Court Gives Dominant Firms More Flexibility on Pricing

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For over 60 years, antitrust law recognized claims for "price squeezes," which can occur where a dominant supplier in one market also competes with its buyers in their market, e.g., a dominant manufacturer or wholesaler supplies retailers while itself selling at retail. A price squeeze is where the dominant firm, sometimes called an "upstream" firm because it supplies markets further up the stream of commerce, "squeezes" its downstream or retail competitors' profit margins by (a) charging its buyers/retail competitors high wholesale prices and/or (b) cutting its own retail prices.

In the seminal monopolization case of *United States v. Aluminum Co. of America (ALCOA)* (1945),[1] the U.S. Court of Appeals for the Second Circuit—speaking through Judge Learned Hand with final appellate authority because four Supreme Court justices had to recuse themselves[2]—held unlawful a price squeeze where, had the defendant itself paid the wholesale price it was charging competitors (akin to a transfer price between the defendant's wholesale and retail operations), the defendant's retail price would have been below cost.

On Feb. 25, 2009, the Supreme Court issued its decision in *Pacific Bell Telephone Co. v. linkLine Communications Inc.*, which virtually nullifies antitrust claims for above-cost price squeezes, and which rejects *ALCOA's* wholesale "transfer" price analysis. The Court gave short, footnoted shrift to *ALCOA's* 60-year precedent, stating only: "Given developments in economic theory and antitrust jurisprudence since *ALCOA*, we find our recent decisions in *Trinko* and *Brooke Group* more pertinent to the question before us."

Although certain aspects of *ALCOA* have been rightly critiqued on economic grounds,[3] the case continues to be cited for its principles of monopolistic conduct, it continues to be widely taught in law school. The Supreme Court's back-of-the-hand treatment to such an iconic precedent is remarkable.

Building on its recent precedent in the 2004 *Trinko* case and its less recent 1992 *Brooke Group* decision, the Court ruled that so long as the alleged monopolist priced above cost, neither charging high wholesale prices nor cutting retail prices by itself could give rise to an antitrust claim, and therefore such price-squeeze claims are not viable under U.S. law.

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Regarding wholesale pricing, merely charging high or monopoly prices does not violate U.S. antitrust law, and antitrust law imposes no duty on a wholesale/upstream monopolist to deal with its competitors, except under very limited circumstances not present in *linkLine*. See *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP* (2004).[4]

Regarding retail/downstream pricing, cutting prices "often is the very essence of competition." Therefore, allowing price-squeeze claims, where the retail price is above cost, would risk harm to competition because "[f]irms might raise their retail prices or refrain from aggressive price competition to avoid potential antitrust liability." See *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.* (1993).[5]

The Court reasoned that it would be "most troubling" that neither monopolists nor the courts would have the ability to gauge whether the lower prices were lawful, so long as they were above cost. There would be no way for a monopolist to determine what a fair or reasonable margin would be for its competitors, or even to determine what its competitors' margins are (a practice itself discouraged by competition law). And the courts are ill-equipped to act as industry rate regulators.

The Court's opinion also seriously calls into question antitrust claims premised in any way on lowering prices to above-cost levels. It held that linkLine's claim of low, non-predatory retail pricing finds "no support in our existing antitrust doctrine," because the risk of imposing liability for low pricing is to create the very harm that competition law is supposed to avoid. Such liability is limited to predatory pricing, i.e., below-cost pricing with a dangerous probability that the defendant will recoup its investment in below-cost pricing by subsequently raising prices to supracompetitive levels. It also held that it has "repeatedly emphasized the importance of clear rules in antitrust law," suggesting that it would apply predatory pricing analysis to all claims with an aspect of low pricing.

One such claim very likely would be a so-called "bundled-discounting" claim. A bundled discount is where a firm grants a discount on one product if customers purchase a different second product. For example, a hot dog vendor grants a discount on a hot dog if customers also purchase a beverage. Such discounts are "varied and pervasive," being employed by firms with large amounts of capital as well as small. *Cascade Health Solutions v. PeaceHealth* (9th Cir. 2008).[6] Given bundled discounts' prevalence in the economy and the fact that they provide consumers with more products at lower » Page 7

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cost, bundled discounts are generally procompetitive. *PeaceHealth;* see also *LePage's Inc. v. 3M* (3d Cir. 2003).[7] In *Jefferson Parish Hospital District No. 2 v. Hyde* (1984),[8] the Court explicitly acknowledged the procompetitive benefits of package pricing, although it was not directly addressing a bundled-discounting claim.

As some courts and commentators have held, however, bundled discounts may create anticompetitive effects if employed by monopolists in certain circumstances.[9] Take, for example, a hot dog monopolist controlling the lower Manhattan courthouse district, where busy court personnel cannot spend more than ten minutes for lunch. If the monopolist grants a discount on its hot dogs when customers also buy a beverage, and no one else can provide lunch, then the hot dog vendor may be able to drive other beverage sellers out of business. Those who sell only beverages must match hot dog discounts with beverage discounts, squeezing beverage sellers' margins because they cannot spread discounts over multiple products. See *SmithKline Corp. v. Eli Lilly & Co.* (3d Cir. 1978).[10]

Thus, bundled discounts theoretically raise the same potential competitive concern as price squeezes: lowering rivals' margins. In the case of price squeezes, rivals have both higher costs of purchasing from the monopolist and lower revenue from decreasing retail prices. In the case of bundled discounts, rivals have lower revenue from increased discounts.

Given the Court's serious concerns in *linkLine* about antitrust claims that are premised on competitors' margins being squeezed, and because bundled discounts are usually procompetitive conduct that the antitrust laws are designed to encourage—not stifle—it is very likely that it would apply *linkLine's* analysis to bundled-discounting claims. Should this happen, the Court would allow bundled-discounting claims only where the prices of the products in the bundle are below the monopolist's costs of those products, and where there is a dangerous probability that the monopolist would be able subsequently to raise prices of the competitive product (beverages, not hot dogs) to supracompetitive levels.

In short, the Court's *linkLine* decision marks a significant departure from long-standing precedent, and possibly heralds a wide-ranging shift in U.S. law governing pricing by monopolists.

1. 148 F.2d 416.
2. The Supreme Court subsequently expressly approved Judge Hand's opinion. *American Tobacco Co. v. United States*, 328 U.S. 781, 812-14 (1946).
3. See III Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law ¶¶611c-611e, at 22-25 (3d ed. 2008).
4. 540 U.S. 398. In *Trinko*, the Court intimated that a monopolist may be subjected to a duty to deal with rivals only where the monopolist had a prior course of voluntarily dealing with them, and its refusal to deal made no economic sense but for the likelihood that it would result in monopoly. In both *Trinko* and *linkLine*, the Federal Communications Commission had imposed duties to deal as a matter of telecommunications regulation, not antitrust law. In both cases, the Court cited the existence of the regulatory scheme as warranting less need for antitrust intervention.
5. 509 U.S. 209.
6. 515 F.3d 883.
7. 324 F.3d 141.
8. 466 U.S. 2.
9. See generally Timothy J. Muris & Vernon L. Smith, "Antitrust and Bundled Discounts: An Experimental Analysis," 75 ANTITRUST L. J. 399 (2008).
10. 575 F.2d 1056.