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The History and Debate Underlying the Use of Price-Cost Tests

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One common means by which firms compete is through low pricing. According to some schools of legal thought, however, lowering prices can potentially be anticompetitive, particularly when a firm lowers its prices below its putative costs. To evaluate whether a firm's pricing behavior is potentially anticompetitive, courts historically have examined whether a product's price falls below its cost. Such a comparison of price and cost (known as a price-cost test) has also been used to evaluate a broader array of conditional pricing conduct when price is alleged to be the primary mechanism of exclusion. Examples of such conduct include loyalty discounts, bundled discounts, and exclusive dealing. Despite the seeming simplicity of comparing price and cost as a means of gauging the potential for anticompetitive conduct, the use of price-cost tests is controversial and different schools of thought, advocated by eminent legal scholars, exist as to the reliability of using such tests.

The modern formulation of testing for the existence of predatory pricing came out of a claim by Brooke Group against Brown & Williamson Tobacco.[1] In that matter, the Supreme Court required Brooke Group to prove two elements: (1) that Brown & Williamson had priced their generic cigarettes below an appropriate measure of cost and (2) that Brown & Williamson had a reasonable possibility of recouping losses incurred due to pricing below cost. This has come to be known as the "Brooke Group" test. Given the relative difficulty of proving predatory pricing claims under this test, particularly the recoupment aspect of the test, few cases are today being brought alleging such "naked" predatory pricing.[2] Instead, claims of below-cost pricing generally involve some type of conditional pricing discount such as a bundled, loyalty or market share discount. Two examples, stemming from the Cascade Health and ZF Meritor matters, help to illustrate this progression.[3]

In 2008 the Ninth Circuit considered Cascade Health Solution's claims against PeaceHealth based on allegations of putatively anticompetitive bundled discounting.[4] The court determined that for multi-product cases the discount provided by the defendant on an entire bundle of products must be allocated to only the contestable product (i.e., the product sold by the defendant's rival). The resulting price of the contestable product should then be compared to an appropriate measure of that product's cost. The court also rejected the recoupment requirement specified in *Brooke Group*. This version of the price cost test has become known as the discount attribution test.

In 2012, the Third Circuit was presented with claims related to loyalty and market share discounts.[5] In that matter, ZF Meritor claimed that its efforts to compete with Eaton, the only supplier of heavy-duty truck transmissions from the 1950s until Meritor's entrance in 1989, were undermined by Eaton's long-term agreements, which required some customers to meet market share requirements. Although Eaton argued that ZF Meritor's claims of discounted pricing required a price-cost test, the Third Circuit ultimately rejected the application of the price-cost test, stating that price was not the predominant mechanism of exclusion in Eaton's contracts. The Third Circuit instead concluded that other aspects of Eaton's

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

[2] *See* for example, Herbert Hovenkamp, *Federal Antitrust Policy: The Law of Competition and Its Practice*, West Publishing, Co.: St. Paul, MN, 1994 at § 8.1.

[3] As an aside, in 2003 LePage's, a producer of private-label tape, brought a case before the Third Circuit alleging that its rival, 3M, engaged in exclusive dealing and offered bundled discount programs. The court rejected the requirement of a price-cost test to evaluate whether 3M's bundled discounts were predatory. Rather, the court chose to evaluate 3M's actions based on whether it had "engaged in exclusionary or predatory conduct without a valid business justification." Although the allegations related to bundled discounts—not the predatory pricing of a single product—the court's decision to reject the requirement of a comparison of price and cost to assess below-cost pricing allegations appeared to contradict the previous *Brooke Group* decision. For a further discussion, *see* Neal Stoll and Shepard Goldfein, "Brooke Group Test on Multiproduct Discounting Nears?" *New York Law Journal*, vol. 238, no. 74, October 2007.

[4] *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883 (9th Cir. 2008).

[5] *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d 254 (3d Cir. 2012).

long-term agreements functioned as exclusionary mechanisms.

The progression of below-cost pricing claims and the variety of matters in which such claims have come to be pled has fueled a number of debates about the appropriate use (and usefulness) of price-cost tests. One salvo in this debate came in June 2013 when Joshua Wright, then a Commissioner of the Federal Trade Commission, gave a speech regarding the evaluation of loyalty discounts. Wright took a stance against the use of the price-cost test as a means of evaluating whether such discounts have the effect of excluding potential rivals from the marketplace.[6] Instead, Wright advocated that despite the apparent simplicity of price-cost tests, an analysis of loyalty discounts should be conducted under an exclusive dealing framework. This stance prompted several responses from eminent legal experts.

One response to Wright comes from Daniel Crane, an associate dean and professor of law at the University of Michigan. Crane characterizes his disagreement with Wright as revolving around the question "of whether antitrust law should ever condemn a loyalty discount that the allegedly excluded rival could have met without pricing below cost."[7] Crane believes a rival is not foreclosed if it does not have to price below cost (i.e., that it has a potential "counterstrategy" that it can adopt in order to compete). As a result, Crane concludes that price-cost tests can provide a "screen" by which to evaluate pricing conduct and that conduct that results in above-cost pricing should represent a safe-harbor. These views are closely mirrored by those of Thomas Lambert, a professor of law at the University of Missouri. In response to the same Wright speech, Lambert observed:

[A]ny rival that loses sales because of a manufacturer's above-cost loyalty discount must be either less efficient than the manufacturer (so it can't match the manufacturer's discounted price) or unwilling to lower its price to the level of its cost. In either case, the rival is unworthy of antitrust's protection, where that protection amounts to prohibiting cuts that provide consumers with immediate benefits.[8]

A rival opinion, expressed by Steven Salop, a professor of law and economics at Georgetown University, specifically takes issue with the notion that price-cost tests should be applied to "equally efficient competitors."[9] According to Salop, even the entry of a less efficient competitor, that otherwise would be foreclosed by certain pricing conduct, can help provide pricing discipline in the marketplace. Salop also rejects the use of price-cost tests because he claims that it can result in both false negatives (behavior that forecloses rivals but entails above-cost pricing) and false positives (behavior that does not foreclose rivals but entails below-cost pricing).[10] Thus, Salop believes that courts should consider price-cost tests as simply one of many relevant evidentiary factors and that price-cost tests should not be a primary or "trump" factor for either side in a dispute. In this same vein Salop also believes that courts should not view the results of price-cost tests as being dispositive (e.g., above-cost pricing necessarily indicating that a defendant can "escape liability"). Such formalism is characterized by Salop as "Creeping Brookism". Instead, consistent with the opinions expressed by Wright, Salop advocates that courts should adopt a rule of reason analysis for evaluating pricing conduct and that the appropriate framework under which to do so is to be found in the raising rivals' costs paradigm.[11]

The use of price-cost tests and their potential role as a safe-harbor for certain types of pricing conduct is not simply an academic issue, though, as the Third Circuit is currently confronting these issues head-on in the *Eisai Inc. v. Sanofi-Aventis* matter. In that matter, the district court granted summary judgment on the basis that there was no factual dispute that at all times the defendant priced above cost.[12] Thus, in explaining its ruling

[6] Joshua Wright, "Simple but Wrong or Complex but More Accurate? Exclusive Dealing-Based Approach to Evaluating Loyalty Discounts," presented at the Bates White 10th Annual Antitrust Conference on June 3, 2013.

[7] Daniel Crane, "Dan Crane on Commissioner Wright's Rejection of a Price-Cost Test for Loyalty Discounts," *Truth on the Market*, June 6, 2013.

[8] Thomas Lambert, "Should There Be a Safe Harbor for Above-Cost Loyalty Discounts? Why I Believe Wright's Wrong," *Truth on the Market*, June 6, 2013.

[9] Steven Salop, "Wright is Right and Price-Cost Safe Harbors are Wrong: The Raising Rivals' Costs Paradigm, Loyalty Discounts and Exclusive Dealing," *Truth on the Market*, June 7, 2013.

[10] Steven Salop, "Conditional Pricing Practices and the Two Anticompetitive Exclusion Paradigms," DOJ/FTC Workshop on Conditional Pricing Practices, June 23, 2014.

[11] *See* for example, Steven Salop and David Scheffman, "Raising Rivals' Costs," *American Economic Review*, vol. 73, no. 2, May 1983, pp. 267-271.

[12] *See* Redacted Brief of Appellees Sanofi-Aventis U.S. LLC and Sanofi US Services, Inc. in Opposition to Appeal by Easai,

in that matter, the Third Circuit will likely have to express an opinion as to whether price-cost tests create a safe-harbor for certain types of pricing conduct. By upholding the district court's decision, the Third Circuit would likely have to affirm that price-cost tests create a safe-harbor while overriding the district court's decision would likely require a disavowal of such a safe-harbor.

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