

PeaceHealth: An Evolutionary Step in the Antitrust Analysis of Bundled Discounts

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Bundled discounting—such as a burger with fries and a soda, or phone service with cable television and internet access – can reflect legitimate transactional cost-savings or other benefits associated with the bundled purchase of multiple products or services. However, when offered by a monopolist to unfairly exclude an equally efficient competitor, bundled discounts harm consumer welfare and create monopolization concerns under Section 2 of the Sherman Act (Section 2).¹

The Ninth Circuit decision in *Cascade Health Solutions v. PeaceHealth* establishes the presumptive legality of bundled discounts that do not exclude a hypothetical, equally efficient producer of competitive products—that is, products that compete with components of the bundled package.² The *PeaceHealth* decision creates a circuit split over the appropriate legal standard for evaluating bundled discounting practices.³ The current circuit split reflects the difficulty in distinguishing between “good” and “bad” discounts.

¹ 15 U.S.C. § 2. Section 2 prohibits monopolization, attempts to monopolize, and conspiracies to monopolize. In addition, the Federal Trade Commission Act, 15 U.S.C. § 45, empowers the Federal Trade Commission (the FTC, which technically does not enforce the Sherman Act) to challenge unfair competition, including activities that violate Section 2.

² 515 F.3d 883 (9th Cir. 2008).

³ The *PeaceHealth* Court explicitly rejected the holding of *LePage’s, Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003). Under *LePage’s*, bundled discounts offered by a monopolist are unlawful if they substantially foreclose portions of the market to a competitor that does not provide an equally diverse group of services—and therefore cannot make a comparable offer. *Id.*

Recently, the parties settled the *PeaceHealth* lawsuit.⁴ But the large number of recent federal cases with bundling implications indicates that this issue will continue to be hotly litigated by other parties.⁵ Further judicial proceedings to resolve the circuit split—most likely including a Supreme Court ruling—therefore should be anticipated.

This article discusses the *PeaceHealth* decision. It is intended to crystallize the antitrust issues associated with bundled discounting, particularly for general healthcare practitioners and others who are interested in monitoring developments in this area of law. (For a more detailed analysis of the *PeaceHealth* discount allocation standard—including a comparison to alternative standards that have been adopted or recommended, practical concerns in the application of this test, as well as key questions that counsel should ask in evaluating the potential antitrust risk associated with a particular discount arrangement—please see the forthcoming article, “All Together Now? *Evolving Antitrust Approaches to Bundled Discounting*” which will be published in the April 2009 edition of the *Journal of Health & Life Sciences Law*.)

Bundled Discounting Defined

Bundling, generically defined, is offering for sale at a single price two or more goods or services that the consumer otherwise could purchase separately. Bundled discounting occurs when a seller offers a group of products (or services) at a lower price than the aggregate charge for the goods if purchased individually. For example, a group

⁴ On August 25, 2008, the parties advised the Ninth Circuit that they had resolved their dispute. *Cascade Health v. PeaceHealth*, No. 05-35627 (9th Cir. Sept. 3, 2008).

⁵ Recent bundling cases include *Delaware Valley Surgical Supply Inc. et al. v. Johnson & Johnson et al.*, No. 08-55105, 2008 WL 1886050 (9th Cir. Apr. 30, 2008) (involving bundling of sutures and “endomechanical products”; complaint dismissed because plaintiff lacked standing to sue under the Sherman Act); *Meijer Inc. v. Abbott Labs*, No. 07-5985 (N.D. Cal. July 7, 2008) (involving alleged bundling of “boosting” and “boosted” HIV drugs); *Invacare Corp. v. Respironics, Inc.*, No. 04-1580 (N.D. Ohio Oct. 23, 2006) (involving a medical device manufacturer that bundled masks worn by persons with obstructive sleep apnea with devices that blow air into the masks); *Masimo Corp. v. Tyco Health Care Group, L.P.*, No. 02-4770 (C.D. Cal. Mar. 22, 2006) (involving rebates offered by Tyco to hospitals that purchased both Tyco’s oximetry and non-oximetry products); *J.B.D.L. Corp. v. Wyeth-Ayerst Labs., Inc.*, No. 01-0704 (S.D. Ohio June 13, 2005) (involving rebates offered by Wyeth to pharmacy benefit managers based on combined purchases of estrogen-replacement drugs, oral contraceptives, an antidepressant, an antibiotic, a calcium channel blocker, and a beta blocker), *aff’d*, 485 F.3d 880 (6th Cir. 2007); *In re Hypodermic Prods. Antitrust Litig.*, MDL No. 1730, 2007 WL 1959225 (D.N.J. Jun. 29, 2007) (denying motion to dismiss in a bundling and exclusive dealing case where the plaintiff alleged that the defendant manufacturer entered into agreements with customers for “millions of dollars in cash payments” for exclusivity, citing news articles describing the alleged agreements). Additionally, in September 2008, the U.S. Department of Justice (DOJ) established safe harbors for certain discount arrangements. U.S. DEP’T OF JUSTICE, COMPETITION AND MONOPOLY: SINGLE-FIRM CONDUCT UNDER SECTION 2 OF THE SHERMAN ACT 63, n. 136 (2008) (citations omitted), available at www.usdoj.gov/atr/public/reports/236681.pdf.

purchasing organization may offer discounts based on volume purchasing across multiple product lines. Similarly, a hospital system may offer discounts to health plans that agree to include its hospitals as a preferred provider of primary, secondary, and tertiary services. Although bundled discounts often create a “win-win” for buyers and sellers, they can be anticompetitive when used by a monopolist to exclude a smaller competitor.

Background Facts and Jury Verdict

In *PeaceHealth*, McKenzie, a smaller community hospital, challenged the bundled discounting practices of PeaceHealth, the only other provider of hospital services in Lane County, Oregon.⁶ McKenzie’s 114-bed hospital offered only primary and secondary services.⁷ PeaceHealth’s three hospitals, which operated a total of 465 beds, offered a complete range of hospital services, including primary and secondary services, as well as more complex services known as “tertiary care.”⁸ PeaceHealth had a 75% share of the relevant market for primary and secondary services in Lane County—a presumptive monopoly share under Section 2.

PeaceHealth offered significant discounts on tertiary services to insurance companies that agreed to purchase *all* hospital services—primary, secondary, and tertiary services—exclusively from PeaceHealth. Although McKenzie provided primary and secondary services at a lower cost than PeaceHealth, the smaller hospital could not match the bundled discounts that PeaceHealth provided across its wider array of services. McKenzie filed an antitrust action, asserting that PeaceHealth’s pricing arrangements were intended to exclude it from the market for primary and secondary services.

Specifically, McKenzie alleged that PeaceHealth was engaged in unlawful monopolization, attempted monopolization, conspiracy to monopolize, tying, exclusive dealing, and violations of state law. Prior to trial, the district court granted summary judgment on the tying claim. In doing so, the court ruled that McKenzie failed to

⁶ In *PeaceHealth*, the plaintiff sued the hospital offering bundled discounts as well as three health plans that contracted with that hospital. For purposes of this article, the plaintiff is referred to as “McKenzie”

⁷ Primary and secondary services are common medical services, such as setting broken bones or performing a tonsillectomy. *PeaceHealth*, 515 F.3d at 891.

⁸ Tertiary services include cardiovascular surgery and intensive neonatal care. *Id.*

establish that PeaceHealth had forced purchasers wanting only tertiary services (the purported tying product) to acquire primary and secondary services (the purported tied product).⁹ The remaining claims went before a jury. The jury rejected McKenzie's claims that PeaceHealth had engaged in monopolization, conspiracy to monopolize, and exclusive dealing. But, the jury found that PeaceHealth had engaged in an attempt to monopolize, and awarded the plaintiff \$5.4 million in damages (which would be trebled to \$16.2 million under the antitrust laws).¹⁰

The Ninth Circuit Adopts a Discount Allocation Standard

On appeal, PeaceHealth argued that the district court incorrectly instructed the jury on the standard for unlawful bundled discounting under Section 2.¹¹ The jury instruction, which was based on *LePage's, Inc. v. 3M*, did not require the jury to consider whether PeaceHealth's discounted price was below cost. It stated:

Bundled price discounts may be anti-competitive if they are offered by a monopolist and substantially foreclose portions of the market to a competitor who does not provide an equally diverse group of services and who therefore cannot make a comparable offer.¹²

PeaceHealth argued that this instruction improperly allowed the jury to find exclusionary conduct based on a smaller competitor's inability to offer a matching bundled discount.¹³

The Ninth Circuit rejected the holding in *LePage's* and ruled that the district court improperly instructed the *PeaceHealth* jury. The appeals court adopted a discount allocation standard under which the defendant's total bundled discounts must be allocated to competitive products offered by a hypothetical, equally efficient competitor. If the resulting price of the competitive products is below the defendant's incremental

⁹ *Id.* at 913. A tying arrangement is a device used by a seller with market power in one product market to extend its market power to a distinct product market. *Id.*, citing *Paladin Assocs., Inc. v. Mont. Power Co.*, 328 F.3d 1145, 1159 (9th Cir. 2003).

¹⁰ Under this verdict, McKenzie also was entitled to approximately \$1.6 million in attorneys' fees and costs. *PeaceHealth*, 515 F.3d at 891.

¹¹ McKenzie cross-appealed the district court's grant of summary judgment rejecting claims that PeaceHealth's discount arrangements constituted unlawful exclusionary dealing. Both parties appealed the district court's award of attorneys' fees and costs. *Id.* at 893.

¹² *Id.* at 898, n.9. See *supra* note 3.

¹³ The Ninth Circuit took the unusual step of requesting amicus briefs, and in response received numerous briefs, on the appropriate standard for assessing the legality of bundled discounting. *Id.* at 899, n.8.

cost of production, the bundled discount may be found to be exclusionary under Section 2.¹⁴ In adopting this standard, the court expressed a desire to provide “clear guidance” for sellers that offer bundled discounts, noting that the standard permits a seller to “easily ascertain its own prices and costs of production and calculate whether its discounting practices run afoul of the rules we have outlined.”¹⁵

Bundling as Unlawful Tying or Exclusionary Conduct

The Ninth Circuit’s ruling in *PeaceHealth* also underscores the risk that bundled discounting may create antitrust exposure as unlawful tying or de facto exclusionary dealing.¹⁶ Unlawful tying occurs when a seller with market power offers “to sell one product (the tying product) but only on the condition that the buyer also purchases a different (or tied) product, or at least agrees that he will not purchase that product from any other supplier.”¹⁷ The essential characteristic of unlawful tying lies in the seller’s coercion or “exploitation of its control over the tying product to force the buyer into the purchase of a tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms.”¹⁸ Unlawful exclusionary dealing typically occurs when, as a result of agreements that require buyers to purchase all, or a substantial portion, of their total requirements from a particular supplier, other firms are foreclosed from selling or buying particular products or services.¹⁹

¹⁴ For the purpose of assessing the propriety of bundled discounts, the Ninth Circuit determined that the average variable cost of production is the appropriate measure of incremental cost. The court pointed to the adoption of this methodology by several circuit courts, and to the recommendation of Professors Areeda and Turner. *Id.* at 909–10 (citing Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697, 712, 716 (1975)).

¹⁵ *Id.* at 907.

¹⁶ Tying and exclusive dealing can create antitrust exposure under both Section 1 of the Sherman Act, 15 U.S.C. § 1, and Section 2. See generally, e.g., *U.S. v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001) (addressing the differences between exclusive dealing under Section 1 and Section 2; holding that tying conduct violated Section 2 and remanding for a determination on whether conduct violated Section 1). As a practical matter, conduct that would be legal for a nondominant firm may be exclusionary and unlawful when performed by a monopolist.

¹⁷ *Northern Pac. Ry. v. United States*, 356 U.S. 1, 5–6 (1958).

¹⁸ *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 12 (1984). Because of the element of coercion, tying is a per se violation of the antitrust laws when implemented by a monopolist. *Id.* Where a seller lacks market power in the tying market, a tie may be unlawful under the rule of reason if it leads to anticompetitive effects in a relevant market. See *Med Alert Ambulance, Inc. v. Atlantic Health Sys., Inc.*, No. 04-1615, at II(b)(3) (D. N.J. Aug. 6, 2007) (denying defendant’s motion for summary judgment).

¹⁹ See, e.g., *United States v. Dentsply Int’l, Inc.*, 399 F.3d 181 (3d Cir. 2005); *Microsoft Corp.*, 253 F.3d at 34; *U.S. Healthcare Inc. v. Healthsource, Inc.*, 986 F.2d 589, 594 (1st Cir. 1993).

The courts generally recognize that tying and exclusive dealing can result in “consumers . . . receiv[ing] greater value for the same expenditure,”²⁰ and therefore will evaluate a firm’s business justifications for a particular arrangement, as well as the economic impact of that arrangement.²¹ (Although tying is classified as a per se violation under certain conditions, such arrangements generally are not condemned without analysis of their purpose and effect²²). Antitrust concerns with both tying and exclusive dealing generally result from the seller’s restrictions on the purchaser’s freedom to choose between competing products.²³ The critical issue is whether such arrangements create a risk that a significant portion of the market will be foreclosed to competing sellers (or buyers).²⁴

On appeal by McKenzie, the Ninth Circuit reviewed and reversed the district court’s determination (on PeaceHealth’s motion for summary judgment) that PeaceHealth’s bundled discounting did not constitute unlawful tying under Section 1.²⁵ The district court had granted summary judgment because McKenzie presented no evidence that insurers were explicitly coerced into purchasing primary and secondary services from PeaceHealth.²⁶ However, the Ninth Circuit explained that coercion may occur either “as an implied condition of dealing or as a matter of economic imperative through . . . bundled discounting.”²⁷ In other words, a de facto tie may exist where the seller purports to offer the products separately, but the bundled discounts leave purchasers with “no rational economic choice other than purchasing [the bundled package].”²⁸

²⁰ 9 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1717b2, at 185 (2d ed. 2004).

²¹ See, e.g., *NCAA v. Bd. of Regents*, 468 U.S. 85, 104 n.26 (1984) (“tying may have procompetitive justifications that make it inappropriate to condemn without considerable market analysis”); *Jefferson Parish*, 466 U.S. at 44–47; *Standard Oil Co. v. United States*, 337 U.S. 293 (1949); *Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320, 329, 334 (1961); *accord Roy B. Taylor Sales, Inc., v. Hollymatic Corp.*, 28 F.3d 1379, 1384 (5th Cir. 1994); *U.S. Healthcare v. Healthsource, Inc.*, 986 F.2d at 594.

²² Tying agreements are classified as per se violations where (1) two products or services are involved, (2) the sale of one product or service is conditioned on the purchase of another, (3) the seller has sufficient economic power to enable it to restrain trade in the market for the tied product, and (4) a not insubstantial amount of trade in the tied product is affected. See, e.g., *Fortner Enters. v. U.S. Steel Corp.* (*Fortner I*), 394 U.S. 495, 498–99 (1969).

²³ See, e.g., *Northern Pac. Ry. v. U.S.*, 356 U.S. at 6.

²⁴ See, e.g., *Jefferson Parish*, 466 U.S. at 44–46.

²⁵ *PeaceHealth*, 515 F.3d at 912–16.

²⁶ See *id.* at 912.

²⁷ *Id.* at 914–15.

²⁸ *Id.* at 916, n.27; see also *Marts v. Xerox, Inc.*, 77 F.3d 1109 (8th Cir. 1996) (unlawful tying arrangement is possible even where products are offered separately if purchasing them together is the only viable option); *Ramallo Bros. Printing, Inc. v. El Dia, Inc.*, 392 F. Supp. 2d 118 (D.P.R. 2005) (“To establish coercion, the plaintiff must demonstrate that defendant’s pricing structure ‘force[s] the buyer into the

The Ninth Circuit determined that the need for further factual development rendered summary judgment on the tying claim inappropriate. In particular, there was a genuine factual dispute as to whether, either as an implied condition of dealing or as a matter of economic imperative (created through bundled discounting), PeaceHealth forced insurers wishing to purchase tertiary services to purchase primary and secondary services as well. The court reasoned that, as the sole provider of tertiary services in Lane County, PeaceHealth might have the ability to force unwanted purchases of primary and secondary services.²⁹ Indeed, despite its testimony that it “voluntarily” entered into its contracts with PeaceHealth, one insurance company characterized itself as a “hostage” of PeaceHealth’s pricing practices.³⁰ Further, the court found it permissible to infer coercion based on the fact that only four of the twenty-eight (about 14%) insurers operating in the county purchased PeaceHealth’s services separately.³¹ Similarly, although the Ninth Circuit was not asked to review the jury’s determination that PeaceHealth’s conduct did *not* constitute exclusive dealing, the *PeaceHealth* decision suggests that bundled discounting also can create antitrust exposure as de facto exclusionary dealing. Even where exclusivity is not an explicit condition of dealing, it may be possible to infer an exclusionary arrangement if a bundled discount results in substantial foreclosure of competing sellers (or buyers). For example, where discounts or rebates are structured as “all or nothing” discounts, customers may be induced to purchase exclusively from the discounter in order to maximize their discounts.³²

purchase of tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms.’ . . . The element of coercion, however, cannot be satisfied by mere discounts or other forms of package sales unless the combined purchase is the only economically-viable alternative.”); *Compuware Corp. v. Int’l Bus. Machines Corp.*, 366 F. Supp. 2d 475 (E.D. Mich. 2005) (“Forcing can exist when tying is ‘economic’ i.e., when the products are available separately, but only at significant economic disadvantage”); *cf. Zschaler v. Claneil Enters., Inc.*, 958 F. Supp. 929 (D. Vt. 1997) (“The Court will not infer coercion from the mere bundling of products by Defendants”).

²⁹ *PeaceHealth*, 515 F.3d at 915.

³⁰ *Id.* at 914–16 (noting that the proper analysis of tie-ins is unsettled, the Ninth Circuit declined to address whether a bundled discount must be below a relevant measure of cost to establish the coercion element of a tying claims.) The DOJ recently called for “rule of reason” analysis of tie-ins, even when used by dominant firms. See SECTION 2 REPORT at 89.

³¹ *Id.* at 915 (citing 10 AREEDA & HOVENKAMP, ¶ 1758b at 327 (2d ed. 2004) (“a trivial proportion of separate sales shows that the package discount is as effective as an outright refusal to sell [the tying product] separately”).

³² See generally *LePage’s*, 324 F.3d at 159.

Conclusion

Further judicial proceedings will be necessary to resolve the circuit split and provide a uniform, nationally applicable standard for bundled discounting. As the Ninth Circuit recognized, “there is limited judicial experience with bundled discounts, and academic inquiry into the competitive effects of bundled discounts is only beginning.”³³ For a more detailed discussion of bundled discounting please see the April 2009 edition of the Journal of Health & Life Sciences Law.

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³³ *PeaceHealth*, 515 F.3d at 908.