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Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

Clarifying Section 2 Of The Sherman Act

Law360, New York (October 21, 2008) -- In the wake of the Microsoft case and similar matters both within the United States and elsewhere, there has been substantial interest within the antitrust community in the government's setting forth clear standards for evaluating the conduct of dominant market participants with respect to such conduct as pricing, tying, unilateral refusals to deal, etc.

Much attention, therefore, was focused on the series of public hearings that the U.S. Department of Justice ("DOJ") had held jointly with the Federal Trade Commission ("FTC"), on issues related to the enforcement of Section 2 of the Sherman Act.

On Sept. 8, 2008, DOJ released its report based on those hearings: "Competition and Monopoly: Single-Firm Conduct Under Section 2 of the Sherman Act." www.usdoj.gov/aatr/public/press_releases/2008/236975.htm.

Unfortunately, this report does not represent the views of the entire federal enforcement armada. Indeed, with a national election looming, it might not represent the definitive views of any part of the government for very long.

On the same day that the DOJ released its report, three of the current four Commissioners of the FTC released their own statement explaining the refusal of their agency to adopt the DOJ report.[1]

In that statement, the Commissioners set forth their belief that "if adopted by the courts, [the DOJ report] would be a blueprint for radically weakened enforcement of Section 2 of the Sherman Act." www.ftc.gov/opa/2008/09/section2.shtm.

In short, the Commissioners suggested that in crafting its report, the DOJ overstated the law as it exists to date and proposed "safe harbors" that ultimately could aid firms with monopoly or near monopoly power in foreclosing rivals.

Thus, it is clear that the DOJ report cannot be held to be truly definitive within the government as a whole. However it does provide useful guidance into how the DOJ will assess Section 2 conduct going forward in the immediate future.

As a result, firms must weigh that utility with the understanding that the report does not represent the position of the FTC.

Furthermore, unless courts adopt some or all of DOJ's conclusions, it is unclear that the report will deter private plaintiffs or the FTC from bringing actions against dominant firms.

Unfortunately, given the diversity of views among the federal judiciary, the likely scenario will be that some courts will adopt the conclusions of the report, while others will decline to do so – creating even more uncertainty for firms attempting to comply with the constraints of Section 2 of the Sherman Act.

Nevertheless, firms may want to gain an understanding of the DOJ's positions in the report and include those positions in analyzing risks associated with contemplated conduct and crafting defenses to those actions that might be brought or threatened.

The DOJ's report analyzes a wide variety of issues under Section 2, including specifically addressing the various types of conduct that implicate the provision.

Two of the more interesting analyses are the discussions of bundled discounting and predatory pricing. Each purports to provide "practical" application tests and safe harbors for firms—although how successful firms will be in being able to adopt these tests and safe harbors remains speculative.

Bundled discounting is described by the report as "the practice of offering discounts or rebates contingent upon a buyer's purchase of two or more distinct products." "Competition and Monopoly: Single-Firm Conduct Under Section 2 of the Sherman Act" at 91.

Noting that bundled discounts can benefit consumers, and that courts have taken varying approaches on those discounts, the DOJ suggests the use of two different safe harbors for bundled discounting.

The first safe-harbor would only apply where competitors could offer similar bundled discounts. This would be a "price-cost" safe harbor, under which a bundled discount would not be illegal under Section 2 of the Sherman Act provided that a competitor could offer a similar bundle and that "the price of the bundles is not below an appropriate measure of cost

of the bundle.” *Id.* at 101.

In those instances where there are no competitors who could offer similar bundled products, a different safe harbor would apply—the “discount-allocation” safe harbor.

This safe harbor would allow consideration of the “appropriate measure of a monopolist’s costs for the competitive product in a bundle to its imputed price of that product.” *Id.* at 101.

Thus, a plaintiff would have to demonstrate that the price allocated to the bundled product at issue was below its incremental price. *Id.*

For those bundled discounts that fall outside of either of the foregoing safe-harbors, the DOJ suggests that the conduct at issue should not be presumed anticompetitive, but instead that a potential plaintiff must be required to prove “actual or probable harm to competition”. *Id.* at 105.

Moreover, the DOJ recommends that such bundled discounts only be found to be illegal when the discount provides no pro-competitive benefits, or if the anticompetitive harm from the discount is “substantially disproportionate” to its procompetitive benefits. *Id.* at 105.[2]

Even if it is assumed that the courts will adopt the DOJ’s recommendations with respect to bundled discounts, firms still might find it difficult, in practical terms, to evaluate whether or not they are operating within a safe harbor.

Indeed, to satisfy the first safe harbor, firms will have to evaluate competitors’ offerings to determine whether those offerings constituted a comparable bundle and, even if so, whether a court would come to the same assessment of a competitor’s options.

Those firms also will have to be able ensure (and subsequently demonstrate) that the price of the bundle is “not below an appropriate measure of cost of the bundle.” *Id.* at 101.

Indeed, determining whether the price is below an appropriate measure of cost is the same analysis the DOJ suggests as a safe harbor in a predatory pricing context.

Thus, the difficult question is how likely it is that firms will be able, or willing, to determine the “appropriate measure of cost of the bundle”.

Similar to its assessment concerning alleged predatory pricing, the DOJ proposed that the appropriate measure to be used in analyzing cost is the average avoidable cost. Average avoidable costs are those costs that “could have been avoided by not engaging in the

predatory strategy.” *Id.* at 64.

These costs should include both variable and fixed costs. Thus, while the DOJ’s report gives a somewhat simplistic example to demonstrate the effectiveness of this cost measure—the example provided assumes no fixed costs for the product at issue.

Unfortunately, the determination of fixed cost, and the fixed cost that should be allocated to each product, is the more challenging assessment for firms to make.

Although the report acknowledges that panelists at the hearings indicated that determination of the average avoidable cost might be difficult for firms to accomplish, the DOJ “believes” that this method is easier than others that have been proposed by economists in the past. *Id.* at 66.

The second safe harbor suggested by DOJ provides little relief as to technical components because it requires a firm to compare the cost of the “competitive product in a bundle” with the allocated price (including all discounts and rebates) of that product.

To be successful in its challenge, a plaintiff would have to be able to demonstrate that the defendant firm sold the competitive product in the bundle an “imputed price that was below its incremental cost of that product.” *Id.* at 101. That methodology is not without inherent difficulty.

As noted above, the report also provides a detailed analysis of predatory pricing and the appropriate approach to making a determination that a firm is engaging in such conduct. As an initial matter, the DOJ proposes that any pricing that is above average total cost of a product should be considered *per se* legal.

In its analysis, the DOJ also explains that pricing below average total costs can, in some instances, be “economically rational”. *Id.* at 61.

Thus, under the DOJ’s theory, it would not be enough for a plaintiff simply to demonstrate that prices are below average total cost.

As it does in determining the anti-competitive effect of bundled pricing, the DOJ indicates that it will rely on average avoidable costs in determining whether prices are predatory.

While, if it is assumed that they can do the appropriate analysis, firms might find comfort in the DOJ’s approach.

However, unless and until courts adopt the report's guidance as law, it is unclear whether that approach will provide any real relief from suits by private plaintiffs.

The report also addresses what the DOJ's approach will be in instances where a firm lowers its prices to meet those of a competitor.

While acknowledging that the Robinson-Patman Act provides for a "meeting competition defense," the DOJ refused to extend this defense to its Section 2 analysis of predatory pricing.

Therefore, dominant firms that are faced with low rates of a competitor cannot price comparably—if that pricing could be deemed predatory.

As a result, dominant firms embarking on any new pricing strategy, regardless of the reason, should perform a detailed analysis of the relationship between pricing and costs.

Given the division of views among the federal enforcement agencies, the lack of judicial adoption of the DOJ report at this point and staff and policy changes that might follow the upcoming national elections, the DOJ report, while extensive in analyzing a firm's attempts to comply with Section 2 of the Sherman Act, cannot be taken as truly definitive and its use in practical terms remains uncertain.

--By Stuart M. Gerson (pictured) and Patricia M. Wagner, Epstein Becker & Green PC

Stuart Gerson is a member of Epstein Becker & Green in the firm's Washington, D.C., and New York offices. Patricia Wagner is an associate in the Health Care and Life Sciences Practice in the firm's Washington, D.C., office.

[1] Commissioners Harbour, Liebowitz and Rosch issued the joint statement. Commissioner Kovacic did not join in the statement and instead issued his own statement.

[2] In response to the DOJ's recommendations, the Commissioners strongly suggest that the DOJ's analysis failed appropriately to reflect the current status of the law, noting that the Supreme Court has only used the price-cost rules for purposes of analyzing predatory pricing. Indeed, the DOJ's report acknowledges the variation in lower courts treatment of bundled discounts.

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