

# Predatory Pricing and Bundled Rebates: The Ramifications of *LePage's Inc. v. 3M*<sup>1</sup> for Consumers

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## INTRODUCTION

Imagine two firms competing in the transparent tape market. Firm A is the dominant firm, with a ninety-percent market share. Firm A also manufactures a wide variety of other products, such as stationery and packaging products. Firm B has a smaller market share in the transparent tape market, but has found a successful niche selling private-label transparent tape.

Firm A decides to enter the private-label transparent tape market in direct competition with Firm B. In hopes of gaining market share in the transparent tape market, Firm A offers distributors a rebate based on volume sales of all products which Firm A produces. Firm B sues Firm A claiming a violation of the antitrust laws.<sup>2</sup> Firm B claims that the volume discounts, also known as bundled rebates, constitute exclusionary conduct.<sup>3</sup> The court accepts this argument. As a result, antitrust liability is imposed on Firm A without showing that an equally efficient firm could match or beat Firm A's rebates. The end result is that action which could be characterized as pro-competitive is held to be exclusionary and anticompetitive.

This hypothetical is reflective of the result the Third Circuit Court of Appeals reached in *LePage's Inc. v. 3M*.<sup>4</sup> In *LePage's*, the Third

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1. *LePage's Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003) (en banc), *cert. denied*, 124 S. Ct. 2932 (2004).

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2. Specifically, Firm A is charged with the willful maintenance of monopoly power in violation of section 2 of the Sherman Act. *See* Sherman Act, 15 U.S.C.S. § 2 (2004).

3. *See infra* notes 38–39 and accompanying text.

4. *LePage's*, 324 F.3d at 141.

Circuit held that the Minnesota Mining and Manufacturing Company (3M) violated section 2 of the Sherman Act<sup>5</sup> by offering bundled rebates across six of its product lines.<sup>6</sup> The court rejected 3M's business justification for this pricing strategy and put the validity of all bundled rebates into question.

This Note addresses the negative implications of the *LePage's* decision. Part I describes the goals of the applicable antitrust laws. Part II examines the monopolization provision of the Sherman Act and predatory pricing. Part III discusses the law of predatory pricing and bundled rebates. Part IV reviews the rule created by *LePage's* and the court's reasons for adopting such a rule. Part V then analyzes the potential problems created by the decision. Finally, Part VI proposes a new rule for dealing with bundled rebates.

## I. GOALS OF ANTITRUST LAW

The goals of the antitrust laws have been subject to considerable scholarly debate.<sup>7</sup> Some scholars believe that the main purpose of the antitrust laws is to improve economic efficiency.<sup>8</sup> Others have argued that non-economic concerns such as justice or the protection of small businesses are the primary goals of the antitrust laws.<sup>9</sup>

Leading antitrust scholars argue that the primary economic goal of

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5. 15 U.S.C.S. §§ 1–7 (2004).

6. *LePage's*, 324 F.3d at 154. The bundled rebates which 3M offered spanned six different product lines: Health Care Products, Home Care Products, Home Improvement Products, Stationery Products, Retail Auto Products, and Leisure Time. *Id.*

7. Robert H. Lande, *Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged*, 34 HASTINGS L.J. 65, 67 (1982). Lande notes that it is unanimously agreed that Congress enacted the antitrust laws to encourage competition, but Congress's ultimate goals are still subject to substantial disagreement. *Id.* Lande recognizes that the prevailing view is that the antitrust laws were motivated by a desire to increase economic efficiency. *Id.* at 68.

8. R. BORK, *THE ANTITRUST PARADOX* 90 (1978). Judge Bork states “[t]hat the whole task of antitrust can be summed up as the effort to improve allocative efficiency without impairing productive efficiency so greatly as to produce either no gain or a net loss in consumer welfare.” *Id.*

9. See Louis B. Schwartz, “Justice” and Other Non-Economic Goals of Antitrust, 127 U. PA. L. REV. 1076, 1078 (1979). Schwartz argues that the “dogma that ‘antitrust law protect competition not competitors’ overstates the case and ignores considerations of justice.” *Id.* Schwartz proposes qualifying the statement by adding “unless individual competitors must be protected in the interests of preserving competition.” *Id.* Schwartz concludes that the goals of the antitrust laws will occasionally require the protection of competitors. *Id.*

the antitrust laws is the efficient allocation of resources to maximize consumer welfare.<sup>10</sup> These scholars equate efficiency with consumer welfare, mainly in the form of lower prices.<sup>11</sup> As a basis for this interpretation these scholars read the legislative history of the Sherman Act to state that economic efficiency is the only goal of the antitrust laws.<sup>12</sup>

Other scholars advance non-economic goals of antitrust legislation, including the dispersion of political power and protection of small businesses.<sup>13</sup> Proponents of non-economic goals believe that these values should be considered in addition to economic efficiency considerations.<sup>14</sup> They point to the history of late nineteenth-century America and comments made before the passage of the Sherman Act to support their assertions.<sup>15</sup>

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10. Herbert Hovenkamp, *Distributive Justice and the Antitrust Laws*, 51 GEO. WASH. L. REV. 1, 4 (1982).

11. *Id.* Hovenkamp summarizes the leading scholars who claim that economic efficiency is the central goal of the antitrust laws. Professors Areeda and Turner argue that maximizing consumer welfare is the primary goal of the antitrust laws. *Id.* The professors found that “antitrust precedents prefer economic goals.” *Id.* According to the professors, attempting to accommodate non-economic goals results in subverting the basic purposes of the antitrust laws. *Id.* Economic efficiency, in its most basic form, is “what makes consumers best off.” *Id.*

Professor Bork also argues that economic efficiency is the central goal of the antitrust laws. *Id.* Professor Bork believes that the legislative history of the antitrust laws and the precedents established by the courts over the years demonstrate the concern for consumer welfare. *Id.*

12. Proponents of the efficiency view argue that the relevant legislative history of the Sherman Act and subsequent case law can lead to only one conclusion; the antitrust laws are designed to maximize economic efficiency. Lande, *supra* note 7, at 69. Antitrust analysis should only be concerned with implementing actions that maximize economic efficiency. *Id.* Social, political, or other non-efficiency criteria should not be considered because they are “completely without legal foundation.” *Id.*

13. Hovenkamp, *supra* note 10, at 1. Summarizing the proposed goals of the antitrust laws, Hovenkamp observes that there are a wide variety of alternatives. *Id.* Examples include maximizing consumer welfare, economic efficiency, protection of small businesses, unclogging markets, and the dispersion of economic and political power. *Id.*

14. *Id.*

15. Lande, *supra* note 7, at 96. Lande suggests that Congress sought to prevent large businesses from gaining social and political power. Lande notes that “pressure from consumers burdened by higher prices” could not completely explain the passage of the Sherman Act. *Id.* Before the passage of the Sherman Act, “consumers paid less for goods than at almost any time since the end of the Civil War.” *Id.* at 97. The end of the nineteenth century gave rise to the industrial revolution and large-scale production. *Id.* at 97–98. The revolution brought about efficiencies and price drops while contributing to the formation of trusts. *Id.* at 98.

Comments made during the Congressional debates also support this view. Senator Sherman stated, “If we will not endure a king as a political power we should not endure a king over the production, transportation, and sale of any of the necessities of life.” 21 CONG. REC. 2457

In addition to the debate over the meaning of the Sherman Act's legislative history, the plain language of the statute only creates more questions. Congress enacted the Sherman Act "to protect trade against unlawful restraints and monopolies."<sup>16</sup> Section 2 of the Sherman Act makes monopolization a felony, punishable by a fine or imprisonment.<sup>17</sup> Nowhere in the Sherman Act are crucial terms like "restraint of trade," "monopoly," or "competition" defined.<sup>18</sup>

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(daily ed. Mar. 21, 1890) (statement of Sen. Sherman). Sherman elaborated by stating: "The point for us to consider is whether, on the whole, it is safe in this country to leave the production of property, the transportation of our whole country, to depend upon the will of a few men sitting at their council board in the city of New York . . ." 21 CONG. REC. 2570 (daily ed. Mar. 24, 1890) (statement of Sen. Sherman).

At another point during the debates, Senator Sherman remarked:

The popular mind is agitated with problems that may disturb social order, and among them none is more threatening than the inequality of condition, of wealth, and opportunity that has grown within a single generation out of the concentration of capital into vast combinations to control production and trade and to break down competition. These combinations already defy or control powerful transportation corporations and reach state authorities. They reach out their Briarean arms to every part of our country. They are imported from abroad. Congress alone can deal with them, and if we are unwilling or unable there will soon be a trust for every production and a master to fix the price for every necessity of life.

21 CONG. REC. 2460 (daily ed. Mar. 31, 1890) (statement of Sen. Sherman).

Although the dispersion of political power may have been one goal of Senator Sherman, his goals also included economic efficiency and lower prices to consumers. He claimed that the bill did not seek to prevent the formation of corporations, but only to "prevent and control combinations made with a view to prevent competition, or for the restraint of trade, or to increase the profits of the producer at the cost of the consumer." 21 CONG. REC. 2457 (daily ed. Mar. 31, 1890) (statement of Sen. Sherman).

16. See the official title of the Act, ch. 647, 26 Stat. 209, 209 (1890).

17. 15 U.S.C.S. § 2 (2004). Section 2 states:

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by a fine not exceeding \$10,000,000 if a corporation, or, if any other person, \$350,000, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

18. HERBERT HOVENKAMP, *FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE* 47 (2d ed. 1999). Hovenkamp describes some of the problems of ascertaining the meaning of the Sherman Act. The legislative history contains conflicting statements made by parties with different motives. With most statutes, when the legislative history is ambiguous, a solution is to look at the plain meaning of the statute. However, looking at the plain meaning of the Sherman Act proves inconclusive. The language is vague because "the Sherman Act condemns 'every contract, combination or conspiracy in restraint of trade,' or every person who shall 'monopolize,' without giving a clue about what those phrases mean."

Some commentators reconcile the questions created by the ambiguous legislative history and language of the Sherman Act by treating antitrust law as common law.<sup>19</sup> This approach clarifies the substantive law by looking at judicial precedent.<sup>20</sup> Although the federal courts originally looked to the common law as it existed in 1890, decisions quickly deviated from the common law and created new rules to deal with changes in the American economy.<sup>21</sup> The common-law approach does not force the courts to interpret the Sherman Act based on nineteenth-century doctrine, but instead focuses on a precedent-oriented method of interpretation.<sup>22</sup> The common-law view is particularly appealing because it allows the antitrust rules to change along with the needs of society.<sup>23</sup>

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*Id.* Instead, the meaning must be determined through collateral sources.

19. *Id.* at 51. Hovenkamp solves the problem of legislative and statutory interpretation by assuming “that antitrust violations are a kind of ‘common law’ offense, where judicial precedent defines the substance of the legal rules to be applied.” *Id.* He notes that most of the practices that the Sherman Act condemns had been addressed under the common law. *Id.* Hovenkamp claims that the original intent of the Sherman Act was to “federalize” the common law to create an effective forum over monopolies operating in multiple states. *Id.*

The federalizing of the common law is supported by the legislative history of the Sherman Act as well. Senator Sherman claimed that the bill did not create any new substantive law, but merely “applie[d] old and well recognized principles of the common law to the complicated jurisdiction of our State and Federal Government.” 21 CONG. REC. 2456 (1890).

20. *Id.* In the earliest cases decided under the Sherman Act, judges based their opinions by looking at common law precedents.

See also William L. Letwin, *The English Common Law Concerning Monopolies*, 21 U. CHI. L. REV. 355 (1954). Letwin claims that the framers of the Sherman Act believed that “they were merely declaring illegal offenses that the common law had always prohibited.” *Id.*

21. HOVENKAMP, *supra* note 18, at 54. See generally *United States v. Addyston Pipe & Steel Co.*, 85 F. 271, 278–91 (6th Cir. 1898), *aff’d* 175 U.S. 211 (1899).

See also Letwin, *supra* note 20, at 355. Letwin notes that the judges and legislators should have recognized “that the common law grows.” *Id.* However, they may not have realized that the common law was going to change direction to “prohibit practices it had formerly endorsed, or to protect arrangements it had earlier condemned.” *Id.*

22. HOVENKAMP, *supra* note 18, at 52. Hovenkamp views the common law approach as a “precedent-oriented manner of interpretation, not a set of substantive doctrines.” *Id.*

23. *Id.* Hovenkamp feels that viewing antitrust laws as a kind of common law makes the legislative history and plain language of the statute less important than that of other statutes. *Id.* He adds that the “intention was not to ‘freeze’ the common law as it existed in 1890, but rather to regard the common law as an ongoing, ever changing body of rules.” *Id.* Hovenkamp notes that “[t]he standards to be applied always have and probably always will shift as ideology, technology and the American economy changes.” *Id.*

This view is consistent with Letwin’s view that “the common law at any given time reflects the economic theories and policies favored by the community, and may change as radically as those theories and policies.” Letwin, *supra* note 20, at 355.

## II. MONOPOLIZATION & PREDATORY PRICING IN GENERAL

Economic theory suggests that in a competitive market, the seller's price of a good is determined by the cost of producing it, and every consumer willing to pay the market price will be able to buy the product.<sup>24</sup> The market achieves equilibrium through the law of supply and demand.<sup>25</sup> In comparison, a monopolist is faced with different price and output decisions than a seller in a perfectly competitive market.<sup>26</sup> A monopolist has power over price because if the monopolist reduces output, total market output will decline and prices will go up.<sup>27</sup>

A monopolist's power over price often results in social costs. Social costs are incurred when a transaction results in net loss.<sup>28</sup> Monopolists create social costs by charging monopoly prices. The total social cost of a monopoly equals the loss produced by monopoly pricing, offset by any social gains collected by the monopoly.<sup>29</sup> Monopolies also produce what economists call a deadweight loss.<sup>30</sup> Deadweight loss is created when customers forego their first product choice in a transaction in lieu of their second choice.<sup>31</sup>

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24. HOVENKAMP, *supra* note 18, at 3. The economic model of perfect competition relies on certain conditions. In the perfect competition model, there are numerous sellers, each small enough that its output (or lack thereof) will not affect the output decisions of other sellers in the market. The sellers produce a homogenous product and buyers make their purchasing decisions based solely on price. All producers have equal access to inputs and all market participants are fully informed about market conditions. *Id.*

25. *Id.* Price in a market is determined by the supply available and the amount that customers, at the margin, are ready to pay. When supply is not infinite, market allocates goods based on customer's willingness to pay.

Different customers may have different "reservation" prices, or the highest amount that the particular customer is willing to pay for the product. Although customers may have different reservation prices, each buyer will pay the same price, assuming the buyer is fully informed. This condition is referred to as "equilibrium." *Id.*

26. *Id.*

27. *Id.* at 12. Although a monopolist does have some power over price, this power is not infinite. If a monopolist attempts to charge too high of a price, even buyers with a high reservation price will look to an alternative product. *Id.*

28. *Id.* at 17. If A values a product at \$100 which was produced for \$50, the sale of the product to A for \$100 will result in society being \$50 better off.

29. *Id.*

30. *Id.* at 19.

31. *Id.* Some customers that would pay the competitive price for a product are unwilling to pay the monopoly price. Instead, these customers resort to buying a product that would have been their second choice in a competitive market. The social cost of monopoly is a customer

In addition to economic objections to monopolies, there are a number of political objections. One political argument against monopolies is that monopolies cause a transfer of wealth from consumers to producers.<sup>32</sup> A second argument is that monopolies facilitate collusion among competing firms.<sup>33</sup> The third political argument against monopolies lies in a policy preference to promote small business.<sup>34</sup> Although some of the political arguments against monopolies have been mentioned in the legislative history of the Sherman Act, the prevailing case against monopolies is based on economic efficiency considerations.<sup>35</sup>

In 1966, the Supreme Court spelled out the standard elements of a section 2 monopolization claim: first, that the defendant possessed “monopoly power in the relevant market,” and second, that the power was willfully maintained instead of acquired through “superior product, business acumen, or historic accident.”<sup>36</sup>

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having to resort to his second choice. *Id.*

32. RICHARD POSNER, ANTITRUST LAW 18 (1976). The argument assumes that monopolists are wealthier than consumers. Posner also notes that the argument is undermined by the fact that competition will tend to transform a monopolist’s expected gains into social costs. When this happens, the surplus consumer wealth will not be transferred to the shareholders of the monopoly, but instead will be used in competition to become a monopolist. *Id.*

33. *Id.*

34. *Id.* at 19. This argument presupposes that small businesses should be given preferential treatment over large businesses. While Posner feels that the argument is not completely without merit, he believes that antitrust policy is inappropriate to promote the interests of small businesses. *Id.* Posner feels that the best antitrust policy for small businesses is no antitrust policy. *Id.*

35. *Id.* at 20. There are some circumstances in which monopolistic practices may be efficient. *Id.* at 22. If a monopoly is created in a small market in comparison to the efficient scale of production, a single firm may have lower costs than if the market contained more than one firm. *Id.* In this case, the profit-maximizing monopoly price will be lower than the competitive price. *Id.* An economic-efficiency analysis in this case would suggest that the monopoly should be encouraged. *Id.*

36. *United States v. Grinnell Corp.*, 384 U.S. 563, 570–71 (1966). The Court stated the elements as follows:

The offense of monopoly under § 2 of the Sherman Act has two elements: (1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historical accident.

*Id.*

The Supreme Court has defined monopoly power as “the power to control prices or exclude competition.”<sup>37</sup> The second element of the monopolization claim focuses on “exclusionary conduct”<sup>38</sup> that prevents competition on the merits.<sup>39</sup> One example of exclusionary conduct is predatory pricing.<sup>40</sup> In its most basic form, predatory pricing occurs when a dominant firm sells below cost to drive a competitor out of business.

Most modern economists believe that predatory pricing is irrational business behavior.<sup>41</sup> The costs of attempting a predatory pricing scheme are high, and the chances of succeeding are low.<sup>42</sup>

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37. *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 391 (1956).

38. Exclusionary conduct encompasses a wide variety of activities when performed by a monopolist. HOVENKAMP, *supra* note 18, at 289. Some examples of conduct which have been found to be exclusionary since the passage of the Sherman Act include reductions in output, tying arrangements, predatory pricing, expansion of capacity or output, and price discrimination. *Id.*

39. *See Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 605 n.32 (1985). In *Aspen Skiing*, the Supreme Court stated that exclusionary conduct “not only (1) tends to impair the opportunities of rivals, but also (2) either does not further competition on the merits or does so in an unnecessarily restrictive way.” *Id.* The Court also noted that a firm’s actions can be characterized as exclusionary or predatory if they operate to exclude rivals on any basis other than efficiency. *Id.* at 605.

40. Predatory pricing generally means the practice of selling below cost to drive competitors out of business. HOVENKAMP, *supra* note 18, at 335. Judge Posner offers another definition of predatory pricing. POSNER, *supra* note 32, at 188. To Posner, predatory pricing is “pricing at a level calculated to exclude from the market an equally or more efficient competitor.” *Id.* Under Posner’s definition, he claims that there are only two types of practices that qualify as predatory pricing: “selling below short-run marginal cost and selling below long-run marginal cost with the intent to exclude a competitor.” *Id.* at 188–89.

41. *See generally* Rosario Gomez et al., *Predatory Pricing: Rare Like a Unicorn?*, available at <http://www.people.virginia.edu/~cah2k/predhbk.pdf> (last visited Jan. 10, 2005). The authors related an anecdote of a colleague who “posed the question of whether predatory pricing was rare like an old stamp or ‘rare like a unicorn.’” *Id.* at 1.

*See also* Thomas J. DiLorenzo, *The Myth of Predatory Pricing*, Cato Policy Analysis No 169, available at <http://cato.org/pubs/pas/pa-169.html> (last visited Feb. 28, 1992). DiLorenzo claims that predatory pricing is “one of the oldest big business conspiracy theories.” *Id.* He notes that in over one hundred cases from 1890 to 1970, there was “absolutely no evidence” that predatory pricing led to the establishment of a monopoly. *Id.* *But see* POSNER, *supra* note 32, at 186. Posner concludes that predatory pricing cannot always be seen as irrational. Posner notes that predatory pricing requires the cooperation of consumers to be effective. *Id.* at 184. Consumers must be willing to buy from the predator. Posner claims that some consumers may not realize the implications of buying from a predator and take advantage of the lower price. *Id.* at 184–85. Although predatory pricing is not an effective method of monopolizing, there are circumstances in which a rational firm may decide to engage in a predatory pricing scheme.

42. *See* POSNER, *supra* note 32, at 184–92. Predatory pricing is not an effective method of monopolizing because the costs of a predatory pricing scheme are high. The costs to the

However, economists and the courts have not always had this view.<sup>43</sup> It was once believed that predatory pricing was easy and commonly practiced by large firms in order to gain a monopoly.<sup>44</sup>

In 1975, Professors Philip Areeda and Donald Turner wrote an influential law review article regarding predatory pricing.<sup>45</sup> Areeda and Turner feel that courts and literature fail to define predatory conduct and exaggerate the likelihood of predatory pricing schemes by large firms.<sup>46</sup> They note that predatory pricing schemes only make economic sense when the potential predator has more resources than its rivals, and when there is a substantial prospect for the recoupment of losses sustained during the predatory period.<sup>47</sup> Areeda and Turner believe there is little likelihood of recouping the losses incurred during predation unless there are extremely high barriers to entry.<sup>48</sup>

The two academics believe that because the practice of predatory pricing would be rare if informed by these economic precedents, courts must be wary of deterring legitimate price competition when

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predator are likely to be the same as or greater than the costs to the competitor. *Id.* at 185.

43. DiLorenzo, *supra* note 41. DiLorenzo states that although the theory of predatory pricing is not consistent with modern economic theory, prior to 1958 predatory pricing was conventional wisdom. *Id.* He states that both economists and antitrust practitioners accepted the theory of predatory pricing as “a matter of faith,” without any inquiry into the economic underpinnings of the theory. *Id.*

*See also* ROGER D. BLAIR & DAVID L. KASERMAN, *ANTITRUST ECONOMICS* 121 (1985). Blair and Kaserman assert that predatory pricing was the subject of antitrust folklore for many years. *Id.* Acknowledging arguments that predatory pricing is irrational, they do find that there are some circumstances in which predatory pricing may be rational. One is the case in which the predator seeks to reduce the value of a competitor’s assets in order to purchase them at a low price. *Id.* at 122. Predatory pricing may also be rational if pursued in order to demonstrate to potential market entrants what may happen if a competitor enters the market. *Id.* at 123.

44. HOVENKAMP, *supra* note 18, at 336. During the early twentieth century, many believed that the Standard Oil monopoly was created through predatory pricing. *Id.*

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

46. *Id.* at 697–98.

47. *Id.* at 698. Areeda and Turner argue that predation cannot be successful if the rival firm has resources equal to or greater than those of the alleged predator. *Id.* The second prerequisite to successful predation is even less likely in their eyes because even if the predator is successful in driving the rival out of business, the durable assets of the competitor will remain in the market. *Id.* Monopoly profits will only last until new entry into the market occurs, and economic theory suggests that monopoly profits encourage others to enter the market. *Id.* Because of this, predation is unlikely to succeed unless there are very high barriers to entry in a particular market. *Id.* at 699.

48. *Id.*

devising rules to mitigate litigation.<sup>49</sup> The professors propose new cost-based rules that distinguish between legal and illegal pricing.<sup>50</sup>

In order to understand the cost-based rules proposed by Areeda and Turner, one must first understand the different types of cost measures. Fixed costs stay the same regardless of how much of a product a firm produces.<sup>51</sup> Variable costs are costs that change depending on the number of product units produced.<sup>52</sup> Average variable cost (AVC) is determined by dividing all variable costs by output.<sup>53</sup> Total cost is calculated by adding fixed cost to total variable cost.<sup>54</sup> Marginal cost is the rise in total cost to a firm when it produces one more unit of a product.<sup>55</sup> Finally, fixed cost and variable cost are a function of the anticipated change in both output and time.<sup>56</sup> The variable costs relevant to predatory pricing are those in the short run—the time in which a firm cannot build new plants or purchase new equipment.<sup>57</sup>

Areeda and Turner reason that because a rational firm seeking to maximize profits examines the incremental effects on revenues and costs, the relevant cost measure in predatory pricing claims is

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49. *Id.*

50. *Id.* at 732–33.

51. *Id.* at 700.

Fixed costs are costs that do not vary with changes in output. They typically include some management expenses, interest on bonded debt, depreciation (to the extent that equipment is not consumed by using it), property taxes, and other irreducible overhead. And though not an accounting cost, fixed costs should be deemed to include return on investment that would currently be necessary to attract capital to the firm—what the economist refers to as the *opportunity cost* to the owners of the firm. In short, it is reasonably accurate to say that fixed costs are costs that would continue even if the firm produced no output at all.

*Id.* (emphasis added).

52. *Id.* Areeda and Turner define variable costs as those “that vary with changes in output.” *Id.* Examples of variable costs include materials, labor used to make the product, or per unit royalties. *Id.*

53. *Id.*

54. *Id.*

55. *Id.* Marginal cost depends only on variable costs because fixed costs do not change with output. *Id.* Marginal cost typically decreases during periods of low levels of output, but increases when a plant is operating near full capacity. *Id.*

56. *Id.* at 701.

57. *Id.* Areeda and Turner noted that all costs could be considered variable when a firm already functioning at full capacity seeks to expand capacity by building more plants. *Id.* In the long run, all inputs can be changed; “thus all costs are variable over the long run.” *Id.*

marginal cost.<sup>58</sup> As a result, they develop two relationships between prices and marginal cost. First, they conclude that prices equal to or higher than marginal cost should not be predatory because only less efficient firms would suffer larger losses per unit than the alleged predator.<sup>59</sup> Second, prices below marginal cost should be conclusively illegal when performed by a monopolist.<sup>60</sup> Finally, Areeda and Turner mention that while marginal cost is the economically sound division between competitively low prices and predatory below-cost prices, AVC should be used as a proxy because of the administrative difficulties of measuring marginal cost.<sup>61</sup>

The Areeda-Turner test for predatory pricing<sup>62</sup> has been met with mixed results in the circuit courts.<sup>63</sup> However, the First, Second, Fifth, and Eighth Circuits have adopted it.<sup>64</sup>

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58. *Id.* at 701–02. Economic theory suggests that in perfect competition a firm maximizes profits by producing enough product to make its marginal cost equal to the market price. *Id.* at 702. This phenomenon produces the most efficient use of allocation of resources. *Id.* The market price is equal to consumer demand for the last unit of output and marginal cost is equal to the current cost to produce the product. *Id.* Higher prices would mean that some consumers would not be able to buy a product even though they were willing to pay for the cost of production. *Id.*

59. *Id.* at 711. Areeda and Turner acknowledge that this might cause the destruction of an equally efficient firm and deter entry of other equally efficient firms; however, they could not find an acceptable solution to eliminate this risk. *Id.* The problems with creating a price floor above marginal cost include allowing an inefficient firm to survive, reducing industry output, and wasting economic resources. *Id.*

60. *Id.* at 713. Areeda and Turner conclude that the only possible justifications for pricing below marginal cost are promotional pricing or meeting a competitor's price. *Id.* However, they feel that these justifications are of "dubious merit" and only rarely applicable so that the presumption of illegality should be conclusive. *Id.*

61. *Id.* at 716. Marginal cost cannot generally be calculated by examining traditional accounting records, which only show observed AVC. *Id.*

62. *See supra* text accompanying notes 59–61.

63. One circuit court has compared the Areeda-Turner test to the *Venus de Milo* by calling it "much admired and often discussed, but rarely embraced." *McGahee v. N. Propane Gas Co.*, 858 F.2d 1487, 1495 (11th Cir. 1988).

64. *See Clamp-All Corp. v. Cast Iron Soil Pipe Inst.*, 851 F.2d 478, 483 (1st Cir. 1988) (stating ordinary measure of a predatory price is a price below incremental cost); *N' eastern Tel. Co. v. Am. Tel. & Tel. Co.*, 651 F.2d 76, 87 (2d Cir. 1981) (adopting marginal cost as test for predatory pricing). The Second Circuit also noted that when a conflict occurs between the competing antitrust goals of protecting competition and rescuing a competitor, preserving competition must prevail. *Id.* The court also adopted the Areeda-Turner proposal of using AVC as the surrogate for marginal cost because of the difficulty of determining marginal cost. *Id.* at 88.

*See also Int'l Air Indus., Inc. v. Am. Excelsior Co.*, 517 F.2d 714, 724 (5th Cir. 1975) (holding prices below AVC to be anticompetitive). The court also held that prices below short-

### III. APPLICABLE CASES

#### A. *Predatory Pricing*

*Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*<sup>65</sup> developed the modern standard by which predatory pricing claims are governed. In *Brooke Group*, the Supreme Court held that to prevail on a claim of predatory pricing under section 2 of the Sherman Act, the plaintiff must prove that the defendant's prices were below a certain measure of costs.<sup>66</sup> Additionally, the Supreme Court requires the plaintiff to show that the defendant would be able to recoup its investment in current below-cost prices by future accumulation of monopoly profits.<sup>67</sup>

*Brooke Group* involved the cigarette manufacturing industry, which was dominated by only six firms.<sup>68</sup> In 1980, Liggett introduced a line of generic cigarettes known as "black and whites" which were offered at prices thirty percent lower than branded cigarettes.<sup>69</sup> Liggett's generic-cigarette market share grew to ninety-seven percent by 1984.<sup>70</sup> Prior to Brown & Williamson's entry into the market,

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run profit-maximizing price are anticompetitive when the barriers to entry are high enough to allow predator to recoup benefits before new entry is possible. *Id.*

See also *Henry v. Chloride, Inc.*, 809 F.2d 1334, 1346 (8th Cir. 1987) (holding prices above AVC to have a rebuttable presumption of legality and prices below AVC to have a rebuttable presumption of illegality).

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

66. *Id.* at 222.

67. *Id.* at 224.

68. *Id.* at 213. The cigarette manufacturing industry has been highly concentrated for decades. *Id.* At the time of the lawsuit, production had been controlled by R.J. Reynolds, Philip Morris, American Brands, Lorillard, Liggett (the former corporate name of Brooke Group Ltd.), and Brown & Williamson. *Id.* The market leaders were R.J. Reynolds, with a twenty-eight percent market share, and Philip Morris, with a forty percent market share. *Id.* Brown & Williamson was third with a market share of around twelve percent. *Id.* Due to the oligopolistic market structure, the cigarette industry was highly profitable and earned profits above the competitive level, similar to monopoly profits. *Id.*

69. *Id.* Liggett lead the way in developing the generic segment of the cigarette industry by offering its black and whites, true generics packaged in plain white cartons with black lettering. *Id.* Other generics in the cigarette market include private label generics bearing the name of a specific purchaser such as a retailer; branded generics bearing a brand name but sold at deep discount with little or no advertising; and Value-25s, packs of twenty-five sold at prices lower than the cost of a standard twenty pack of cigarettes. *Id.*

70. *Id.* at 212–13. Before Liggett introduced its black and whites in 1980, generic cigarettes constituted less than one percent of the United States cigarette market. *Id.* at 213.

generic cigarettes only represented approximately four percent of the total domestic cigarette market.<sup>71</sup>

After losing market share to Liggett, Brown & Williamson responded by entering the generic-cigarette market and selling its own black and white cigarettes.<sup>72</sup> This sparked a price war at the wholesale level that Brown & Williamson won by allegedly selling its generic cigarettes at below cost.<sup>73</sup> Liggett filed suit claiming that Brown & Williamson's use of volume rebates to wholesalers was a predatory scheme designed to raise generic-cigarette prices for the protection of Brown & Williamson's monopoly profits on branded cigarettes.<sup>74</sup>

The Court concluded that Brown & Williamson was entitled to judgment as a matter of law because it had no reasonable prospect of recouping the losses suffered during the predatory scheme.<sup>75</sup> The Court began by stating that a plaintiff seeking to establish a predatory pricing claim must prove that the prices are below a measure of its rival's costs, but did not specify whether that cost was average total cost (ATC) or AVC.<sup>76</sup> The Court reasoned that low prices that are above cost do not threaten competition and may benefit consumers.<sup>77</sup>

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71. *Id.*

72. *Id.* at 215. In July of 1983, Brown & Williamson began selling Value-25s, and in early 1984 introduced its own generic black and whites. *Id.* The other cigarette manufacturers also responded to Liggett's introduction of generic cigarettes. R.J. Reynolds introduced black and whites in 1983. *Id.* R.J. Reynolds also lowered its list prices on Doral brand cigarettes to provide competition at Liggett's price levels. *Id.*

73. *Id.* at 216–17. Liggett tried to beat Brown & Williamson's prices five times, but at the end of each round, Brown & Williamson sustained its price advantage. *Id.* This price war occurred before Brown & Williamson had sold any generic cigarettes. *Id.*

74. *Id.* at 217. Liggett's actual claim was a price discrimination claim under the Robinson-Patman Act. The Robinson Patman Act, 15 U.S.C. 13(a) (2002). However, the Court stated that a predatory pricing claim under § 2 of the Sherman Act and a primary-line price discrimination claim under the Robinson-Patman Act share the same prerequisites for recovery. *Brooke Group*, 509 U.S. at 222.

75. *Brooke Group*, 509 U.S. at 243. The Court stated that "a reasonable jury is presumed to know and understand the law, the facts of the case, and the realities of the market." *Id.* The Court held that the evidence was insufficient to support a finding that Brown & Williamson's alleged predatory pricing scheme "was likely to result in oligopolistic price coordination and sustained supracompetitive pricing in the generic segment of the national cigarette market." *Id.* Because of this, Brown & Williamson could not threaten competition or cause an injury that the antitrust laws proscribe. *Id.*

76. *Id.* at 223. The Court relied on earlier cases to reason that only below-cost pricing should be deemed predatory. *Id.* The Court also declined to address the conflict in the lower courts over what the appropriate measure of cost should be. *Id.* At the least, any price above

The Court continued its analysis by imposing the recoupment requirement and noting that without the prospect of recoupment, predatory pricing lowers market prices and enhances consumer welfare.<sup>78</sup> Because the prospect of recoupment is so essential to a predatory pricing scheme, the Court noted that while below-cost prices may injure a competitor the injury is not important so long as competition is not harmed.<sup>79</sup> In making this assertion, the Court noted that the antitrust laws were “passed for the protection of competition, not competitors.”<sup>80</sup>

According to the Supreme Court, the prospect of recoupment depends on the predator obtaining enough market power to set prices above the competitive level for a time period long enough to recover losses incurred during the period of below-cost pricing.<sup>81</sup> To

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ATC should be conclusively presumed legal.

77. *Id.* The Supreme Court reasoned that low prices above predatory levels do not threaten competition. Noting that this principle has been adhered to in all types of antitrust claims, the Court stated that the “exclusionary effect of prices above a relevant measure of cost either reflects the lower cost structure of the alleged predator, and so represents competition on the merits, or is beyond the practical ability of a judicial tribunal to control without courting intolerable risks of chilling legitimate price cutting.” *Id.* The Court was concerned that any other rule would protect competitors from the loss of profits from legitimate price competition. In view of the goals of the antitrust laws, this result would be perverse. *Id.*

78. *Id.* at 224. The Court considered recoupment the ultimate object of a predatory pricing scheme. *Id.* The Court even realized that while unsuccessful predatory pricing may cause inefficient resource allocation, it is “in general a boon to consumers.” *Id.*

79. *Id.* at 225. The Court stated that the question wasn’t whether the defendant participated in predatory practices, but whether there was a dangerous probability that the defendant would monopolize a specific product market. *Id.* Drawing an analogy to business torts, the Court remarked that “[e]ven an act of pure malice by one business competitor against another does not, without more, state a claim under the federal antitrust laws.” *Id.*

80. *Id.* at 224. The statement that the antitrust laws were passed for “the protection of competition, not competitors,” came from *Brown Shoe Co. v. United States*, 370 U.S. 294, 320 (1962). However, this statement, which has become a maxim of antitrust law, has been taken out of context. *Brown Shoe* actually held in favor of protecting small business. *Id.* at 344. Later in the opinion, the Court in *Brown Shoe* stated:

But we cannot fail to recognize Congress’ desire to promote competition through the protection of viable, small, locally owned business. Congress appreciated that occasional higher costs and prices might result from the maintenance of fragmented industries and markets. It resolved these competing considerations in favor of decentralization. We must give effect to that decision.

*Id.*

81. *Brooke Group*, 509 U.S. at 225–26. On its own, below-cost pricing is insufficient to allow an inference of probable recoupment. An inference of injury to competition is not permitted on the basis of below-cost price either. *Id.*

determine whether recoupment was likely, the Court analyzed the allegedly predatory scheme and the structure and conditions of the market.<sup>82</sup> The Court found that the concentrated nature of the market prevented any reasonable inference that Brown & Williamson would recoup any predatory losses.<sup>83</sup>

The standards formulated in *Brooke Group* have dimmed plaintiffs' chances of recovering on predatory pricing claims. The Court found this narrowing of potential claims necessary due to the rarity of predatory pricing schemes<sup>84</sup> and the high costs of mistaken liability.<sup>85</sup> Because lowering prices is often the essence of competition, the Court felt that lower standards for predatory pricing would chill competition instead of preserving it.<sup>86</sup> Since the Supreme Court's decision in *Brooke Group*, no plaintiff has succeeded on a predatory pricing claim in the federal courts.

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82. *Id.* at 226. The Court even gave examples of market structures in which summary judgment of the case would be appropriate. *Id.* In highly competitive markets, markets with no barriers to entry, or markets in which the alleged predator does not have enough excess capacity to absorb market shares of rivals, the case will not even survive summary judgment. *Id.*

83. *Id.* at 228. The Court noted any profits made by Brown & Williamson would have to be shared with the other manufacturers; in this case requiring Brown & Williamson to earn nine dollars in profit for every dollar spent in predation. *Id.* Furthermore, tacit coordination among oligopolists is the least likely method of recouping losses from a predatory pricing scheme. *Id.* First, there is the difficulty of accomplishing tacit coordination. Second, there is a likelihood that any attempt to discipline another oligopolist will result in competition. *Id.*

84. *Id.* at 226. The Court stated that while predatory pricing attempts are rare, successful predatory pricing is even rarer. *Id.*

*See also* Frank H. Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. CHI. L. REV. 263 (1981). Easterbrook comments that many predatory pricing theories have been advanced by scholars. *Id.* He questions whether the number of theories is because predatory pricing is "a common but variegated phenomenon, curable by no single antidote? Or [are there] so many theories for the same reason that 600 years ago there were a thousand positions on what dragons looked like?" *Id.* at 264.

85. *Brooke Group*, 509 U.S. at 226.

86. *Id.* The Court thought that "[i]t would be ironic indeed if the standards for predatory pricing liability were so low that antitrust suits themselves became a tool for keeping prices high." *Id.* at 226–27.

### *B. Bundled Rebates*

The Third Circuit encountered the practice of bundled rebates for the first time in *SmithKline Corp. v. Eli Lilly & Co.*<sup>87</sup> In that case, SmithKline challenged Eli Lilly's Cephalosporin Savings Plan (CSP) under section 2 of the Sherman Act.<sup>88</sup> Eli Lilly introduced five cephalosporin antibiotics in the United States and owned the patents on four of the forms.<sup>89</sup> SmithKline entered into direct competition with the antibiotic cephazolin, which it marketed under the name Ancef.<sup>90</sup> In 1975, Eli Lilly revised its CSP to provide rebates on purchases of minimum quantities of three of the five cephalosporin antibiotics that Eli Lilly offered.<sup>91</sup>

The court found that the Revised CSP worked to deny Ancef purchasers the three percent bonus rebate on purchases of Keflin, Keflex, and Kefzol.<sup>92</sup> In order to meet Eli Lilly's rebate, SmithKline would have had to offer rebates of sixteen percent to average-size hospitals and thirty-five percent to large hospitals.<sup>93</sup>

The Third Circuit found that Eli Lilly enjoyed monopoly power in the cephalosporin market.<sup>94</sup> Eli Lilly willfully maintained that

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87. *SmithKline Corp. v. Eli Lilly & Co.*, 575 F.2d 1056 (3d Cir. 1978).

88. *Id.* at 1059.

89. *Id.* Eli Lilly first introduced Keflin (cephalothin), followed by Keflex (cephalexin), Loridine (cephaloridine), Kafocin (cephaloglycin), and Kefzol (cefazolin). *Id.* From 1964 through 1973 Eli Lilly enjoyed a legal monopoly on cephalosporins due to its patents. *Id.* In 1973 competition among cephalosporins began as manufacturers began to distribute new varieties of cephalosporins. *Id.*

90. *Id.* at 1059. SmithKline's version of cephazolin was introduced after Eli Lilly's Ancef, and was marketed under the name Kefzol. *Id.* SmithKline and Eli Lilly were the only United States producers of cephazolin due to non-exclusive licenses granted by the Japanese developer. *Id.*

91. *Id.* at 1060. The Revised CSP provided for an additional three percent bonus rebate. *Id.*

92. *Id.* at 1061–62. Because Eli Lilly did not condition the purchase of one cephalosporin antibiotic with the purchase of another cephalosporin or refusal to deal with SmithKline, the court did not examine the Revised CSP under the tie-in doctrine. *Id.* at 1062. To establish an illegal tying, three elements are necessary: 1) agreement to sell a product is conditioned on the fact that buyer must buy a second tied product, 2) seller must have enough economic power to restrain trade of the tied product, and 3) a substantial amount of interstate commerce must be affected. *Id.* at 1062 n.3.

93. *Id.* at 1062.

94. *Id.* at 1065. The court concluded that the proper market was for cephalosporins instead of all antibiotics. *Id.* at 1064. The determination of the relevant market depends on cross-elasticity of demand. *Id.* Elasticity of demand for a product refers to the change in demand for a

monopoly power by linking cephalozin with two of the cephalosporins that SmithKline did not produce.<sup>95</sup> The court found that Eli Lilly's power to exclude competition was supported by evidence that the high costs of research and development in the pharmaceutical industry erected barriers to entry.<sup>96</sup>

A Second Circuit district court addressed bundled rebates in *Ortho Diagnostic Systems, Inc. v. Abbott Laboratories, Inc.*<sup>97</sup> Abbott manufactured five commonly-used tests for screening blood supplies.<sup>98</sup> Each test screened for a different virus,<sup>99</sup> so they were not interchangeable.<sup>100</sup> Ortho sold only three of the five tests,<sup>101</sup> and Abbott's sales accounted for seventy to ninety percent of all blood tests sold.<sup>102</sup> Abbott also sold DMS, or data management systems, designed to assist consumers in interpreting the test results.<sup>103</sup>

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product in response to changes in price. *Id.* at 1063. If products are interchangeable, then a positive cross-elasticity of demand is present because a rise in the price of the first product without a similar price rise in the second product will result in an increase in demand for the second product. *Id.* If a positive cross-elasticity of demand is present, then the products are close substitutes and should both be considered in determining the relevant market.

The court found that the changes in the amounts of the cephalosporins and other antibiotics purchased by hospitals were not directly related to changes in cost. *Id.* From 1966 to 1974, hospital purchases of cephalosporins increased by 700% while penicillin G purchases decreased by sixty percent. *Id.* at 1064. The only reasonable substitute to challenge Keflin was a new generation of anti-infectives, which were stifled by Lilly's Revised CSP. *Id.*

95. *Id.* at 1065. The court noted that the effect of the Revised CSP was to force SmithKline to offer rebates on one product equal to the rebates offered for the three products offered by Eli Lilly. *Id.* The court stated that "[w]ere it not for Lilly's Revised CSP, the price, supply, and demand of Kefzol and Ancef would have been determined by the economic laws of a competitive market. The Revised CSP blatantly revised those economic laws and made Lilly a transgressor under § 2 of the Sherman Act." *Id.*

96. *Id.*

97. 920 F. Supp. 455 (S.D.N.Y. 1996).

98. *Id.* at 457–58. The five tests, or assays, are used to test blood supplies for the presence of viruses. *Id.* at 458. HBsAg tests blood for the presence of hepatitis B; Hbc or Anti-Core, tests for the core of hepatitis B; HCV tests for hepatitis C; HTLV tests for a virus associated with leukemia; and HIV-1/2 tests for strains of the human immunodeficiency virus, or HIV. *Id.*

99. *See supra* note 98.

100. *Ortho*, 920 F. Supp. at 458.

101. *Id.* at 459. Ortho sold the HBsAg, Anti-core, and HCV tests which directly competed with Abbott's tests. Ortho also manufactured an HTLV test, but it had not been accepted by customers so it was not competitive with Abbott's HTLV test. *Id.*

102. *Id.* There were two other competitors in the market, Organon-Technika and Genetic Systems, Inc. *Id.* Organon-Technika sold the Anti-Core, HBsAg, and HIV-1/2 tests, while Genetic Systems, Inc. sold the HBsAg and HIV-1/2 tests. *Id.* Neither of these firms amounted to significant competition in the market for the blood tests. *Id.*

103. *Id.* at 458.

The crux of Ortho's complaint was that Abbott entered into a contract offering different prices depending on the amount of tests purchased.<sup>104</sup> In essence, Ortho claimed that Abbott's bundled pricing constituted predatory pricing.<sup>105</sup> The court began by discussing the relationship between pricing and competition.<sup>106</sup> The court described price-cutting as a classic, socially desirable form of competition.<sup>107</sup> However, predatory price-cutting could also result in competitive harm.<sup>108</sup> The court's main concern was to prevent fashioning a rule that would end up penalizing competitive price-cutting in a fervent attempt to punish anticompetitive price-cutting.<sup>109</sup>

The court noted that Ortho's claim differed from the typical predatory pricing claim because it involved the bundled pricing of complementary products, including some products in which the defendant enjoyed monopoly power.<sup>110</sup> Focusing on Areeda's and Turner's rationale, the court addressed the distinct nature of bundled

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104. *Id.* at 460–61.

The CCBC contract contained four sets of test prices: those for members buying (1) all five assays from Abbott, which included also certain instruments and Abbott's DMS software; (2) four assays and Abbott's DMS; (3) four assays without Abbott's DMS; and (4) three or fewer tests.

*Id.* at 460.

105. Ortho advanced several theories of antitrust liability. They claimed that Abbott's scheme amounted to monopolization and attempted monopolization under § 2 of the Sherman Act, as well as claim particular to the Second Circuit, of monopoly leveraging under § 2 of the Sherman Act. *Id.* at 465. All three offenses, however, "require predatory or anticompetitive conduct or the inappropriate use of monopoly power by the defendant." *Id.*

106. *Id.* at 465.

107. *Id.* The District Court considered lowering prices as a classic, socially desirable form of competition. Society benefits from price-cutting because lower prices make more goods available to more people. *Id.* One result of competitive price-cutting, however, is that some competitors may be driven out of business. The competitors exit from the market is tolerated as a natural consequence of vigorous competition and attributed to an inability of the competitor to compete efficiently. *Id.*

108. *Id.* The court described how price-cutting by a dominant firm with greater resources could drive competitors out of business and then recoup the losses sustained by restricting output and raising prices. *Id.*

109. *Id.* at 466. Price-cutting gives rise to a great dilemma. On the one hand, price-cutting offers great social benefits to consumers. On the other hand, in certain circumstances, price-cutting can also threaten competition. Because of these competing concerns, courts must be careful to avoid creating precedents that "penalize or threaten to penalize beneficial price cutting in an unduly zealous effort to punish less desirable forms." *Id.* The court's major concern was to avoid creating a rule that discourages vigorous price competition. *Id.*

110. *Id.*

prices by modifying the analysis.<sup>111</sup> The court framed the question by asking whether a firm with monopoly power in one market, but facing competition in other markets, can price the bundle above AVC and still force an equally efficient firm out of business.<sup>112</sup> Because the court found that this scenario was hypothetically possible,<sup>113</sup> modification of the Areeda-Turner test was necessary in bundled pricing cases involving a monopolist presence in one or more product markets.<sup>114</sup> The court created a rule for bundled pricing cases in which the plaintiff must prove that the monopolist has either priced below AVC, or that the plaintiff is an equally efficient producer of the competitive product and the defendant's pricing makes it unprofitable for the plaintiff to stay in the market.<sup>115</sup> Any other rule would protect inefficient competitors against legitimate price competition to the detriment of consumers.<sup>116</sup>

#### IV. LEPAGE'S DECISION

The Third Circuit completely avoided the question of predatory pricing in *LePage's Inc. v. 3M*.<sup>117</sup> LePage's claimed that 3M maintained its monopoly in the transparent tape market through

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111. *Id.* at 469. The court reasoned that the AVC standard developed by Areeda and Turner was designed to identify cases in which the predator may drive an equally-efficient firm out of business. *Id.* at 466–67.

112. *Id.* at 467.

113. *Id.* The court posed a hypothetical involving shampoo and conditioner. *Id.* Firm A makes shampoo and conditioner, but Firm B makes only shampoo. *Id.* Firm A's AVC for conditioner is \$2.50, and its AVC for shampoo is \$1.50. *Id.* Firm B's AVC for shampoo is \$1.25, making B the more efficient producer of shampoo. *Id.* Suppose A prices conditioner at \$5 and shampoo at \$3 if bought separately, but at \$3 and \$2.25 if bought as a package. *Id.* Without package pricing, A's price for both products is \$8. *Id.* B must price its shampoo at \$3 or less to compete with A because the customer will be paying \$5 for the conditioner regardless of the supplier of shampoo. *Id.* A's package price of \$5.25 is above AVC on both products, but B would be forced to charge \$0.25 or less for the shampoo to compete because customers will need the conditioner from A. *Id.* B would be forced out of the shampoo market, even though B is the more efficient producer and A is not pricing either product below AVC. *Id.*

114. *Id.* at 469.

115. *Id.*

116. *Id.* at 469–70. The district court stated that “only price cutting that threatens equally or more efficient firms is condemned under Section 2.” *Id.* at 469. The court thought that any other rule might have the effect of “requir[ing] businesses to price their products at unreasonably high prices (which penalize the consumer) so that less efficient competitors can stay in business.” *Id.* at 470.

117. *LePage's*, 324 F.3d at 141.

exclusionary practices.<sup>118</sup> In particular, LePage's claimed that 3M's bundling of rebates across product lines and entrance into exclusive contracts constituted exclusionary practices.<sup>119</sup> 3M argued that the conduct was more akin to predatory pricing, and LePage's claim would fail because 3M's prices were never below cost, even if the entire bundled discount was applied to the transparent tape.<sup>120</sup> The court, however, rejected the proposition that a monopolist violates section 2 of the Sherman Act only when prices are below cost.<sup>121</sup> To distinguish the case from *Brooke Group*, the majority stated that LePage's did not make a predatory pricing claim.<sup>122</sup> The court stated that it was up to a jury to decide if 3M's actions deliberately discouraged its customers from dealing with LePage's.<sup>123</sup>

Instead, the court found that a section 2 Sherman Act violation could occur if a monopolist engaged in exclusionary conduct without a valid business justification.<sup>124</sup> To support the decision, the majority examined different types of conduct which had previously been held exclusionary.<sup>125</sup> Cases cited found violations of section 2 in many forms of conduct: a legal monopoly obtained through patent fraud, predatory pricing, a monopolist's refusal to grant access to essential facilities, and refusals to deal.<sup>126</sup>

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118. *Id.* at 147. LePage's sold private label tape, and in 1992 LePage's had an eighty-eight-percent market share of private label tape. However, 3M maintained approximately ninety percent of the transparent tape market. *Id.* at 144. In the early 1990s, 3M entered into direct competition with LePage's in the private label tape market. *Id.*

119. *Id.* at 145. The bundled rebates which 3M offered spanned six different product lines: Health Care Products, Home Care Products, Home Improvement Products, Stationery Products, Retail Auto Products, and Leisure Time. *Id.* at 154.

120. *Id.* at 155.

121. *Id.* at 152.

122. *Id.* at 151.

123. *Id.* at 150. The court stated that "the record in this case comfortably supports an inference that the monopolist made a deliberate effort to discourage its customers from doing business with its smaller rival." *Id.* (quoting *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 610).

124. *Id.* at 152.

125. *Id.* at 152-54.

126. *Id.* at 152-53; *see also* *Walker Process Equip., Inc. v. Food Mach. & Chem. Corp.*, 382 U.S. 172 (1965); *U.S. Philips Corp. v. Windmere Corp.*, 861 F.2d 695 (Fed. Cir. 1988); *Otter Tail Power Co. v. United States*, 410 U.S. 366 (1973); *Byars v. Bluff City News Co., Inc.*, 609 F.2d 843 (6th Cir. 1979).

Next, the Third Circuit compared 3M's conduct with Eli Lilly's conduct in *SmithKline*.<sup>127</sup> Finding that 3M's conduct was substantially identical to that of Eli Lilly, the court held that 3M's bundled rebates operated to exploit its monopoly power.<sup>128</sup> According to the Third Circuit, the foremost anticompetitive effect of 3M's bundled rebates was the foreclosure of portions of a market to a competitor who did not offer a similar array of products.<sup>129</sup> Asserting that the effects of 3M's rebates, due to its extensive catalog of products, were even larger than those attributed to Eli Lilly's rebates in *SmithKline*, the court found 3M's conduct at least as anticompetitive as Eli Lilly's.<sup>130</sup>

In addition to the foreclosure effects of the bundled rebates, the court noted that LePage's introduced evidence to showing that the bundled rebates were designed to exclude LePage's from the market.<sup>131</sup> LePage's argued that the structure of the rebates forced distributors to deal only with 3M in order to maximize the rebate and avoid financial penalties for not meeting a quota in a particular product line.<sup>132</sup>

After considering the effects attributable to the bundled rebates and exclusive dealing arrangements, the Third Circuit recognized that the jury could reasonably infer that 3M sought to eliminate the lower-

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127. *LePage's*, 324 F.3d at 155–56.

128. *Id.* at 156.

129. *Id.* at 155.

130. *Id.* at 157. The dollar amount of 3M's rebate to Sam's Club in 1996 was \$666,620. LePage's sales to Sam's Club in 1993 totaled \$1,078,484. This amounted to 3M giving rebates to some customers which were as much as half of LePage's total tape sales. Because of these numbers, the court stated that "3M's conduct was at least as anticompetitive as the conduct which this court held violated § 2 in *SmithKline*." *Id.*

131. *Id.* at 158. Evidence showed that a buyer from LePage's largest customer, K-Mart, said to LePage's, "I can't talk to you about tape products for the next three years." *Id.* However, with the exception of express exclusive dealing contracts with Venture and Pamida, the exclusive dealing arrangements complained of by LePage's did not contain an express exclusivity requirement. The issue was that because the rebates were so large, a customer such as K-Mart would buy as much as possible from 3M to maximize its rebate. The result was that the customer would not buy from LePage's. *Id.*

132. *Id.* at 159. The rebates offered could be maximized by dealing with 3M in as many product lines as possible, often resulting in a distributor exclusively dealing with 3M in those product lines.

priced, private-label transparent tape from the market in order to reap profits from higher-priced Scotch tape.<sup>133</sup>

Because of the anticompetitive effects of the bundled rebates, the court had to consider whether there was a valid business justification for the practice.<sup>134</sup> The court held that even though 3M's activities were in line with its economic interests, this was not a valid business reason for purposes of a section 2 claim.<sup>135</sup> The court maintained that 3M did not meet the burden of persuasion merely by claiming that single invoices and bundled shipments increased efficiency.<sup>136</sup> Because 3M did not advance a valid business justification, the court affirmed the lower court's decision that 3M violated section 2 of the Sherman Act.<sup>137</sup>

#### V. THE PROBLEMS CREATED BY *LEPAGE'S*

There are two important ramifications of the *LePage's* decision. First, the Third Circuit's decision circumvents the Supreme Court's rationale in *Brooke Group*. The court's decision to classify 3M's conduct as exclusionary, rather than predatory, can only be seen as a method to avoid proving that 3M sold below-cost and had a reasonable prospect of recouping its losses.<sup>138</sup>

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133. *Id.* at 162. This sounds very much like a typical predatory pricing scheme in which a rival seeks to eliminate a competitor with present below-cost pricing in order to collect monopoly profits in the future.

134. *Id.* at 163–64.

135. *Id.* at 163. The court noted that a “business justification is valid if it relates directly or indirectly to the enhancement of consumer welfare. Thus pursuit of efficiency and quality control might be legitimate competitive reasons . . . while the desire to maintain a monopoly market share or thwart the entry of competitors would not.” *Id.* (citing *Data Gen. Corp. v. Gramman Sys. Support Corp.*, 36 F.3d 1147, 1183 (1st Cir. 1994)).

136. *Id.* at 164. While 3M alluded to efficiency concerns in an attempt to give a valid business justification for the exclusionary conduct, the court felt it was highly unlikely that savings from single invoices or bundled shipments would reach the millions of dollars returned to customers through the bundled rebates. *Id.*

137. *Id.* at 169.

138. *Id.* at 151. The court stated that *LePage's* did not make a predatory pricing claim. *Id.* However, the fact that *LePage's* didn't make a predatory pricing claim should not have precluded the court from looking at the substance of the allegations. A plaintiff in a traditional predatory pricing case, which is a subset of exclusionary conduct, should not be able to avoid *Brooke Group* merely by pleading the claim as exclusionary conduct. The most likely reason *LePage's* claimed exclusionary conduct instead of predatory pricing was to avoid the standards created by *Brooke Group*, see *supra* Part III.A.

The core of LePage's claim was that the rebates given by 3M destroyed its ability to compete. More simply, 3M's prices were predatory. The bundling of rebates should not enable LePage's to avoid the ramifications of *Brooke Group* altogether.

The Third Circuit's circumvention of *Brooke Group* is more problematic than the actual outcome of the case. Given the *Brooke Group* decision, the facts of *LePage's* should have been adequate to assert a predatory pricing claim. Assuming that 3M's prices were below-cost, LePage's had the requisite evidence to state a prima facie predatory pricing claim. Unlike the oligopoly in *Brooke Group*, 3M had secured a monopoly in the transparent tape market. If 3M's prices were below-cost and drove LePage's out of business, 3M would have been able to recover monopoly profits. The District Court and the Third Circuit Court of Appeals found that barriers to entry were high in the transparent tape market.<sup>139</sup> If any firm could succeed in a predatory pricing scheme after *Brooke Group*, it would have to be a firm with monopoly power in a market with high barriers to entry.

Without knowing whether 3M's bundled rebates drove its prices below-cost, it is impossible to say that the bundled rebates were anticompetitive. The Supreme Court's rationale in *Brooke Group* suggested that prices above cost are either competitive behavior or beyond the ability of the courts to control without chilling competitive price cutting.<sup>140</sup> The Third Circuit claimed that *Brooke Group* was inapplicable because LePage's did not make a predatory pricing claim.<sup>141</sup> However, in *Brooke Group* the Supreme Court stated that low prices above predatory levels benefit consumers without threatening competition.<sup>142</sup> The Supreme Court also suggested that this principle applies to any antitrust claim, not only predatory pricing claims.<sup>143</sup> Therefore, the rationale of *Brooke Group*

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139. *LePage's*, 324 F.3d at 162. The Third Circuit spoke of 3M's exclusionary conduct as a plan to eliminate private label tape. 3M even conceded that it would be able to recoup the profits by selling higher priced Scotch tape if there were no other competition in the private label tape segment. *Id.*

140. *Brooke Group*, 509 U.S. at 223; see also *supra* note 76 and accompanying text.

141. *LePage's*, 324 F.3d at 151.

142. *Brooke Group*, 509 U.S. at 223.

143. *Id.*

should have applied in *LePage's*, even if the court felt that *LePage's* did not state a predatory pricing claim.

As a result of *LePage's*, bundled rebates are viewed differently than standard price competition. The reason for this is not entirely clear. The Third Circuit felt that bundled rebates could prevent an equally efficient rival from competing if the rival did not offer a product line of comparable diversity.<sup>144</sup> Instead of framing the issue as one of exclusionary practices, the Third Circuit could have followed the approach of *Ortho*. *Ortho* suggested a rule for bundled rebates in which the plaintiff must prove that a monopolist priced below AVC, or that the plaintiff is at least as efficient a producer of the competitive product as the defendant.<sup>145</sup>

If the Third Circuit adopted the *Ortho* rule, *LePage's* claim would surely have failed. *LePage's* neither attempted to prove that 3M's prices were below cost, nor claimed that it was as efficient at manufacturing tape as 3M. In fact, *LePage's* conceded that 3M was a more efficient tape producer.<sup>146</sup>

Nevertheless, the Third Circuit found that 3M's conduct was anticompetitive. One possible justification for this result is judicial policy favoring the protection of small business. While there is some legislative history to support this argument, the Supreme Court has endorsed the maxim that the antitrust laws are designed to protect competition, not competitors.<sup>147</sup>

The second major ramification is that the Third Circuit's decision opens the door for juries to find that a monopolist violates section 2 of the Sherman Act by offering bundled rebates that result in harm to competitors. Taken to its logical conclusion, the holding of *LePage's* may be seen as a complete prohibition on a monopolist's offering of bundled rebates. This result marks the crucial difference between the *SmithKline* and *LePage's* decisions. In *SmithKline*, evidence was introduced to show how much of a discount *SmithKline* would have had to offer to compete with *Eli Lilly*.<sup>148</sup> *LePage's* did not even make

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144. *LePage's*, 324 F.3d at 155.

145. *Ortho*, 920 F. Supp. at 469.

146. *LePage's*, 324 F.3d at 177 (Greenberg, J., dissenting).

147. See *supra* note 80 and accompanying text.

148. *SmithKline*, 575 F.2d at 1062. Although *Eli Lilly's* rebate was only three percent, due to the amount of volume sales, *SmithKline* would have had to offer rebates of sixteen percent to

an attempt to measure the discount it would have had to offer to meet 3M's rebates.<sup>149</sup> Without requiring a plaintiff to produce specific evidence that the bundled rebates forced the plaintiff to make drastic reductions in price, the Third Circuit deemed bundled rebates illegal when offered by a monopolist.

This result is disturbing because it allows the antitrust laws to reach perverse results.<sup>150</sup> In effect, bundled rebates, which should be seen as a legitimate form of price competition, become outlawed. Competition is chilled when a monopolist is foreclosed from vigorous price competition against inefficient competitors. The end result is higher prices for consumers.

## VI. A NEW RULE FOR BUNDLED REBATES

Distinguishing between pro-competitive and anticompetitive price-cutting is a difficult task for the courts.<sup>151</sup> The law should not deter competitive price-cutting just because it takes the form of bundled rebates. The unique nature of bundled rebates requires new rules to ensure the preservation of robust competition. One possible solution is to create two rules to govern the practice of bundled rebates.

The first rule would apply in cases when the bundled rebates are offered by a firm that does not have a monopoly in any of the products comprising the bundle.<sup>152</sup> In these cases, courts should adopt

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average size hospitals and thirty-five percent to larger hospitals. *Id.*

149. *LePage's*, 324 F.3d at 175 (Greenberg, J., dissenting). In his dissent, Judge Greenberg disagreed with the majority's use of *SmithKline* due to this lack of evidence. He noted that although the size of 3M's rebates was substantial, *LePage's* did not produce any figures to show how much it would have to cut prices to compete with 3M. *Id.* Judge Greenberg criticized *LePage's* argument by recognizing that *LePage's* controlled sixty-seven percent of the private label tape business at the time of trial. *Id.*

150. In speaking about traditional predatory pricing, the Supreme Court in *Brooke Group* stated that protecting competitors from lost profits due to price competition would make any decision by a firm to cut prices to increase market share illegal. *Brooke Group*, 509 U.S. at 223. The Court thought that this result would be perverse in light of the antitrust laws. *Id.*

151. *See supra* note 109 and accompanying text.

152. It is possible that this situation is not very likely to occur. *LePage's*, *Ortho*, and *SmithKline* dealt with bundled rebates in the past in which the defendant was a monopolist of one of the products in the bundle. *See LePage's*, 324 F.3d at 141; *SmithKline*, 575 F.2d at 1056; *Ortho*, 920 F. Supp. at 455.

the *Ortho* rule.<sup>153</sup> The plaintiff should be required to prove that the alleged predator had priced below AVC, or that the plaintiff is at least as efficient in producing the competitive product as the defendant.<sup>154</sup> If the plaintiff is as efficient as the defendant, then the plaintiff is also required to prove that the defendant's pricing prevents the plaintiff from realizing a profit from production.<sup>155</sup> This rule would further the economic efficiency goal of antitrust law<sup>156</sup> and prevent suits by inefficient competitors.

The second rule proposed to deal with bundled rebates should govern when the rebate is offered by a monopolist such as 3M. These circumstances require a slightly more restrictive rule due to aversion towards monopolies in antitrust law.<sup>157</sup> When bundled rebates are offered by a monopolist, the plaintiff should be required to prove that the defendant's prices are below the firm's total cost, or that the plaintiff is an equally efficient firm who cannot profit under the defendant's pricing structure.

There are several reasons for the use of total cost instead of AVC in circumstances where bundled rebates are offered by a monopolist. First, if a monopolist is offering bundled rebates, any efficiencies created will lower the monopolist's total cost of doing business. A rational, competitive monopolist should be more concerned with long-run profit maximization than short-run profit maximization.<sup>158</sup> Total cost is a better indicator of long-run profit maximization than AVC.<sup>159</sup>

Second, the actions of a monopolist are subject to more scrutiny under the antitrust laws than actions taken by non-monopolist firms.<sup>160</sup> In keeping with this trend, the rule would subject monopolists to more scrutiny than other firms. Additionally, this approach would create a bright-line rule. A bright-line rule allows a monopolist to know exactly when lowering prices crosses the line

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153. See *supra* note 113 and text accompanying notes 112–13.

154. *Ortho*, 920 F. Supp. at 469; see also *supra* text accompanying note 115.

155. *Id.*

156. See *supra* note 11 and text accompanying notes 10–11.

157. See *supra* text accompanying notes 26–31.

158. See *supra* note 57 and accompanying text.

159. See *supra* notes 55 and 57 and accompanying text accompanying notes 54–57.

160. See *supra* notes 24–35 and accompanying text.

from being socially-desirable, pro-competitive behavior to the level of threatening, anticompetitive behavior.

#### CONCLUSION

Bundled rebates, like lowering prices, can represent either pro-competitive or anticompetitive behavior. To determine whether the rebate is pro-competitive or anticompetitive, a court should analyze the conduct in light of the economic goals of antitrust and the desire to protect competition. Behavior by a monopolist is more likely to be anticompetitive than behavior by a firm that is not a monopolist. In order for competitors to know the rules of the game, two clear rules should be devised for determining whether bundled rebates are pro-competitive or anticompetitive.

Bundled rebates offered by a monopolist should be illegal only when offered at a price below total cost, or when they prevent an equally efficient producer from competing. Bundled rebates offered by a firm that is not a monopolist should only be illegal when offered at a price below AVC, or when they prevent an equally efficient producer from competing.

These rules achieve the best balance between promoting vigorous price competition in the short-run, and ensuring that monopolists do not take control of markets in the long-run.