.2 to 2.0 percent.¹¹ On the other hand, as LePage's and the majority emphasized, those rebates involved payments of millions of dollars, because 3M's customers bought a lot of 3M products.¹² Eager to earn the maximum amount of 3M rebates, many customers did opt to shift sales away from LePage's. LePage's contended that it could not have matched the economic value of 3M's rebates without offering steep, and likely unprofitable, discounts on its smaller base of private-label tape sales. *Id.* at 161. However, LePage's did not attempt to prove that 3M's rebates were below cost by any measure, even if the entire amount of the dollar savings were allocated to 3M's private-label tape sales. *Id.* at 147 n.5. Nor did LePage's try to demonstrate that 3M's rebates made it impossible for LePage's—or a hypothetical firm that was as efficient as 3M¹³—profitably to lower its tape prices far enough to offer a deal that allowed retailers to save as much or more money than under 3M's programs. *Id.* at 177 (dissent).

3M's strategies were partially successful. By 1997, LePage's share of private-label tape sales had declined from 88 to 67 percent, and its profitability had plunged. *Id.* at 170, 175–76 (dissent); see also *id.* at 161. At that point, LePage's played its antitrust card, challenging 3M's course of conduct under both Section 1 and Section 2 of the Sherman Act, and Section 3 of the Clayton Act. After more than two years of litigation, a jury found in favor of LePage's on its Section 2 monopolization claim.¹⁴ The district court declined to overturn the verdict, and 3M appealed. On appeal, neither market definition nor 3M's status as a monopolist was at issue. 3M did not contest the jury's conclusion that the relevant market consisted of all transparent tape sales—both branded and private-label—in the United States, and that 3M possessed monopoly power in that market.¹⁵ The only significant issue was whether 3M had willfully maintained that power.

⁷ *Id.* at 154, 158–59; LePage's Brief at 8–12.

⁸ See LePage's Brief, at 63–64.

⁹ *Id.* at 8.

¹⁰ *Id.* at 40–41; see also, e.g., *id.* at 14–15.

¹¹ 324 F.3d at 170–71 (dissent); see also Brief of Appellant Cross-Appellee at 14–15 (Mar. 29, 2001) (3M Brief).

¹² 324 F.3d at 154; LePage's Brief at 45–47.

¹³ LePage's apparently conceded that it was less efficient than 3M. 324 F.3d at 177 (dissent).

¹⁴ The jury rejected LePage's Sherman § 1 and Clayton § 3 exclusive dealing claims. The jury found for LePage's on its "attempted maintenance of monopoly power" claim, which the district court and the court of appeals found insufficient as a matter of law to state a § 2 claim. 324 F.3d at 145.

¹⁵ 3M Brief at 9.

The En Banc Court's Decision

At the court of appeals, the case was a war between two diametrically opposed views of how Section 2 of the Sherman Act should be applied in the context of a claim involving price discounts. Initially, a divided Panel of the Third Circuit sided with 3M's view and reversed the district court's judgment.¹⁶ It viewed the case as involving a form of predatory pricing claim, which failed as a matter of law because LePage's made no effort to prove that 3M's prices were below cost—or at least that LePage's was an equally efficient competitor and could not profitably match 3M's discounts. 277 F.3d at 376, 380–81. The Panel dealt with the Third Circuit's 24-year old decision in *SmithKline Corp. v. Eli Lilly & Co.*, 575 F.2d 1056, 1065 (3d Cir. 1978), which had affirmed a finding of Section 2 liability based on a similar bundled discount program, by distinguishing the case. Unlike in *SmithKline*, LePage's had not proven that it could not compete in the face of 3M's rebate programs. 277 F.2d at 378.

A vehement dissent by Judge Sloviter was followed by an order vacating the Panel decision and setting the case for rehearing en banc. The en banc court reversed field 180 degrees. In an opinion written by Judge Sloviter,¹⁷ the court reached the following conclusions:

- **Brooke Group.** The court swiftly rejected 3M's efforts to have the case treated under the standard applicable to predatory pricing cases. It suggested that *Brooke Group*¹⁸ should not be read as applying to pricing by a monopolist, and may not even stand for the proposition that “a company's pricing action is legal if its prices are not below costs.” 324 F.3d at 151. But even if *Brooke Group* did establish a safe harbor for a monopolist's above-cost pricing, the case did not help 3M because LePage's did “not make a predatory pricing claim.” *Id.*
- **The Cavalcade of Supreme Court Precedent.** To help it chart a course that bypassed the shoals of predatory pricing law, the court recited in detail the evolution of the Supreme Court's Section 2 jurisprudence in the “modern era.” In six pages of detailed discussion, the court of appeals marched through the last half-century of cases—from *Alcoa* to *Kodak*¹⁹—to reach two basic conclusions. First, the court squarely rejected 3M's “legal theory that after *Brooke Group*, no conduct by a monopolist who sells its product above cost—no matter how exclusionary the conduct—can constitute monopolization.” 324 F.3d at 147, 152.²⁰ Second, the court of appeals derived from *Alcoa* and the other Supreme Court precedents the principle that a monopolist willfully maintains its power in violation of Section 2 whenever it deliberately takes any action that “discourages its customers from doing business with its smaller rival,”²¹ unless the defendant “could explain its actions on the basis of valid business reasons.”²²

At the court of appeals,
the case was a
war between two
diametrically opposed
views of how Section 2
of the Sherman Act
should be applied in
the context of a claim
involving price
discounts.

¹⁶ The Panel decision was reported at 277 F.3d 365 (3d Cir. 2002).

¹⁷ Three judges dissented, including both members of the Panel majority.

¹⁸ *Brooke Group Ltd v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

¹⁹ *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451 (1992).

²⁰ This characterization was a straw man because 3M's position that it could not be held liable absent a showing that its prices were below cost was limited to the context where “LePage's case was all based upon claims about discount prices and rebates.” *3M* Brief at 36, 51. 3M did not seek to establish the broader principle of § 2 jurisprudence that the court rejected.

²¹ 324 F.3d at 150 (quoting *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 610 (1985) (citing in turn *Lorain Journal Co. v. United States*, 342 U.S. 143, 149 (1951))).

²² 324 F.3d at 151 (citing *Kodak*, 472 U.S. at 483); see also 324 F.3d at 152 (referring to the Supreme Court's consistent holdings that a monopolist will violate § 2 if it “engages in exclusionary or predatory conduct without a valid business justification”).

- **Bundled Rebates as Exclusionary Conduct.** The court of appeals readily found that there was sufficient evidence supporting the jury's determination that 3M's bundled rebates were "exclusionary" and "could reasonably have been viewed as effectuating exclusive dealing arrangements because of the way in which they were structured." *Id.* at 154. The court first characterized 3M's rebates as having provided "powerful incentive[s] . . . to customers to purchase 3M tape rather than LePage's in order not to forgo the maximum rebate 3M offered." On this view of the world, 3M's price reductions amounted to six or seven figure "penalties" for choosing LePage's. *Id.*

Next, the court cited a leading treatise for the proposition that bundled rebates have an "inherent anticompetitive effect," even when they yield "aggregate prices above cost."²³ This characterization was puzzling in light of the treatise's statement—quoted by the court just one paragraph later—that the authors presume that the "anticompetitive case . . . is in the minority."²⁴ In any event, the court of appeals explained that it regarded bundled rebates as anticompetitive because they "may foreclose portions of the market to a potential competitor who does not manufacture an equally diverse group of products and who therefore cannot make a comparable offer." *Id.* at 155.

Finally, the court turned to *SmithKline* as support for its conclusion that bundled rebates are anti-competitive. The *SmithKline* case addressed the market for cephalosporins, in which Lilly was dominant and SmithKline was an upstart competitor. SmithKline challenged Lilly's multi-line volume rebates, which had led hospitals to "conjoin their purchases" of one of Lilly's cephalosporins (Kefzol) with two others (Keflin and Keflex) that were Lilly's "leading sellers." *Id.* at 156 (quoting *SmithKline*, 575 F.2d at 1061). Kefzol was the private-label tape of its era: "less expensive but otherwise of similar quality" to Lilly's Keflin and Keflex. SmithKline offered its own "cheaper" cephalosporin, Ancef, but Lilly's bundled rebates made it difficult for SmithKline to compete. It would have had to offer discounts on Ancef ranging from 16 to 35 percent in order to provide the same "net dollar amount" as Lilly could provide with a "3% bundled rebate" on its larger volume of cephalosporin sales. 324 F.3d at 156 (quoting *SmithKline*, 575 F.2d at 1062). This bundling was unlawful monopolization because the jury could have found that "the result was [for Lilly] to sell all three products on a non-competitive basis in what would have otherwise been a competitive market for Ancef and Kefzol," and that "SmithKline's prospects for continuing in the cephalosporin market under these conditions [were] poor." *SmithKline*, 575 F.2d at 1065.

- **"Exclusive Dealing."** The court of appeals also concluded that 3M's bundled rebates were exclusionary "exclusive dealing practices." 324 F.3d at 159. Even though 3M's payments to retailers were not expressly exclusive, the jury could have found that they were "designed to induce [customers] to award business to 3M to the exclusion of LePage's." *Id.* at 158. The court relied on *Tampa Electric*²⁵ for the proposition that an arrangement need not contain any "express exclusivity requirement" in order to be treated as exclusive dealing (324 F.3d at 157), and it relied on the D.C. Circuit's *Microsoft* decision²⁶ for the proposition that exclusive dealing can support a Section 2 violation even if it forecloses substantially less than 100 percent of the market (324 F.3d at 158–59). The court of appeals had no difficulty concluding that the jury could have found that at least some of 3M's customers regarded its bundled dis-

²³ 324 F.3d at 155 (citing PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 749, at 83 (Supp. 2002)).

²⁴ AREEDA & HOVENKAMP, *supra* note 23.

²⁵ *Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320, 327 (1961).

²⁶ *United States v. Microsoft Corp.*, 253 F.3d 34, 69–71 (D.C. Cir.) (en banc), *cert. denied*, 534 U.S. 952 (2001).

counts as amounting to “all-or-nothing” offers that required the customer to give 3M all of its tape business in order to earn the maximum level of rebate. *Id.* at 159.

- **Anticompetitive Effects.** The next step in the court of appeals’ analysis was its conclusion that there was sufficient evidence for the jury to find that the “long-term effects of 3M’s conduct were anticompetitive.” *Id.* at 163. It is unclear why the court paused to consider this issue, since it had already said more than once that the jury could have found that 3M’s conduct violated Section 2. *Id.* at 159. In any event, the outcome of this step in the court’s analysis was not in doubt given the court’s earlier conclusion that 3M’s actions were exclusionary. The court set a very low threshold for finding anticompetitive effects: whenever a monopolist acts to prevent one or more new or potential competitors from gaining a foothold in the market by exclusionary conduct, “its success in that goal is not only injurious to the potential competitor but also to competition in general.” *Id.* To the court of appeals, 3M’s success spoke for itself. 3M’s rebates hurt LePage’s. As the court of appeals explained, the “discount LePage’s would have had to provide to match the discounts offered by 3M through its bundled rebates can be measured by the discounts 3M gave or offered.” Those discounts were indeed large in dollar terms. Had LePage’s matched them, it would have suffered a reduction in earnings “calculated by comparing the discount that LePage’s would have been required to provide.” *Id.* at 161. “That amount,” the court held, “would represent the impact of 3M’s bundled rebates on LePage’s ability to compete, and that is what is relevant under § 2 of the Sherman Act.” *Id.* (emphasis added).²⁷

To the court of appeals,

3M’s success spoke for

itself. 3M’s rebates

hurt LePage’s.

This comment appears to suggest that harm to LePage’s was enough to make 3M’s conduct “anticompetitive,” but the court of appeals also observed that 3M’s conduct “harmed competition itself, a *sine qua non* for a § 2 violation.” *Id.* at 162. In part this was the obvious consequence of LePage’s being 3M’s only domestic competitor. The court also cited evidence from 3M’s files indicating that 3M desired to do away with the private-label segment altogether so that it could charge higher prices for its premium Scotch-brand tape. *Id.* at 163. That evidence was relevant because “intent is relevant to proving monopolization.” *Id.* And the court noted that there was substantial evidence that barriers to entry existed in the transparent tape market. *Id.*

- **Business Justifications.** Having found 3M’s conduct exclusionary, and, for good measure, anticompetitively so, the court turned to consider whether 3M’s actions were “carried out for ‘valid business reasons,’ the only recognized justification for monopolizing.” *Id.* (quoting *Kodak*, 504 U.S. at 483). The court’s analysis proceeded in three steps. First, the court rejected the contention that 3M’s conduct was justified simply because 3M was acting “in furtherance of its economic interests.” *Id.* The court observed that “it can be assumed that a monopolist seeks to further its economic interests and does so when it engages in exclusionary conduct,” and stated that this motivation alone is *never* a “valid business reason.” *Id.* at 164.

Second, the court considered whether 3M had borne its burden of persuading the jury that its conduct was justified by “actual economic efficiencies” (*id.*) or the “enhancement of consumer welfare.” *Id.* at 163 (quoting *Data General Corp. v. Grumman Systems Support Corp.*, 36 F.3d 1147, 1183 (1st Cir. 1994)). The “millions of dollars 3M returned to customers in bundled rebates”

²⁷ This impact, the court noted, was also “apparent” from the declines in earnings and sales that LePage’s realized while 3M’s rebate programs were in effect. 324 F.3d at 161.

(*id.* at 164) did not suffice. Instead, 3M apparently was required to show that the bundling of its products achieved real cost savings through, for example, the use of single invoices or single shipments. 3M had not attempted such a showing. *Id.*

Finally, the court noted that there was evidence indicating that the proffered justifications were not the real motivation for 3M's conduct. The jury was entitled to conclude, for example, that 3M had "entered the private-label market only to 'kill it.'" *Id.* (quoting internal 3M document). That, the court held, is "precisely what § 2 prohibits." *Id.*²⁸

The Dissent

The dissenting opinion, authored by the same judge (Greenburg, J.) who wrote the vacated opinion for the Panel majority, and joined by two other members of the court, made five principal points:

- The trial record suggested that there were many causes for LePage's' loss of share in the private-label segment other than 3M's discounting practices. *Id.* at 171–73.
- The majority misapplied *SmithKline*, because LePage's did not demonstrate (or even try to prove) that it could not profitably "match the rebates 3M paid to particular customers." *Id.* at 175.
- LePage's should not be allowed to prevail without showing that 3M's pricing was below cost (*id.* at 173), or at least satisfying the "stricter tests devised by other courts considering bundled rebates" by proving that a single-product competitor that was as efficient as 3M could not profitably match 3M's linked multi-product rebates. *Id.* at 177.
- 3M's conduct was justified by a valid business reason because, unlike in *Aspen Skiing* and other cases, 3M was not acting against its short-run economic interests. *Id.* at 178–79. Instead, it was behaving in a way that "likely increased its sales." *Id.* at 179.
- LePage's' claim that 3M entered into two expressly exclusive contracts was "attenuated" in light of LePage's' ability to retain a "two-thirds share of the private label business," and the two contracts could not have been responsible for the "total drop" in LePage's' business. *Id.* at 180.

The Aftermath

The Third Circuit's Panel decision in *LePage's*, which had overturned the jury verdict against 3M, left the precise standard applicable to Section 2 claims against bundled rebates substantially in doubt. The en banc court's decision to vacate that decision and rehear the case created even more uncertainty and raised a number of interesting questions about how the full court would decide the case.²⁹ The en banc decision in *LePage's* now provides resounding answers to some of those questions.

In the arena of bundled discounts and other complicated pricing arrangements, there is no doubt that *LePage's* will have significant consequences for the behavior of firms with large market shares. But *LePage's* may cast a longer shadow that influences how litigants and courts approach the difficult task of distinguishing legitimate competition by a monopolist from unlawful

²⁸ The majority opinion also addressed and rejected 3M's claims that the court improperly calculated damages and used jury instructions that provided inadequate guidance. 324 F.3d at 164–69.

²⁹ Many of those questions were considered last May in this publication. See David L. Meyer & Raymond A. Atkins, *LePage's v. 3M: Will the Third Circuit Make Brooke Group Stick in Assessing the Legality of a Monopolist's Bundled Discount Programs?*, ANTITRUST SOURCE (May 2002), available at <http://www.abanet.org/antitrust/source/may02/legality.pdf>.

“exclusion” in many diverse settings. If that is the case, the decision will be a boon for competitors eager to rein in aggressive competition by their larger rivals.

What Did the Court Decide? *LePage’s* weighs in heavily on three key questions that are central, not only to the treatment of bundled discounts and other complex price structures, but to the law of monopolization generally.

1. Price Level vs. Price Structure: When Do Low but Non-Predatory Prices Become “Exclusionary” Prices?

The clearest and most significant holding of *LePage’s* is that claims against a monopolist’s bundled rebates programs should not be analyzed as predatory pricing claims. This means that, under *LePage’s*, plaintiffs need not attempt to prove that the defendant’s prices were below costs. The Panel decision’s somewhat tentative reliance on *Brooke Group* thus turns out to have been more like a “Post-It” (a.k.a. a “repositionable note”)³⁰ than adhesive tape. The en banc court removed it.

This aspect of the court’s decision raises two crucial questions. *First*, what kinds of “pricing” will fall outside the ambit of predatory pricing law. The court purports to distinguish between single-product “volume discounts”—which it regarded as “concededly legal” (324 F.3d at 154)—and 3M’s rebate programs, which involved more than one product and in many instances multiple product lines. The latter—no matter how far above 3M’s costs—are not eligible for analysis under the rubric of “predatory pricing” law for the simple reason that *LePage’s* did not make all of the products that 3M’s programs linked.

Less clear is what pricing actions other than simple volume discounts will run afoul of *LePage’s*. The apparent rationale of the court’s decision—that the plaintiff, no matter how efficient, cannot “match” the defendant’s discounts—would seem to cast a fairly wide net capable of snaring many unwary discounters. Programs that link products across multiple markets in which a plaintiff does not compete are certainly at risk if the defendant has monopoly power. But any linkage across products within a single product line appears equally vulnerable under *LePage’s*. Many of 3M’s offending rebates did not involve products outside the market in which 3M had a monopoly. Instead, they linked 3M’s various transparent tape products (Scotch brand and private-label), all of which *LePage’s* alleged and 3M conceded were in the same market as the tape *LePage’s* produced. Because *LePage’s* chose to compete only in one segment of that market—private-label—3M’s decision to link its private label prices with purchases of other 3M tape caused those prices to be viewed as potentially “exclusionary” rather than “predatory” under the rubric of *Brooke Group*.³¹

LePage’s’ lawyers argued that the distinction between 3M’s conduct and the kind of pricing amenable to treatment under predatory pricing principles was that 3M’s conduct concerned “price structure” rather than merely “price levels.”³² The Third Circuit did not quite endorse that view, but it did not explicitly reject it either. Indeed, a key theme of the court of appeals’ decision is that *LePage’s*’ ability to match the *value* of 3M’s rebate programs was irrelevant; what mattered was *LePage’s*’ inability to provide the same kind of program because it lacked 3M’s multi-product scope.

On this theory, creative lawyers may well argue that the rationale of *LePage’s* should apply to any pricing that is more complicated than a mere reduction in price level and which the plaintiff cannot match tit-for-tat. A wide array of pricing programs may be vulnerable under this approach.

³⁰ 3M Brief at 7.

³¹ In this regard, *LePage’s* is not different from *SmithKline*. *SmithKline* similarly addressed pricing programs that were limited to multiple products within a single market—albeit decades before *Brooke Group*.

³² *LePage’s* Brief at 63.

The clearest and most significant holding of *LePage’s* is that claims against a monopolist’s bundled rebates programs should not be analyzed as predatory pricing claims.

“Monopolists” will often have a base of sales that includes many brand-loyal customers, making it impossible for the upstart competitor to “match” the defendant’s volume or market share targets. Nor would it be a stretch to argue that, under *LePage’s*, single-product volume or market share discounts fall outside the predatory pricing rubric when they are structured so as to “condition” a customer’s maximum discount levels on the customer buying so much of the defendant’s product that the customer has no interest in the plaintiff’s competing product. No less than 3M’s rebates, which *LePage’s* argued were conditioned in this way, such programs could be deemed “exclusive dealing” under the rationale of *LePage’s*. *See id.* at 159.³³

This uncertainty about the sweep of *LePage’s*’ rationale begs a second, more serious question, to which the court does not provide a satisfactory answer. Why should structured discounts be treated differently than unstructured discounts? So far as the record discloses, 3M’s rebates were no more harmful to *LePage’s* than an equal number of dollars off of 3M’s private-label prices. Stated another way, although *LePage’s* offered evidence that customers were induced to shift their purchases to 3M to take advantage of 3M’s rebates, there was no evidence that the structure of 3M’s prices, as distinct from their level, mattered to the decisions of these customers.

To be sure, the court emphasized that the multi-product character of 3M’s programs allowed it to provide customers with big dollar savings without reducing its prices very much. *LePage’s* would not have been able to provide the same number of dollars without quite significant price reductions, and the court may have inferred that it was truly impossible for any single-product firm—no matter how efficient—to compete on the merits in this environment. But the court of appeals did not require *LePage’s* to offer evidence proving that proposition. And because it did not insist on such proof, the decision could be read as insulating *LePage’s* and similarly-situated competitors from the occasional need to make big price reductions.

One reason the court may have been reluctant to apply predatory pricing principles was its apparent perception that the relationship between 3M’s prices and 3M’s costs could only be performed on an “aggregate” basis for the entire “bundle” of linked products. *See id.* at 155. If that were so, applying predatory pricing standards probably would give a multi-product monopolist unduly wide latitude to price “above cost” and at the same time undermine effective competition by an efficient single-product rival.³⁴ But such an approach was not the only way that *LePage’s* might have shown that 3M’s prices were predatory. As cautiously suggested in 3M’s brief, *LePage’s* might have attempted to demonstrate that 3M’s rebates, if allocated to the one 3M product with which *LePage’s* competed, would render 3M’s effective price for that product below its costs for that product.³⁵ Alternatively, *LePage’s* might have attempted to make the showing—suggested in *Ortho*³⁶—that a (hypothetical) company that was as efficient as 3M, but which only sold private-

³³ *See also* 324 F.3d at 154 (jury could have viewed the rebates as “effectuating exclusive dealing arrangements because of the way in which they were structured”).

³⁴ This “aggregate” approach for assessing the price-cost relationship in a multi-product setting has led other commentators to conclude that exclusionary rebates should not be analyzed as predatory pricing. AREEDA & HOVENKAMP, *supra* note 23.

³⁵ 3M Brief at 43; *see also* Willard K. Tom, David A. Balto & Neil W. Averitt, *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 ANTITRUST L.J. 615, 628–29 (2000) (noting that volume-based incentive discounts can be incentives to exclusivity and can also be viewed “as predatory under the usual cost-based tests” if the discount, when ascribed to the incremental units that generate the discount, results in marginal prices below marginal costs).

³⁶ *Ortho Diagnostic Sys., Inc. v. Abbott Labs., Inc.*, 920 F. Supp. 455, 467–69 (S.D.N.Y. 1996).

label tape, could not profitably match 3M's rebates by reducing its prices.³⁷ These two tests appear to be equivalent, because an equally-efficient single-product competitor *could* profitably match 3M's rebates unless and until those rebates became so large that, if allocated entirely to 3M's private-label sales, would bring the effective price for private-label tape below 3M's costs. However, LePage's did not attempt either showing. Nor, for the most part, does the record indicate that it even attempted in the market place to match the dollars available under 3M's discount programs.

The two key factors that the court of appeals discussed in explaining its conclusion that 3M's bundled rebate programs were exclusionary should send a chill down the spine of any firm with a large market share that desires to retain its market position.

Absent any showing that 3M's rebates affected LePage's (much less a hypothetically efficient single-product competitor) differently than a steep but above-cost discount on 3M's own private-label sales, the case became indistinguishable in substance—if not in form—from single-product volume discounts, such as those at issue in *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000). *Concord Boat* applied *Brooke Group* to overturn a Section 2 judgment against an alleged monopolist's above-cost market share discount programs that, like the 3M programs in *LePage's*, strongly encouraged but did not compel customers to buy from the defendant instead of the plaintiff. The Eighth Circuit, unlike the Third in *LePage's*, emphasized that above-cost discounting is generally desirable and cannot be controlled without “courting intolerable risks of chilling legitimate price cutting.” *Concord Boat*, 207 F.3d at 1061 (quoting *Brooke Group*, 509 U.S. at 223). The court of appeals in *LePage's*, by contrast, did not so much as hint that it regarded the millions in rebates paid by 3M as potentially beneficial to consumers and competition.

2. If It's Not “Predatory” Pricing, What Is the Standard? The court of appeals also had a great deal to say about when conduct by a “monopolist” that does not qualify for treatment as predatory pricing is “exclusionary” under Section 2. On this issue of quite general interest to firms with large market shares—not just those with complex bundled rebate programs—the court of appeals did not offer a neat and tidy “standard” for judging when conduct might be deemed exclusionary. Instead, it took refuge in the jury's verdict and emphasized the breadth of Section 2, quoting the D.C. Circuit's comment that “anticompetitive conduct” comes in “too many different forms, and is too dependent upon context, for any court or commentator ever to have enumerated all the varieties.”³⁸

The two key factors that the court of appeals discussed in explaining its conclusion that 3M's bundled rebate programs were exclusionary should send a chill down the spine of any firm with a large market share that desires to retain its market position. The first, and apparently independently sufficient, factor was harm to LePage's. 3M's conduct caused LePage's to lose sales because it could not (or chose not to) match the deals 3M was able to offer customers. The court's discussion of the “anticompetitive effect” of 3M's bundled rebates provides the clearest indication that it viewed the harm caused LePage's as sufficient to treat 3M's conduct as exclusionary. That discussion focused on the fact that 3M's payments to customers encouraged them to buy 3M's tape, and LePage's could not match 3M's payments by discounting its own private-label tape without suffering reduced profits because of its more limited base of sales. 324 F.3d at 161–62.

³⁷ The *Areeda-Hovenkamp* treatise endorses this as the proper test for assessing whether a monopolist's bundled discounts are anticompetitive. AREEDA & HOVENKAMP, *supra* note 23 (“we would require [LePage's] to show that a hypothetical equally efficient firm making only one of the products subject to the bundled rebate could not have competed successfully”). The treatise criticizes the *LePage's* Panel dissent, which focused on LePage's inability to compete, as being “overly solicitous of small firms” and “den[ying] customers the benefits of the defendants lower costs.” *Id.* at 82. Ironically, the en banc majority (incorrectly) cites the same section of this treatise in support of its view that bundled discounts have an “inherent anticompetitive effect.” 324 F.3d at 155.

³⁸ *Id.* at 152 (quoting *Caribbean Broad. Sys. Ltd. v. Cable & Wireless PLC*, 148 F.3d 1080, 1087 (D.C. Cir. 1998)).

Equally troubling was the fact that the court did not articulate any threshold for the magnitude of harm required to make conduct exclusionary. In LePage's case, the company lost a meaningful amount of sales and its profits evaporated, but the evidence does not appear to have shown that LePage's suffered a permanently disabling blow. LePage's was not driven out of business, and it still retained 67 percent of the private-label segment when it filed suit. *Id.* at 170 (dissent). Had LePage's been merely one of many rival sellers of transparent tape, harm to LePage's alone might not have been sufficient to constitute exclusion. But LePage's was one of very few tape manufacturers, and the court emphasized that LePage's' harm was equivalent to harm to "competition in general" because "even the foreclosure of "one significant competitor" from the market may lead to higher prices and reduced output."³⁹

The second key factor in the court's analysis was evidence of 3M's *intent* to do away with LePage's and the entire "lower priced" private-label segment of the tape market. *Id.* at 162–163. As the court noted, the "Supreme Court had made clear that intent is relevant to proving monopolization." *Id.* at 163 (citing *Aspen Skiing*, 472 U.S. at 602).

These two factors, however, would seem to be present in many if not most situations where a "monopoly firm" is able to hold onto its market share in the face of competitive challenges. Presumably the successful monopolist will always have caused competitors to lose share, or never to have gained a foothold, and the roster of potential rivals often will be slim. The monopolist will have been able to do something that takes advantage of its existing position and consumers' preferences that would-be challengers cannot successfully match, causing them to lose sales and profits. And presumably the monopolist will always have desired—i.e., intended—that outcome. To be sure, the factual record will not always lead a court or jury to conclude that the monopoly firm foreclosed competition on the merits through its actions, and so the standard—or lack thereof—of *LePage's* will not always be applied to condemn such firms when they prevail in the market. But the case certainly provides little comfort for potential Section 2 defendants.

The potentially overbroad reach of the court's view of exclusionary conduct under Section 2 is reinforced by its praise of the *Alcoa* case as the first of the "modern era." Although the court of appeals accepts Judge Hand's conclusion that that "a firm does not monopolize if monopoly is "thrust upon it" (*Alcoa*, 148 F.2d at 429), it quickly adds that "size carries with it an opportunity for abuse that is not to be ignored" (*id.* at 430 (quoting *Swift*, 286 U.S. at 116)), and emphasizes the portion of Judge Hand's ruling in *Alcoa* that criticized Alcoa's "doubling and redoubling of capacity" (148 F.2d at 431) as an exclusionary practice in violation of Section 2. 324 F.3d at 148. *Alcoa* has been widely criticized as having articulated no coherent standard for distinguishing lawful and unlawful behavior by a monopolist and as suggesting "that a firm with monopoly power might violate Section 2 by pursuing normal commercial conduct that is generally considered procompetitive if the effect of such conduct is to enhance its market position."⁴⁰

3. Will a Strong "Business Justification" Undo the Damage? The court's only recognition that there might be situations in which conduct that harms a competitor, or is intended to do so, should be allowed to survive Section 2 scrutiny is its acknowledgement that monopolists may justify their conduct by proving "valid business reasons." That acknowledgement is a possible silver lining in an otherwise bleak decision for firms with large market shares. On closer examination, however, the silver turns to gray.

³⁹ 324 F.3d at 159 (quoting *Roland Mach. Co. v. Dresser Indus., Inc.*, 749 F.2d 380, 394 (7th Cir. 1984)).

⁴⁰ ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 247 (5th ed. 2002).

According to the court, a monopolist's desire to hold onto its sales—and win sales from smaller rivals—through aggressive use of above-cost price reductions is not a “valid” justification.

According to the court, a monopolist's desire to hold onto its sales—and win sales from smaller rivals—through aggressive use of above-cost price reductions is not a “valid” justification. As the court stated, “[m]aintaining a monopoly is not the type of valid business reason that will excuse exclusionary conduct.” 324 F.3d at 164. Instead, to establish a valid business reason the defendant apparently bears the burden of proving concrete cost savings or other efficiencies of such a magnitude as to outweigh any impact on competitors. In *LePage's*, 3M failed this test because it had merely “allude[d]” to benefits to customers from “single invoices and single shipments,” *id.*, and the court saw no evidence of “actual economic efficiencies,” much less of cost savings that approached the “millions of dollars 3M returned to customers in bundled rebates.” *Id.*

The court's unwillingness to treat the millions 3M “returned to customers” as having any potentially procompetitive weight in the Section 2 calculus is hard to fathom. Just because 3M's rebates sapped *LePage's*' sales and profits does not alter the fact that consumers reaped millions in savings. It is no answer to suggest, as the court does, that those rebates “did not benefit the ultimate consumer” because many of 3M's retail customers may not have passed them on. *Id.* at 163 (quoting district court opinion). This perspective reflects an unduly narrow view of the consumer welfare purposes of the antitrust laws, which treat 3M's retail customers as consumers to the same extent as the “ultimate consumers” that the court apparently preferred to protect.⁴¹ To the extent that *LePage's* was harmed by the mere fact that 3M's rebates effectively lowered 3M's price for private-label tape, that harm stemmed from the “very essence of competition”⁴² and cannot be regarded as “unjustified”—and thus forming the basis for Section 2 liability—without gutting the law's core procompetitive purposes.⁴³

The court's apparent insistence on a tight correlation between the defendant's conduct and “actual economic efficiencies” would have made more sense if the court had framed the question differently. It could have asked, first, whether the way 3M's rebates were structured (e.g., the “linkage” to other products) had an adverse effect on *LePage's* different from that of an equivalent above-cost reduction in the *level* of private-label tape prices alone, and, second, whether the *incremental* effect was justified by some reason other than the desire to harm *LePage's*. In that situation, the court would have focused on the pernicious effects, if any, of 3M's pricing structure rather than treating as evil the beneficial effects of the reduction in price levels that went along with that structure.

A more economically justified inquiry of this nature might have been carried out in several ways. The court might have asked whether the structure of 3M's pricing made “business sense” but for its effect of precluding *LePage's* from profitably matching 3M's rebates. Such an inquiry is similar to that applied by the Supreme Court in *Aspen Skiing*, where the defendant's conduct was found unlawful because the defendant had elected to forgo the short-term benefits of a profitable multi-mountain ticketing arrangement in favor of “reducing competition . . . over the long run.” *Aspen Skiing*, 472 U.S. at 608, 610–11. The federal antitrust agencies have similarly observed that in

⁴¹ For example, the court's perspective is inconsistent with Supreme Court precedent preventing the offensive or defensive use of “passing on.” *Hanover Shoe, Inc. v. United Shoe Machinery Corp.*, 392 U.S. 481 (1968), generally precludes an antitrust defendant from avoiding an antitrust claim by asserting that its direct customer passed on higher prices to the “ultimate customer,” while *Illinois Brick Co. v. Illinois*, 431 U.S. 720 (1977), generally prevents the “ultimate consumer” to whom higher prices were passed on from asserting a claim.

⁴² *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 594 (1986).

⁴³ See *Concord Boat*, 207 F.3d at 1062–63.

cases asserting a duty to assist rivals, “conduct is not ‘exclusionary’ or ‘predatory’ would make no economic sense for the defendant but for its tendency to eliminate or lessen competition.”⁴⁴

Alternatively, the court might have explicitly attempted to balance the anticompetitive aspects of 3M’s price structure (i.e., the exclusionary effects exceeding those of an above-cost single-product discount) against the procompetitive benefits of that pricing structure. Such an inquiry would have been similar to the usual weighing of procompetitive benefits against anticompetitive harms that occurs in applying Section 1’s rule of reason, and may have been close to the Section 2 balancing process suggested by the D.C. Circuit in *Microsoft*.⁴⁵ It would surely have included the beneficial aspects of the price reductions on the procompetitive side of the calculus.

But the court did neither because it skipped the essential first step of sorting out whether 3M’s pricing conduct had any effects beyond those of a per se lawful above-cost single-product price reduction. This placed 3M in an untenable position of having not only to justify its choice of pricing structure but to show that the structure achieved efficiencies equal to the millions in price reductions 3M offered its customers.

And it also placed LePage’s’ claims before the jury in a context where the court’s jury instructions offered precious little guidance for distinguishing lawful price competition by a monopolist from illegal monopolization. The jury was asked whether 3M’s conduct tended to “impair the opportunities of its rivals . . . in an unnecessarily restrictive way.” 324 F.3d at 167. And it was told that 3M could not be held liable if it engaged in “ordinary competitive behavior “ or “the conduct of business that is part of the normal competitive process.” Instead, to violate Section 2, 3M’s conduct must “represent conduct that has made it very difficult or impossible for competitors to engage in fair competition.” *Id.* at 168. These instructions apparently were modeled on the ABA sample jury instructions and those given in *Aspen Skiing*, but they appear to have left the jury at sea in attempting to determine whether the quite obvious pain LePage’s suffered as a result of 3M’s pricing programs constituted something more than the “normal competitive process” and “fair competition.”

What Can Defendants Do to Avoid Condemnation (if They Cannot Avoid the Third Circuit)? The *LePage’s* case is a dangerous one for firms with large market shares that are not content to sit back and watch their market position erode. If the Supreme Court leaves the decision intact, the case will provide potential plaintiffs with an important weapon against their more successful, larger rivals. Potential defendants will face potential Section 2 condemnation, and significant treble damages, if their competitive strategies cost rivals sales or profits⁴⁶ and a jury can be persuaded that those strategies did not constitute “fair” competition. However, there are a few steps defendants can take to minimize the risks created by *LePage’s* even if they cannot avoid having their conduct judged in the Third Circuit.

Strategy One: Stick to Single-Product Volume Discounts. The easiest way to avoid direct application of *LePage’s* is for firms to limit their competitive strategies to above-cost single-product price reductions or unstructured volume discounts. Such discounts are “concededly legal” according to the court of appeals. 324 F.3d at 154.

The easiest way to avoid direct application of LePage’s is for firms to limit their competitive strategies to above-cost single-product price reductions or unstructured volume discounts.

⁴⁴ No. 02-682, Brief for the United States and the Federal Trade Commission as Amici Curiae Supporting Petitioner, *Verizon Communications Inc., v. Law Offices of Curtis V. Trinko, LLP* at 15 (U.S. filed May 2003).

⁴⁵ *Microsoft*, 253 F.3d at 58–59.

⁴⁶ *LePage’s* was awarded over \$65 million in damages, after trebling, based on testimony by *LePage’s*’ expert about the profits it would have earned had 3M’s conduct not caused *LePage’s* to lose market share and forgo anticipated growth. *See* 324 F.3d at 164–65.

More generally, conduct by defendants with “monopoly” power will be viewed with less hostility if they refrain from establishing any linkages between their “monopoly” product and other products they produce, including products in the same line. As the court of appeals’ analysis illustrates, such linkages have an inherent potential to create the impression that rivals are being disadvantaged for reasons unrelated to their ability to compete on the merits in the market at issue.

Strategy Two: Be Prepared to Demonstrate the Efficiencies the Firm’s Behavior Achieves. Pursuing Strategy One alone probably will be unsatisfactory in many cases because creating linkages among products often has the potential to enhance efficiency and meet customer demand.⁴⁷ Where those motivations spur firms with high market shares to consider offering bundled discount programs, the LePage’s decision counsels strongly in favor of taking two key steps first:

- Educate company personnel—including through vigorous antitrust compliance programs—not to devise strategies aimed at preventing rivals from competing on the merits. Also help that personnel understand the importance of perceptions, so that they do not author documents that might be misunderstood as suggesting a desire to do away with competitors or raise prices in the long run, as distinct from a desire to retain or grow business by offering a value proposition that customers prefer. Stated another way, a monopolization case is more likely to go badly if a jury sees documents that say things like “we are doing this to ‘kill’ our competitors so we can raise prices”; and if such documents already exist it would be good to know about them before a discount program or other strategy achieves that effect.
- Equally important, a firm should be prepared to quantify the efficiency benefits that it expects to flow from the proposed course of action. It would be of tremendous value to be able to show a court (or jury, if it comes to that) a serious quantitative analysis, conducted before a program was initiated, that laid out the rationale for the program and its structural elements. Ideally that analysis would demonstrate that a single-product competitor with comparable costs could profitably match the potential price reductions achieved by the program. Even better—and of particular importance if the first analysis does not reach the desired conclusion—would be a more rigorous analysis that quantifies the specific cost savings or other efficiencies that underlie the design of a “bundled” pricing structure that might have the incidental effect of making life difficult for single-product rivals. ●

⁴⁷ Those potential benefits are widely recognized in the law of tying.

Book Review:

Thurman Arnold's International Antitrust Legacy

Wyatt Wells

Antitrust and the Formation of the Postwar World

Columbia University Press ■ 2002

Reviewed by William H. Page

In the decades before the World War II, a new economic philosophy favoring cooperation among competitors challenged the competitive model embodied in the antitrust laws. In the United States, the cooperative model had some successes in, for example, the Webb Pomerene Act of 1918, the associational activities of the 1920s, and the NRA codes of the 1930s. And, of course, antitrust law itself, after some false starts,¹ came to recognize that some forms of cooperation are necessary for efficient production. Outside the United States, however, especially in the economic turbulence following World War I, policymakers adopted such an extreme form of the cooperative model that they not only tolerated but actively assisted the formation and operation of international cartels as means of organizing production. Wyatt Wells's fascinating study shows that America's efforts to project its antitrust policies internationally during and after World War II played a critical role in the destruction of this "cartel ideal," particularly in Western Europe. This ideological transformation had lasting effects for the development of the world economy.

Among the book's many points of interest for antitrust practitioners are its accounts of the formation and operation of cartels. Wells shows that during the prewar period international cartels formed in steel, light bulbs, and rubber, each for different reasons: the steel industry was characterized by high concentration and a homogeneous product; the light bulb industry required extensive sharing of intellectual property; and the rubber industry, although fragmented, enjoyed the supervision of multilateral treaty. By 1939, according to one study, "cartels were active in industries that accounted for 42% of world trade," (p. 25) albeit with varying degrees of success.

In the United States, many of the early New Deal reforms, particularly the NRA, reflected elements of the cooperative ideal. But in his second administration, Roosevelt turned to aggressive antitrust enforcement as central feature of his economic recovery policy, appointing Thurman Arnold to head the Antitrust Division.² Wells reminds us repeatedly of just how radical Arnold's enforcement program was. He quotes, for example, an internal 1942 Division memo that proposed a restructuring of business everywhere in the world (p. 211):

Selling must largely be divorced from manufacture; manufacturing firms must become more narrowly specialized; needless industrial combination, whether vertical or horizontal, must be avoided; and the maximum permitted size in corporate units must approximate the minimum size requisite for efficient,

■
William H. Page
is Marshall M. Criser
Eminent Scholar,
University of Florida
Levin College of Law,
and an Editor of
The Antitrust Source.

¹ See, e.g., *Chesapeake & Ohio Fuel Co. v. United States*, 115 F. 610, 620–21 (6th Cir. 1902).

² See generally ELLIS HAWLEY, *THE NEW DEAL AND THE PROBLEM OF MONOPOLY: A STUDY IN ECONOMIC AMBIVALENCE* (1966).

specialized production. Information about products (advertising) should be provided mainly by disinterested agencies, governmental and private.

The least controversial aspect of the Division's policy program was its opposition to cartels, but even here Arnold took that hostility to new levels, publicly linking Hitler's rise to cartels, and warning darkly of similar threats to democracy in the United States.

Again, Wells reveals the operation of major cartels, this time focusing on links between American firms and the German chemical manufacturer IG Farben. He also offers chronicles the conflicts within the Roosevelt Administration over the role of antitrust in the war mobilization effort. The Division repeatedly insisted that vigorous antitrust enforcement was necessary to sever American firms' involvement with international cartels. Some of the claims were questionable at best. In an important revelation, Wells debunks Arnold's charge—repeated by respected historians to this day—that Standard Oil's deals with IG Farben delayed the development of synthetic rubber essential for the American war effort. Arnold's claims in this and similar cases succeeded in creating a climate of hostility to international cartels. But his vehement insistence on antitrust prosecutions of firms engaged in war production led the Attorney General to cede to the Secretaries of the Army and Navy the power to delay prosecution of antitrust cases that they believed hindered mobilization—a power they wielded freely.³ Arnold also made enemies by repeatedly challenging the actions of the War Production Board on competition grounds. Finally, Roosevelt rid himself of Arnold by appointing the combative Assistant Attorney General to the D.C. Circuit.

Nevertheless, the administration's actions against cartels continued in a variety of contexts, such as farm and regulatory programs, and especially in planning for postwar international trade policies. And the Antitrust Division, despite its setbacks in 1943, resumed its challenges to international agreements, some of which it mischaracterized as cartels. Wells describes a number of Division prosecutions in the immediate postwar period that led to important Supreme Court decisions like *National Lead*, *Line Material*, and *Timken Roller Bearing*.

The most dramatic application of the Antitrust Division's radical policies, however, was in the postwar decartelization and deconcentration programs in occupied Germany and Japan. In both countries, representatives of the Division and their ideological allies sought to impose a restructuring of industry far more extreme than anything conceivable in the United States. Proponents of these policies argued that the German cartels and Japanese Zaibatsu played central roles in the emergence of warlike totalitarian regimes in their respective countries, and that the occupiers must reshape the countries' economies if they hoped to institute democratic reforms. In Germany, the decartelization policy was largely successful, but the more ambitious and dubious deconcentration program fell far short of its most zealous advocates' dreams, although there was a significant restructuring of I.G. Farben. Wells concludes that the occupation policies ultimately succeeded in instilling an antitrust sensibility in Germany, because antitrust ideas accorded well with the process of liberalization in the western zones of occupied Germany and throughout Europe.

The anti-Zaibatsu program, however, was essentially a failure, despite the exclusive American control of postwar Japan's economy and political system. There, as in Germany, an American commission prescribed an extreme program of dissolution of large firms, but the collapse of the Japanese economy and the rise of the Soviet threat prevented any substantial implementation.

*In an important
revelation, Wells
debunks Arnold's
charge—repeated by
respected historians to
this day—that Standard
Oil's deals with IG
Farben delayed the
development of
synthetic rubber
essential for the
American war effort.*

³ See Richard M. Steuer & Peter A. Barile, *Antitrust in Wartime*, ANTITRUST, Spring 2002, at 71.

American policy shifted instead toward promoting recovery. After the occupation, Japanese authorities reversed the few moderate antitrust reforms that Americans had effected. The Japanese Fair Trade Commission, Wells observes, allowed the Zaibatsu to reemerge as Keiretsu and allowed cartels to spread throughout the economy in order to foster “rationalization.” Wells attributes the failure of antitrust in Japan to the hostility of government officials and the virtual absence of foreign trade until well into the 1950s.

In a final chapter, Wells describes the post-war operation of international cartels in oil and steel, and the antitrust policies adopted in response to them. He describes the Antitrust Division’s attempt to prosecute the major oil producers, only to be thwarted by orders from Presidents Truman and Eisenhower. Wells defends presidential interference in these instances on the ground that cartels played a legitimate role in an industry located in highly unstable and undeveloped regions of the world. He contrasts this failure of antitrust enforcement with the largely successful efforts of the European Coal and Steel Community to break up cartels in their industries.

All of these accounts support Wells’s primary argument that antitrust has succeeded in the United States because of our political stability and economic prosperity, and that the United States has exported antitrust successfully only where the policy has been accompanied by political and economic liberalization. Antitrust has failed in countries with unstable autocracies and illiberal trade policies. While Thurman Arnold’s promotion, at all costs, of his populist brand of antitrust was a necessary spur to American efforts to promote competition worldwide, the ultimate success of American policy in other countries turned out to be dependent on pragmatic officials who implemented it in a broader program of political reform and relaxation of trade barriers.

Although Wells’s main story ends in the 1950s, he extends individual parts of his argument into the 1980s. He could have taken the narrative further. It would be interesting to explore the extent to which Arnold’s antitrust vision has influenced the development of European competition law. Wells’s account would also provide an interesting historical context for the Antitrust Division’s more recent prosecutions of international cartels and for the emergence of antitrust enforcement programs in today’s transition economies.

Although Wells is a historian and not a lawyer or an economist, *Antitrust and the Formation of the Postwar World* adds significantly to our understanding of the workings of international cartels and the political context of antitrust enforcement. Antitrust practitioners, policy makers, and academics should welcome it. ●

Paper Trail: Working Papers and Recent Scholarship

Editor's Note: As many likely know, Luke Froeb, currently an Associate Professor at Vanderbilt's Owen Graduate School of Management (<http://mba.vanderbilt.edu/luke.froeb/>), has been named as the next Director of the FTC's Bureau of Economics, succeeding David Scheffman. The change should prove either interesting or confusing to antitrust practitioners. As discussed in this feature a number of times, Scheffman has suggested that the simulation models used to evaluate mergers in differentiated product industries are (at best) inadequate, too-simplified tools for the task, in large part because (in Scheffman's view) the predictions of the models are at odds with real-world behavior. It seems likely that this view contributed to the coordinated effects "push" at the agencies. By contrast, one could fairly say that much of Froeb's professional life has been spent advancing the utility and understanding of simulations of unilateral effects in merger analysis (and elsewhere). Thus, the apparent difference between his views and those of Scheffman could not be more stark. Useful slices of Froeb's views on simulations are contained in two papers co-authored with the Antitrust Division's Gregory Werden, Calibrated Economic Models Add Focus, Accuracy, and Persuasiveness to Merger Analysis (June 2002) (<http://mba.vanderbilt.edu/luke.froeb/papers/sca10.pdf>); and The Antitrust Logit Model for Predicting Unilateral Competitive Effects, 70 Antitrust Law Journal 257 (2002). We understand that Froeb is also largely responsible for creating and maintaining an antitrust Web site, <http://www.antitrust.org/>, a visit to which will aid practitioners in appreciating Froeb's inclinations across the spectrum of antitrust.

—JOHN R. WOODBURY

Papers and Summaries

Craig Peters, Evaluating the Performance of Merger Simulation: Evidence from the U.S. Airline Industry, Economic Analysis Group Discussion Paper (EAG 03-1, Jan. 2003), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=399941

Speaking of the accuracy of merger simulations—this paper by Justice Department economist Craig Peters evaluates the ability of Bertrand simulations to accurately predict the price increases that followed a rush of airline mergers during the 1980s. Peters relies on the frequently used logit model and a more general version of the logit to estimate the premerger demand for airline service generally. Using those estimates, he then infers the own- and cross-price demand elasticities of the services offered by merging parties in six different airline mergers consummated in the mid- or late 1980s. These are (along with the premerger prices) critical inputs into the simulation model. Roughly speaking, he then uses the simulation to predict the post-merger percentage change in prices, comparing them to actual change in prices as well as to evaluate predictive power of the more restrictive logit demand formulation.

This is not a paper for the faint of heart. It presumes a substantial amount of knowledge of the two demand forms estimated. And the paper is ambitious, making an effort to account for the price effect of changes in other observed and unobserved factors (other than the ownership change), including inferred changes in marginal costs.

Among its conclusions, the paper claims that the standard simulation methods account for a large component of the post-merger price change. Yet, an eyeballing of the results suggests substantial differences. For example, Peters predicts a 19.8% fare increase for the Northwest-Republic merger, compared to an actual post-merger increase of 7.2%. Similarly, he predicts a 12.7% increase for the USAir-Piedmont merger, compared to a 20.3% actual fare increase. To be sure, some predictions are closer to the mark than others, but with only six mergers, it's difficult to detect a pattern consistent enough to support the author's conclusion.

To generate more accurate post-merger predictions, Peters urges researchers to "focus our attention on anticipating changes in marginal costs," anticipations that can be included in the model. Yet, to reconcile the differences between his predicted and actual post-merger price changes for these six mergers in a way that is consistent with the underlying prediction model, Peters finds in one case that post-merger marginal costs must have fallen by 10%; in 4 of the 6 mergers, he finds that marginal costs must have increased, in one case by over 20%. (Peters points out that another possible explanation for the differences is a change in firm behavior following the merger or inefficiencies resulting from different collective bargaining agreements—more difficult modeling challenges.) One significant omission is Peters's apparent failure to determine whether the premerger inferred marginal costs looked "reasonable" when compared to an estimate of actual marginal costs, a reality check that is advocated by Froeb and Werden in the "Calibration" paper mentioned above.

While this paper addresses a number of important issues for those who rely on simulations—and for that alone, it's worth reading, the conclusions drawn about the predictive ability of simulations seem tenuous at best.

—JRW

Paul R. Zimmerman, Regional Bell Operating Company Entry into Long-Distance and Non-Price Discrimination Against Rival Interexchange Carriers: Empirical Evidence from Panel Data, *Applied Stochastic Models in Business and Industry* (forthcoming)

In 1984, the Regional Bell Operating Companies—formerly components of AT&T—were required to finally and completely open their networks to long-distance providers that had attempted to compete with AT&T's long-distance service. In the case leading up to the break-up of AT&T, the Justice Department alleged that these providers confronted a non-price wall of resistance by the undivested AT&T's denial of the rivals' ability to reach local exchange service subscribers and thereby originate and complete long-distance calls. In prohibiting the RBOCs themselves from offering long-distance service, the framers of the Modified Final Judgment had hoped to rob the RBOCs of the incentive to engage in such discrimination. Whether by coincidence or design, the two major long-distance rivals to AT&T grew rapidly in the months following the divestiture and the easing of their access to the RBOCs' local exchange customers. The 1996 Telecommunications Act reversed that MFJ policy by allowing the RBOCs to offer within-region long-distance service in competition with AT&T, MCI, and Sprint upon passing a number of "tests" administered on a state-by-state basis by the FCC. Today, RBOCs can offer within-region long-distance service in most states.

In this paper, FCC economist Paul Zimmerman reviews the experience of granting RBOCs within-region authority to determine whether there is any evidence that that patterns of pre-divestiture non-price discrimination have re-emerged. Zimmerman focuses on four tactics that the RBOCs

could use to thwart their new long-distance rivals delaying installation (measured in two ways, as the percentage of commitments met and as the number of average installation days), increased problems on the line, and increased time to repair problems. For the average time to installation and average repair time, the results are consistent with the re-emergence of non-price discrimination by the RBOCs.

However, there are enough puzzles in the results that provide a caution signal to the reader. For example, Zimmerman never provides the reader with how important these apparent problems are. If the increase in installation time is a small fraction of the average installation time, then the likelihood that these effects harm competition in long distance may be small. In addition, there are significant differences in effect that the author does not explain. For example, for some types of access arrangements, there is a statistically significant reduction in the percentage of installation commitments met; for other access types, there is no statistically meaningful effect. And other “control” variables often have signs not predicted by the author. In short, while this is a useful exploratory statistical probe into generically the kinds of issues that gave rise to the *Trinko* case in the first place, the author agrees that more of this kind of statistical analysis needs to be undertaken before concluding that it’s déjà vu all over again. ●

—JRW