DISCOUNTED BUNDLING BY DOMINANT FIRMS

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> Buyers often find package sales attractive; a seller's decision to offer such packages can merely be an attempt to compete effectively—conduct that is entirely consistent with the Sherman Act.[1]

> When the economic advantages of joint packaging are substantial the package is not appropriately viewed as two products, and that should be the end of the tying inquiry . . . . A tie-in should be condemned only when its anticompetitive impact outweighs its contribution to efficiency.[2]

INTRODUCTION

This article discusses the common practice of offering multiple products or services as a package or bundle, where those individual items remain separately available but the package is attractive because the package price is lower than the total price for the constituent products purchased separately. Bundled discounts are distinguished from tying arrangements because, unlike a tie, consumers are not forced to purchase one product as a prerequisite to being allowed to purchase another product. Bundled discounts are in many ways akin to ordinary volume discounts, because in both cases the purchase of additional units leads to a lower overall price.

There is universal agreement that a firm without market power in any of the constituent products should not be condemned under antitrust for offering above-cost discounted bundles. There is also agreement that a dominant firm may offer above-cost discounts on volume purchases of a single monopoly product. There is, however, considerable disagreement whether a firm that is dominant in one product may offer an above-cost discount on a multi-product bundle.

This article argues that a dominant firm's offering above-cost discounts for volume purchases, of either individual products or multiple

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[1] Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 12 (1984) (citations omitted).

[2] *Id*. at 40, 42 (O'Connor, J., concurring).

products, should be *per se lawful* under Section 2 of the Sherman Act even if the lower prices tend to shift business away from single-product rivals. This conclusion follows from three points. First, discounted bundles are commonly offered by firms having no market power whatsoever, and therefore no special suspicion should arise when dominant firms offer them. Second, the common offering of bundles is due to numerous efficiency advantages from the point of view of producers and consumers. Third—and the reason that above-cost bundles should not be just presumptively lawful but per se lawful—fact finders are not able reliably to distinguish between efficient bundles and those whose anticompetitive effects outweigh efficiency. Discounted bundles are an area in which the medical profession's oath "first do no harm" is fully applicable. Courts should be especially reluctant to interfere when a dominant firm offers its customers a price break.

I. DISCOUNTED BUNDLES AS A SUSPECT CLASS

The "normal rule" in American antitrust is that when non-dominant firms are observed commonly engaging in a particular form of conduct in the marketplace, then such conduct is presumptively permissible for a dominant firm also.

> If the practice is one employed widely in industries that resemble the monopolist's but are competitive, there should be a presumption that the monopolist is entitled to use it as well. For its widespread use implies that it has significant economizing properties, which implies in turn that to forbid the monopolist to use it will drive up his costs and so his optimum monopoly price.[3]

Aggressively satisfying customer demand, making a superior product, exercising foresight and business acumen, investing in additional capacity, reducing prices (but not below cost)—all these practices are understood to be permitted by dominant firms just as readily as competitive firms.[4] Indeed such practices should be *encouraged* in the case of dominant firms; legal rules that inhibit monopolists' price-cutting are especially bad, since (by definition) full market pressure to lower prices is missing and more buyers stand to benefit from a price cut.

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3 RICHARD A. POSNER, ANTITRUST LAW 253 (2d ed. 2001).

4 For example, the Supreme Court's holding in *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 222, 226 (1993), that predatory pricing claims must be rejected unless the prices complained of are below cost, "plainly applies to a monopolist." Brief for the United States as Amicus Curiae at 14 n.11, 3M Co. v. LePage's Inc., 324 F.3d 141 (3d Cir. 2003), *cert. denied*, 124 S. Ct. 2932 (2004) (No. 02-1865).

Bundled discounts satisfy the predicate of the normal rule. Virtually all multi-product firms throughout the economy offer such bundled discounts. The universe of bundled discounts includes such simple fare as "value meals" at fast-food restaurants, season ticket offerings of sports teams, and furniture sold both in suites and by individual item. It includes expensive packages offered by travel providers and complex packages involving computer hardware and software, hospital supplies, financial services, and licenses to play copyrighted music. It includes products so commonly offered as a package that the bundling aspect is almost taken for granted—mutual fund shares, round-trip airplane tickets, telephone service allowing calls to all U.S. locations, and multi-channel cable TV service. As one leading textbook puts it:

> Retailers bundle free parking with a purchase in their stores. Grocery stores and fast-food outlets bundle chances in games with purchase of their products. Newspapers with morning and evening editions bundle advertising space in both of them . . . . Symphony orchestras bundle diverse concerts into season subscription tickets. These are but a small fraction of the goods sold in bundles, but they illustrate the breadth of the practice—from commodities to services, from necessities to entertainment.[5]

In short, bundled discounts, offered by firms without market power, are ubiquitous.

Yet in sharp contrast to the legal freedom of competitive firms to offer bundles, or even the freedom of a dominant firm to offer volume discounts when it sells additional units of the same product, the legality of a dominant firm's discounts on multi-product bundles is very much up in the air. Following the Third Circuit's much-criticized[6] decision in *LePage's Inc. v. 3M*,[7] even above-cost bundled discounts may be illegal if courts and juries determine after the fact that the discounts were "exclusionary" of single-product rivals. A wave of new lawsuits has begun challenging bundled discounts in diverse industries.[8] Prominent economists such as Barry Nalebuff

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5 THOMAS T. NAGLE & REED K. HOLDEN, THE STRATEGY AND TACTICS OF PRICING: A GUIDE TO PROFITABLE DECISION MAKING 244-45 (3d ed. 2002).

6 *E.g.,* Daniel A. Crane, *Multi-Product Discounting: A Myth of Non-Price Predation*, 72 U. CHI. L. REV. 27 (2005); Daniel L. Rubinfeld, *3M's Bundled Rebates: An Economic Perspective*, 72 U. CHI. L. REV. 243 (2005).

7 324 F.3d 141 (3d Cir. 2003), *cert. denied*, 124 S. Ct. 2932 (2004)

8 *See, e.g.*, Compl., Genico, Inc. v. Ethicon, Inc. (E.D. Tex. filed Oct. 15, 2004) (No. 5:04-CV-00229) (antitrust complaint challenging discounted bundles of surgical sutures and surgical instruments); First Am. Compl., Rochester Medical Corp. v. C.R. Bard, Inc. (E.D. Tex. filed Aug. 26, 2004) (No. 5:04-CV-00060) (antitrust complaint challenging discounted bundles of different urological catheters); Compl., ConMed Corp. v. Johnson & Johnson, Inc. (S.D.N.Y. filed Nov. 6, 2003) (No. 1:03-Civ-08800) (antitrust complaint challenging discounted bundles of surgical sutures and surgical instruments); Compl., Spartanburg Reg'l Healthcare Sys. v. Hillenbrand Indus., Inc. (D.S.C. filed June 30,

and David Sibley have declared that bundled discounts should be scrutinized to see if they exclude equally efficient competitors, thereby reducing competition.[9] The rising level of challenges to otherwise common conduct is taking the form of another Frankenstein monster created by the plaintiffs' bar.

II. DISCOUNTED BUNDLES AS AN EFFICIENT ECONOMIC TOOL

The market produces so many bundled discount programs not because they are anticompetitive but because they are beneficial to consumers and economically efficient. They function most directly as a form of quantity discount that, by inducing increased sales, can enable a firm to reduce its costs by taking advantage of scale economies,[10] multi-product production and distribution synergies,[11] and economies of scope.[12] Bundled pricing can also lower costs by reducing uncertainty about aggregate demand,[13] and it

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2003) (No. 7-03-2141-20) (antitrust complaint challenging discounted bundles of hospital beds, specialty hospital beds, and other hospital room furniture); Info. Res., Inc. v. Dun & Bradstreet Corp., 294 F.3d 447, 449 (2d Cir. 2002) (antitrust complaint against "favorable pricing" offered when customers bought defendant's retail tracking services for multiple countries) (citation omitted).

9 *E.g.*, Barry J. Nalebuff, *Bundling as a Way to Leverage Monopoly* (Yale School of Management, Working Paper draft Sept. 1, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=586648; Patrick Greenlee et al., *An Antitrust Analysis of Bundled Loyalty Discounts* (Economic Analysis Group Discussion Paper, Oct. 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=600799. Both Nalebuff and Greenlee caution that even competition-limiting bundles can benefit consumers, at least in the short run. Nalebuff, *supra*, at 6, 24 ("Consumers who choose the tying contract must be better off . . . . [T]here is clearly no immediate harm to consumers. However, there is clear harm to competitors . . . ."); Greenlee et al., *supra*, at 16 (noting that "the consumer is strictly better off" purchasing some rival-harming discounted bundles).

10 *See, e.g.*, Asim Ansari et al., *Pricing a Bundle of Products or Services: The Case of Nonprofits*, J. MARKETING RES. 86 (1996); NAGLE & HOLDEN, *supra* note 5, at 3. Scale economies appear to have been an important consequence of 3M's rebate programs. Because 3M used the same production plants for both its Scotch®-brand tape and its off-brand tape products, the unit production costs for all of its tape products were reduced as its total tape output increased. *See* Petition for Writ of Certiorari at 2, 3M Co. v. LePage's Inc., 2003 WL 22428375, *cert. denied*, 124 S. Ct. 2932 (2004) (No. 02-1865).

11 David S. Evans & Michael Salinger, *Why Do Firms Bundle and Tie? Evidence from Competitive Markets and Implications for Tying Law*, YALE J. ON REG. (forthcoming 2005), *available at* http://ssrn.com/abstract=550884. For example, 3M claimed that its bundled discount promoted cross-selling by different business units. *See* Petition for Writ of Certiorari at 4, 3M Co. v. LePage's Inc., 2003 WL 22428375, *cert. denied*, 124 S. Ct. 2932 (2004) (No. 02-1865).

12 *See, e.g.*, NAGLE & HOLDEN, *supra* note 5, at 306-07; Yannis Bakos & Erik Brynjolfsson, *Bundling Information Goods in Pricing, Profits, and Efficiency*, 45 MGMT. SCI. 1613, 1619 (1999) ("Bundling can create significant economies of scope even in the absence of technological economies in production, distribution or consumption.").

13 Yannis Bakos & Erik Brynjolfsson, *Bundling and Competition on the Internet*, 19 MARKETING SCI. 63, 64 (2002).

can reduce overhead and marketing expenses and economize on the quality-signaling benefits of well-known brands.[14] Bundled discount and rebate programs can give diverse customers greater flexibility to choose an optimal combination of products that suits their particular and changing needs, while enabling both the customers and the supplier to avoid the transaction costs of more particularized negotiations.[15] Each of these efficiencies is as likely to be available to a monopoly firm as to a firm having only competitive products. In fact, to the extent the monopoly is derived from high fixed costs or network effects, the firm may have natural efficiencies supplying adjacent product markets.[16]

Moreover, customers themselves increasingly insist on consolidating and reducing the number of their vendors.[17] In competing with one another for the business of such customers, multi-product vendors necessarily must offer bundled discounts if they want to compete on price at all.[18]

Against these efficiencies, critics of bundles argue that the price cut offered on the bundle might not be a price cut at all, but instead simply mitigation of a simultaneous price *increase* in the dominant firm's standalone monopoly product. In this strategy, the dominant firm raises the price of its monopoly product above the optimal monopoly price but allows consumers to recoup the excess by buying a bundle including a competitive product at a discount just equal to the extra monopoly price. Rivals for the competitive product are driven from the market and the dominant firm now has a monopoly on two products. Even a real price cut today, by foreclosing rival opportunities, could lead to the extension of monopoly into additional product markets tomorrow.

Bundle critics assume that one-product rivals are powerless to react to the discounts other than by trying to match them. Thus Little Joe's Dental

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14 *See*, *e.g.*, Michael A. Salinger, *A Graphical Analysis of Bundling*, 68 J. BUS. 85 (1995).

15 *See* NAGLE & HOLDEN, *supra* note 5, at 244-46.

16 For a description of such efficiencies in telephone markets, see PETER W. HUBER, MICHAEL K. KELLOGG & JOHN THORNE, FEDERAL TELECOMMUNICATIONS LAW 92-96, 652-54, 1107-57 (2d ed. 1999).

17 *See*, *e.g.*, Robert J. Vokurka, *Supplier Partnerships: A Case Study*, 39 PRODUCTION & INVENTORY MGMT. J. 30 (1998); Philip B. Evans & Thomas S. Wurster, *Strategy and the New Economics of Information*, HARV. BUS. REV., Sept.-Oct. 1997, at 70.

18 *See*, *e.g.*, Chun-Hsiung Liao & Yair Tauman, *The Role of Bundling in Price Competition*, 20 INT'L J. INDUS. ORG. 365 (2002); Gary D. Eppen et al., *Bundling—New Products, New Markets, Low Risks*, SLOAN MGMT. REV., Summer 1991, at 7; Stefan Stremersch & Gerard J. Tellis, *Strategic Bundling of Products and Price: A New Synthesis for Marketing*, 66 J. MARKETING 55, 70 (2002) ("We find that product bundling of existing products may be optimal because it creates added value for consumers, saves costs, and creates differentiation in highly competitive markets."); Andrea Ovans, *Make a Bundle Bundling*, HARV. BUS. REV., Nov.-Dec. 1997, at 18, 20 (quoting the author of one study of 100 companies for the proposition that bundling reduces information and transaction costs for consumers: "When done correctly, bundling provides customers with simplicity and order in an otherwise chaotic world.").

Floss (an imaginary one-product firm) must match the entire discount that Wal-Mart would lose if Wal-Mart doesn't buy floss from behemoth Johnson & Johnson as part of a hypothetical bundled discount covering hundreds of consumer health products. Bundle critics assume that Little Joe's has no option of joining with a rival bundle to compete head to head against Johnson & Johnson (although the critics do acknowledge that competition between separate bundles, when it occurs, is especially fierce and consumer-beneficial). The critics also assume that the one-product firms are unable to compete one step further upstream to supply an element of the monopolist's bundle. Johnson & Johnson would normally be happy to rebrand and resell Little Joe's floss if it were less costly than Johnson & Johnson's own floss product. In a world of competing bundles, one-product firms necessarily become inputs to the bundle purveyors. Further, the critics assume that the customer, Wal-Mart in this example, isn't savvy enough to perceive the future danger of losing Little Joe's as an alternative floss source and thus will fail to take steps to throw Little Joe's enough business to keep it in the market.

III. CLOSE SCRUTINY INAPPROPRIATE FOR DISCOUNTED BUNDLES

The practical arguments against scrutiny of bundles, looking at institutional abilities of antitrust courts and the incentives created by different rules, arise from two facts. First, bundled discounts on their face are a type of price cut. An antitrust rule that authorizes juries to review (and occasionally to punish) bundled discounts will deter large firms from offering such discounts in the first place—and thus may needlessly increase prices across the economy and directly harm consumers. As then-Judge Breyer explained writing for the First Circuit, "the consequence of a mistake" in this area of law "is not simply to force a firm to forego legitimate business activity it wishes to pursue; rather, it is to penalize a procompetitive price cut, perhaps the most desirable activity (from an antitrust perspective) that can take place in a concentrated industry where prices typically exceed cost."[19]

The Supreme Court, considering single-product price cuts, concluded that any exclusionary effect of an above-cost price cut on smaller competitors likely "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."[20] Indeed, "[e]ven if the ultimate effect of the cut is to induce or reestablish supracompetitive pricing, discouraging a

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19 Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 235 (1st Cir. 1983).

20 Brooke Group v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 223 (1993).

price cut and forcing firms to maintain supracompetitive prices, thus depriving consumers of the benefits of lower prices in the interim, does not constitute sound antitrust policy."[21]

Critics of bundles argue that any device having a potential to leverage monopoly into adjacent areas could ultimately increase prices. But a successful interventionist policy, to do more good than harm, must properly balance two different effects—one pro-consumer (lower prices) and the other anti-rival (lower prices making it harder for one-product firms to compete). The former is an immediate benefit. The latter requires a necessarily speculative prediction of future effects—the degree of foreclosure of the rivals, the success or failure of rivals to team up with others to form offsetting bundles (whose availability would strengthen competition), the ability and willingness of large buyers to preserve one-product firms despite the preference for bundles. It is no answer that antitrust cases often are brought years after the facts have played out, giving courts the advantage of hindsight. Firms offering bundles can't easily predict the effects of price cuts on rivals and will respond to the legal uncertainty by withdrawing discounts rather than risk lawsuits from unsuccessful smaller rivals or class actions. And the deterrence of price-cutting will apply most directly to dominant firms with monopoly products that are precisely the firms that should not be deterred from lowering prices.

A second fact making a more ambitious antitrust rule problematic is the fluidity of product market definition. Bundles are often prototypes of new products. To condemn a bundle is to perpetuate a separate market for each of its constituents, setting up obstacles to the evolution of a new composite product market. Policing product market definitions may be somewhat easier, perhaps, for mature and stable products like transparent tape, yet could easily destroy product evolution in technologically fast-moving industries.

Cable television service, for example, rapidly evolved from "community antennas" capturing and delivering better over-the-air TV signals into today's multi-channel packages of video entertainment. Cable operators argue with some force that disaggregating their multi-channel video offerings into a la carte programs would actually raise prices to consumers.[22]

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21 *Id.* at 223-24.

22 So far, the responsible federal agency agrees:

> The bundling of channels into tiers of service is, generally, an economically efficient way of providing MVPD subscribers with video programming. Although the current MVPD business model may result in some consumer dissatisfaction, government intervention through a la carte regulation likely will harm MVPDs, program networks, and especially MVPD subscribers.

FED. COMMUNICATIONS COMM'N, REPORT ON THE PACKAGING AND SALE OF VIDEO PROGRAMMING SERVICES TO THE PUBLIC (2004), *available at* http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-254432A1.pdf.

Individual programs and programming channels vary widely in popularity, season by season, and thus by offering a portfolio of channels as a package the cable operator can reduce its risk of miscalculating demand of a fickle audience. In similar fashion, many sports teams sell stadium seat tickets not just for multi-game single seasons but, using devices like waiting lists for access to season tickets, for a period that covers effectively multiple seasons. The sports team thus guarantees it can sell tickets to fill the stadium in both good and bad years. The tradeoff between (1) competitively disciplining constituent elements of a bundle by forbidding bundle discounts that arguably shield individual elements from equally efficient one-product rivals versus (2) allowing firms to spread multi-element risks across the entire bundle, thereby reducing total costs, is a subtle one.

CONCLUSION

Too much commerce is affected by bundled discounts to leave the law unclear. Condemning unilateral price-cutting programs requires "an objective, transparent, and economically based standard."[23] A clear standard is essential, for the risk is too great that condemnation otherwise will rest on sympathy for small firms and distaste for large firms' pursuit of every possible sale, perversely punishing economies of scale and aggressive rivalry that benefit the economy.

The proper approach here, as in the Supreme Court's most recent monopolization case, *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP*,[24] is to answer the antitrust question *categorically*, with choice of the categorical rule driven by very serious consideration of both the institutional capacities and the incentives created by the chosen categorical rule. Lay juries aren't likely reliably to distinguish beneficial versus competition-harming bundles at the liability stage, any better than courts are likely to be able to set (and then continually to supervise, possibly for decades) proper price, product market definition, and terms of dealing at the remedies stage. The experience of the 1982 *AT&T* breakup decree (mercifully put to rest by Congress in 1996)[25] involving bundles of local and long dis-

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23 Assistant Attorney General R. Hewitt Pate , The Common Law Approach and Improving Standards for Analyzing Single Firm Conduct, Address Before the Thirtieth Annual Conference on International Antitrust Law and Policy (Oct. 23, 2003), *available at* http://www.usdoj.gov /atr/public/speeches/202724.htm.

24 540 U.S. 398 (2004).

25 *See* United States v. AT&T, 552 F. Supp. 131 (D.D.C. 1982), *aff'd sub nom*. California v. United States, 464 U.S. 1013 (1983), superceded by Telecommunications Act of 1996, Pub. L. No. 104-104, § 601(a)(1). The 1982 decree was itself the modification of a prior federal antitrust decree from 1956, which itself followed a prior 1914 decree. The history of judicial attempts to control varying

tance telephone services and equipment, and the repeatedly-amended, still-ongoing 1941 *ASCAP* decree[26] involving bundles of copyright licenses, suggest that policing proper bundles may be "beyond the practical ability of a judicial tribunal to control."[27]

Allowing courts and juries, after the fact, to second-guess such product definition choices will push such choices in one direction only, tending toward more atomistic (and costly) product offerings. Product definition policing, as illustrated by the *AT&T* and *ASCAP* decrees, "requires antitrust courts to act as central planners, identifying the proper price, quantity, and other terms of dealing—a role for which they are ill-suited."[28]

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bundles of telephone products prior to the 1996 Telecommunications Act required five chapters to summarize. *See* PETER W. HUBER, MICHAEL K. KELLOGG & JOHN THORNE, FEDERAL TELECOMMUNICATIONS LAW 199-421 (1st ed. 1992).

26 *See* United States v. Am. Soc'y of Composers, Authors & Publishers, 1940-1943 Trade Cas. (CCH) ¶ 56,104 (S.D.N.Y. 1941); United States v. Am. Soc'y of Composers, Authors & Publishers, 2001-02 Trade Cas. (CCH) ¶ 73, 474 (S.D.N.Y. 2001) (Second Amended Final Judgment).

27 *Trinko*, 540 U.S. at 414 (quoting Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 223 (1993)).

28 *Id.* at 408.