EATON CASE COULD ALLOW SUPREME COURT TO REFINE STANDARDS IN MONOPOLIZATION CASES

By Steven J. Cernak, Gregory L. Curtner, and Kimberly K. Kefalas, Schiff Hardin LLP

A divided panel of the U.S. Court of Appeals for the Third Circuit in September 2012 upheld a jury verdict against Eaton Corporation and in favor of ZF Meritor LLC and Meritor Transmission Corp.

ZF Meritor LLC (ZFM) and Meritor Transmission Corp. (Meritor) had accused Eaton of illegal monopolization and exclusive dealing through use of a loyalty discount program and other sales tactics when selling their transmissions for heavy duty trucks. Soon, Eaton is expected to petition the U.S. Supreme Court for a writ of certiorari. If the Court grants the petition, it may provide in its decision clarification as to when allegedly exclusionary practices should be analyzed as predatory pricing. Even if the Court denies petition, the Third Circuit's decision (both majority and dissenting opinions) is an important new step in the evolving law regarding the kinds of "exclusionary" contract terms that can be utilized by market participants with high market shares.

Eaton and Meritor made transmissions for heavy duty trucks. The vast majority of heavy duty trucks in the U.S. are linehaul trucks and nearly all of them use only manual or automated mechanical transmissions. Eaton was the only significant manual manufacturer for decades. Meritor entered the market in 1989 and had approximately 17% of the sales 10 years later. Also in 1999, Meritor and ZF Friedrichshafen of Germany formed ZFM to convert ZF's automated mechanical transmissions to U.S. standards. Eaton responded to ZFM's entry by introducing its own automated mechanical transmission and entering long-term agreements with the only four U.S. original equipment manufacturers (OEMs) of heavy duty trucks.

According to Meritor and ZFM, all those agreements, while different for each OEM, included four features that allegedly damaged competition:

1. Eaton offered various forms of price discounts if the OEM purchased Eaton transmissions for a large percentage—anywhere from 65% to 95%—of its needs. Significantly, none of the discounts resulted in any sales at a loss.
2. Eaton required the OEMs to make the Eaton transmissions either the standard (default) or preferred (best-price) choice in their respective databooks. Truck buyers usually, but need not, use databooks to help select truck options.
3. Eaton required some of the OEMs to "preferential price" its transmissions to truck buyers against any competitor's equivalent transmission.
4. each of these agreements was for at least five years, longer than the three-year agreements Eaton and Meritor previously had with at least OEM, Freightliner.

Another feature of each agreement, emphasized by Eaton, was the "competitiveness clause" that allowed the OEM to exclude an Eaton product from the share target if another manufacturer offers transmissions of better quality or lower price.

Both ZFM and Eaton experienced quality problems with their automated mechanical transmissions, but only ZFM's sales share dropped. In late 2003, ZFM was dissolved, and Meritor returned to the market. In 2006, Meritor exited the heavy duty truck transmission business entirely.

Later in 2006, Meritor and ZFM sought treble damages from Eaton for monopolization under Sherman Act §2 and de facto exclusive dealing contracts under Clayton Act § 3.

The jury returned a verdict of liability against Eaton. Subsequently, the judge denied Eaton's motion for judgment as a matter of law. Eaton did not appeal the jury's finding that it had monopoly power, but it did appeal the finding that its actions were anticompetitive.

By a 2-1 vote, the Third Circuit upheld the decision, adverse to Eaton. The majority first had to deal with Eaton's argument that the Supreme Court's Brooke Group test, which was developed to assess whether "predatory" pricing practices are anticompetitive, should have been applied. See Brooke Group v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993). Under the Brooke Group test, low pricing will not be deemed anticompetitive so long as it is above an appropriate measure of cost. While acknowledging that Brooke Group is the applicable standard when price is clearly the predominant mechanism of exclusion, the majority held that there was evidence that several of the non-price elements in Eaton's agreements also contributed to the anticompetitive effects and that evidence was sufficient to support the jury's verdict.

Rather than applying Brooke Group, therefore, the majority conducted a more general rule of reason balancing applicable to any monopolization or exclusive dealing claim. First, it found support in past cases for successful exclusive dealing claims that were only de facto or partial, such as the approximate 85% of the sales foreclosed here. The import of that foreclosure increased because of the length of the agreements. The majority also found evidence sufficient for a jury to find the databook and preferential pricing requirements anticompetitive. Finally and perhaps most significantly, the majority found coercion based on evidence that Eaton might cancel the agreements, rather than simply increase prices, if the OEMs did not meet their market share targets, despite the agreement's competitiveness clause. Because Eaton was by far the larger of the only two suppliers of a necessary truck component, the OEMs could not take the risk of supply disruption.

The dissent agreed with the majority that (a) Brooke Group is not dispositive in every case that challenges pricing practices, and (b) a competitor could act anti-competitively without engaging in below cost prices. To the dissent, however, the Supreme Court's repeated references to the Brooke Group analysis in previous cases has rendered it a "cornerstone of antitrust jurisprudence," and, therefore, it must be a high barrier to success to plaintiffs making these types of claims.

Specifically, the dissent suggested that courts review all elements of such pricing programs, apply Brooke Group, and presume lawful any program with above-cost discounts. The dissent would have found insufficient evidence to support a jury finding that the presumption should be overturned. For instance, the dissent found no support in any prior Clayton Act § 3 cases for exclusive dealing claims when the exclusive dealing was both de facto and partial. Also, the dissent noted that the 85% foreclosure figure relied on by the majority was just an estimate of Eaton's actual share of sales both before and during the challenged period and did not necessarily represent the share of the market foreclosed to ZFM.

The dissent did not agree that there was sufficient evidence that Eaton coerced the OEMs with a threat of cancellation. Only two of the four agreements explicitly allowed Eaton to cancel the agreement if the share targets were not met, and "cancellation" only meant that Eaton would try to recoup its discount, not stop shipping more transmissions. Also, while Eaton was one of only two suppliers to the OEMs, each OEM was one of only four customers; consequently, stopping all shipments would be economically irrational.

Finally, the dissent saw the databook requirements as subjects of negotiation normal to the industry and focused on evidence that ZFM and Meritor had successfully negotiated regarding those terms in the past.

Even if the Supreme Court does not use this case to clarify the standards in this area, this case is important for several reasons.

First, both the majority and dissent limit the reach of an earlier Third Circuit opinion, LePage's Inc. v. 3M, 324 F.3d 141 (3d Cir. 2003), cert. denied, 124 S.Ct. 2932 (2004), that had been read (and criticized) by many commentators as potentially preventing pro-competitive conduct without any clear standards. In LePage's, the court used a balancing approach, rather than applying Brooke Group, to condemn bundled discounts by a multi-product supplier to the detriment of a single product supplier. According to both the majority and dissent here, the LePage's analysis should be limited to bundling, and Brooke Group would apply to allegedly anticompetitive discounts when only a single product is involved and price is clearly the predominant mechanism of exclusion.

Second, Eaton adds two more exhaustive analyses of the case law to the numerous opinions and commentaries discussing the competitive effects of aggressive pricing, bundling, and exclusive dealing tactics by powerful sellers. Finally, because such cases so often turn on the facts specific to the companies and industry involved, its lengthy discussion of the facts here will allow the application of the opinion to other cases.

This case shows why clients with any semblance of market power should discuss with an antitrust lawyer the potential antitrust risks from aggressive pricing and other sales tactics.

Steven J. Cernak, Gregory L. Curtner, and Kimberly K. Kefalas are attorneys in the Antitrust and Trade Regulation Group in the Ann Arbor, Mich., office of Schiff Hardin LLP. Copyright © 2012 by Schiff Hardin LLP. Reprinted with permission of the copyright holder.