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## **BARGAINING OVER LOYALTY**

*DANIEL A. CRANE*

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## **Bargaining Over Loyalty**

**Daniel A. Crane\***

### *Abstract*

Contracts between suppliers and customers frequently contain provisions rewarding the customer for exhibiting loyalty to the seller. For example, suppliers may offer customers preferential pricing for buying a specified percentage of their requirements from the supplier or buying minimum numbers of products across multiple product lines. Such loyalty-inducing contracts have come under attack on antitrust grounds because of their potential to foreclose competitors or soften competition by enabling tacit collusion among suppliers. This article defends loyalty inducement as a commercial practice. Although it can be anticompetitive under some circumstances, rewarding loyal customers is usually procompetitive and price-reducing. The two most severe attacks on loyalty discounting—that loyalty discounts are often disguised disloyalty penalties and that loyalty clauses soften competition—are unlikely to hold as a general matter. Nor are arguments that customers only accede to loyalty inducements because of collective action problems generally true. Dominant buyers who face few collective action problems frequently use loyalty commitments to leverage their buying power and obtain lower prices.

## Bargaining Over Loyalty

**Daniel A. Crane\***

“These kinds of agreements allow firms to reward their most loyal customers. Rewarding customer loyalty promotes competition on the merits.”

*Virgin Atlantic Airways Ltd. v. British Airways PLC*, 257 F.3d 256, 265 (2d Cir. 2001)

Loyalty has an unambiguously positive connotation in ordinary discourse and in most legal fields.<sup>1</sup> For example, ethical canons require attorneys to remain faithful to their clients;<sup>2</sup> trustees and board members owe fiduciary duties to beneficiaries and shareholders;<sup>3</sup> spouses enjoy testimonial privileges based on social conventions respecting marital loyalty;<sup>4</sup> adultery remains criminalized in most states and a felony in some;<sup>5</sup> democratic theory requires judges to remain faithful to the will of the people expressed

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<sup>1</sup> See generally ERIC FELTEN, *LOYALTY: THE VEXING VIRTUE* (2011) (examining the virtue of loyalty in historical and contextual perspective).

<sup>2</sup> Code of Professional Responsibility, Canon 5 (specifying requirements of lawyer loyalty to client).

<sup>3</sup> See, e.g., Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. Pa. J. Bus. L. 675 (2009).

<sup>4</sup> See 8 WIGMORE, *EVIDENCE* § 2333 (McNaughten rev. 1961).

<sup>5</sup> See Mass. Ann. Laws ch. 272, § 14, ch. 274, § 1; Mich. Comp. Laws Ann. §750.30.

in constitutions or statutes;<sup>6</sup> and the law metes out far greater harsher punishment on the traitor than the common enemy.<sup>7</sup> George Fletcher has observed that “[s]ome of the strongest moral epithets in the English language are reserved for the weak who cannot meet the threshold of loyalty: They commit adultery, betrayal, treason.”<sup>8</sup>

Reflecting venomous disapprobation of treachery, Dante placed the traitors Brutus, Cassius, and Judas Iscariot in Lucifer’s jaws in Hell’s ninth circle.<sup>9</sup> In most contexts, loyalty only becomes difficult ethically and morally when loyalty obligations collide—when loyalty to one person means disloyalty to another.<sup>10</sup>

Antitrust law is exceptional—loyalty receives a far less congenial welcome. Antitrust values rivalry between competing sellers, which implies an opportunity to steal business from the rival. Customer loyalty obstructs this hydraulic action. Particularly troubling are inducements to loyalty offered by firms with market power. When dominant sellers offer customers incentives to remain loyal to the seller, these loyalty incentives may stifle competition and harm the very customers offered the ostensibly favorable terms. Even if the customer understands the loyalty incentive’s exclusionary or collusive potential, she may find it to be in her economic interest to accept the incentive since other customers will be accepting it regardless of her decision. Dominant firms may require their customers to remain loyal for the purpose of starving rivals of sales opportunities, thus ensuring that in the long run there are no other sellers to tempt customers into disloyalty. Or, they may use loyalty incentives to facilitate supracompetitive oligopolistic pricing.

Loyalty or fidelity incentives have recently been challenged under the antitrust laws in the United States and the European Union. For example, parallel cases in the U.S. and EU against British Airways and Intel challenged those dominant firms’ practices of incentivizing customers—travel agents or computer manufacturers—to remain loyal to British Airways or Intel at the expense of smaller

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<sup>6</sup> See, e.g., Lawrence Lessig, *Understanding Changed Readings: Fidelity and Theory*, 47 *Stan. L. Rev.* 395 (1995).

<sup>7</sup> See George P. Fletcher, *The Case for Treason*, 41 *Md. L. Rev.* 193 (1982) (PAREN).

<sup>8</sup> GEORGE P. FLETCHER, *LOYALTY: AN ESSAY ON THE MORALITY OF RELATIONSHIPS* 8 (1993).

<sup>9</sup> DANTE ALIGHIERI, *INFERNO*, Canto 34, ll. 64-68, at 537 (Robert M. Durling ed. & trans., 1996).

<sup>10</sup> See Felten, *supra* n. xxx (examining moral dilemmas raised by conflicts of loyalty).

rivals, Virgin Atlantic and AMD.<sup>11</sup> Scores of other cases challenging loyalty discounts, rebates, or other incentives have been filed on both sides of the Atlantic, particularly in private lawsuits in the U.S.<sup>12</sup> An extensive academic literature assesses the ways in which loyalty incentives can exclude competitors or soften competition.<sup>13</sup>

<sup>11</sup> *Virgin Atlantic Airways Ltd. v. British Airways PLC*, 257 F.3d 256 (2d. Cir. 2001) (rejecting Virgin Atlantic’s challenge to British Airways’ loyalty incentives to travel agents); *In re Intel Corp., Administrative Complaint*, FTC Docket # 934 (Dec. 16, 2009), <http://www.ftc.gov/os/adjpro/d9341/091216intelcmpt.pdf> (challenging Intel’s market share rebates to original equipment manufacturers); Summary of Commission Decision of 13 May 2009 Relating to a Proceeding Under Article 82 of the EC Treaty and Article 54 of the EEA Agreement (COMP/C-3/37.990—Intel), 2009 O.J. (C 227) (finding Intel’s market share rebates to original equipment manufacturers incompatible with Articles 101 and 102 of the Treaty on the Functioning of the European Union and fining Intel €1.06 billion); Case C-95/04 P, *British Airways Plc v. Comm’n*, 2007 E.C.R. I-2331 (finding British Airways . . .).

<sup>12</sup> See *infra* text accompanying notes xxx – xxx.

<sup>13</sup> The literature on the potential anticompetitive effects of loyalty discounts includes Einer Elhauge & Abraham L. Wickelgren, *Anti-competitive Exclusion and Market Division Through Loyalty Discounts*, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1937658](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1937658); Einer Elhauge & Abraham L. Wickelgren, *Robust Exclusion Through Loyalty Discounts*, John M. Olin Center for Law, Economics & Business Discussion Paper No. 662 (Jan. 2010); Leslie M. Marx & Greg Shaffer, *Rent Shifting, Exclusion, and Market-Share Discounts*, <http://www.simon.rochester.edu/fac/shaffer/Published/rentshift.pdf>; Jonathan M. Jacobson, *A Note on Loyalty Discounts*, 9-JUN Antitrust Source 1 (2010); Einer Elhauge, *How Loyalty Discounts Can Perversely Discourage Discounting*, 5 J. Comp. L. & Econ. 189 (2009); David E. Mills, *Inducing Downstream Selling Effort with Market Share Discounts*, <http://www.virginia.edu/economics/Workshops/papers/mills/Market%20Share%20Discounts.pdf>; Richard A. Duncan & Brian S. McCormac, *Loyalty & Fidelity Discounts and Rebates in the U.S. & E.U.: Will Divergence Occur Over Cost-Based Standards of Liability*, 9 Sedona Conf. J. 133 (2008); Gianluca Faella, *The Antitrust Assessment of Loyalty Discounts and Rebates*, 4 J. Comp. L. & Econ. 375 (2008); Benjamin Klein & Andres V. Lerner, *The Expanded Economics of Free-Riding: How Exclusive Dealing Prevents Free-Riding and Creates Undivided Loyalty*, 74 Antitrust L. J. 473 (2007); Janusz Ordover & Greg Shaffer, *Exclusionary Discounts*, (CCP Working Paper No. 07-13, 2007); Louis Kaplow & Carl Shapiro, *Antitrust*, in 2 Handbook of Law & Economics 1073 (2007); David Spector, *Loyalty Rebates: An Assessment of Competition Concerns and a Proposed Structured Rule of Reason*, 1 Comp. Pol’y Int’l 89 (2005); Joseph Farrell, *Deconstructing Chicago on Exclusive Dealing*, 50 Antitrust Bulletin 465 (2005); Bruce Kobayashi, *The Economics of Loyalty Discounts and Antitrust Law in the United States*, 1 Comp. Policy Int. 115 (2005); Patrick Greenlee & David Reitman, *Competing with Loyalty Discounts*, (EAG Discussion Paper 04-2, 2004);

Although loyalty incentives can harm competition, they also can enhance consumer welfare by driving down prices and facilitating more efficient exchange between buyers and sellers. One strand missing in the current literature—which largely focuses on the deployment of loyalty incentives by dominant sellers—is the extent to which customers play a strong role in proposing and propagating the use of loyalty incentives. Customers willingly exchange loyalty commitments for lower prices. This phenomenon cannot simply be dismissed as the product of customer collective action problems. Monopsony or oligopsony buyers who face few collective action problems frequently use loyalty discounts to drive prices down. The federal government, perhaps the world’s most powerful buyer, frequently uses loyalty incentives to drive down its acquisition costs. Collective purchasing societies such as hospital Group Purchasing Organizations, Pharmacy Benefit Managers, and buyer cooperatives, which are formed in large part to solve collective action problems, often push for loyalty discounts or rebates as part of their strategy to lower their member prices.<sup>14</sup> Academic marketing literature describes loyalty as a bargaining chip that can be beneficially exploited by both strong and weak buyers.<sup>15</sup>

This Article contributes to the ongoing legal and economic discussion over loyalty discounts in three ways. First, in Part I, it situates the conversation over loyalty discounts within the broader conversation over exclusionary practices and law’s response. In particular, Part I distinguishes loyalty discounts from volume discounts, introduces current legal treatment of loyalty discounts in the United States and European Union, and discusses the way that U.S. antitrust law on loyalty discounts is likely to evolve in light of recent precedent—not primarily by the development of new legal rules but by the expression of judicial maxims such as the quotation from the *Virgin Atlantic* decision at the beginning of this Article.

This Article’s second major contribution is to answer two developing criticisms of loyalty discounts that have the potential to turn into anti-loyalty judicial maxims. The first of these is that

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Willard K. Tom, David A. Balto & Neil W. Averitt, *Anticompetitive Aspects of Market-Share Discounts and Other Incentives to Exclusive Dealing*, 67 *Antitrust L. J.* 615 (2000); Ilya R. Segal & Michael Whinston, *Naked Exclusion: Comment*, 90 *Am. Econ. Rev.* 296 (2000); Eric B. Rasmusen, J. Mark Ramseyer & John S. Wiley, *Naked Exclusion*, 81 *Am. Econ. Rev.* 296 (1991).

<sup>14</sup> See *infra* text accompanying notes xxx – xxx.

<sup>15</sup> See *infra* text accompanying notes xxx – xxx.

loyalty discounts need not be—and often are not—true discounts, but rather disloyalty penalties. This claim is economically implausible, since it would have the seller giving the buyer a choice of accepting either a price above the profit-maximizing monopoly level or else an onerous contractual term above the profit-maximizing monopoly level. Either scenario would effectively cause the monopolist to exceed the profit-maximizing monopoly price and hence be unprofitable. The second criticism of loyalty discounts is that they soften competition between sellers—essentially that they facilitate supracompetitive seller pricing even without excluding any seller from the market. Part II shows that the assumptions underlying this claim are restrictive and not generalizable and that counterevidence suggests that if loyalty discounts are anticompetitive, it is only because they are sometimes exclusionary.

This Article's final major contribution, made in Part III, is to reorient the conversation away from an assumption that loyalty incentives are seller-initiated strategies. Rather, the available evidence suggests that loyalty incentives are often bargaining chips in negotiations between sellers and buyers—invoked by customers as often as suppliers in return for other concessions. Thinking about loyalty incentives as bargaining chips does not dispel the possibility that such provisions can have exclusionary effects, but it does suggest that courts should be cautious about discouraging the use of loyalty incentives, which may take away a chip that buyers could otherwise invoke to improve their position.

## I. FOUNDATIONAL CONSIDERATIONS

### A. Loyalty and Volume

Loyalty provisions come in a variety of forms. The strongest form is a pure exclusive dealing agreement in which the buyer promises to buy all of its requirements from the supplier and not to purchase from any other supplier.<sup>16</sup> Short of this, contracts sometimes contain partial exclusive dealing clauses that commit the buyer to make a specified level or percentage of its purchases from

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<sup>16</sup> See generally 11 PHILLIP E. AREEDA & HERBERT HOVENKAMP, ANTITRUST LAW ¶ 1821 (3d ed. 2011).

the seller.<sup>17</sup> Often sellers seek to induce loyalty rather than to require it. Loyalty inducement provisions also take a good many forms, but their common denominator is an option on the buyer's part to secure a better price by demonstrating greater loyalty. Two common forms are market share discounts and bundled discounts.

Bundled discounts offer a buyer a better price for purchasing minimum amounts of the seller's product across two more separate product lines.<sup>18</sup> For example, in one of the leading recent bundled discount cases, the conglomerate manufacturer 3M offered retailers rebates that were conditioned the retailer making minimum purchases on six of 3M's product lines including Health Care Products, Home Care Products, Home Improvement Products, Stationery Products, Retail Auto Products, and Leisure Time.<sup>19</sup> Unlike a single-product volume discount, the customer can only achieve bundled discounts or rebates by demonstrating loyalty in a number of separate buckets of purchases.

Although bundled discounts partake of many of the attributes of single-product loyalty discounts, they add significant complexities. Bundled discounts create different kinds of exclusionary effects—particularly the potential to exclude rivals that do not sell the dominant firm's full product line.<sup>20</sup> They also may exhibit different sorts of efficiencies or procompetitive justifications—such as the potential to eliminate double marginalization—<sup>21</sup> that would not generally be true of single-product loyalty discounts.<sup>22</sup> Further,

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<sup>17</sup> Tom, et al, *supra* n. xxx at 622-627 (discussing anticompetitive effects arising from partial exclusive dealing);

<sup>18</sup> Daniel A. Crane, *Mixed Bundling, Profit Sacrifice, and Consumer Welfare*, 55 Emory L. J. 423 (2006) (analyzing economics of bundled discounting); Elhauge, *Tying, Bundled Discounts*, *supra* n. xxx (discussing exclusionary potential of bundled discounts); Thomas A. Lambert, *Appropriate Liability Rules for Tying and Bundled Discounting*, 72 Ohio State L. J. 909 (2011); Herbert Hovenkamp, *Complex Bundled Discounts and Antitrust Policy*, 57 Buff. L. Rev. 1227 (2009).

<sup>19</sup> *LePage's, Inc. v. 3M*, 324 F.3d 141, 154 (3d Cir. 2003) (en banc).

<sup>20</sup> See Crane, *Mixed Bundling*, *supra* n. xxx at 443-47 (exploring exclusionary potential of bundled discounts).

<sup>21</sup> *Id.* at 434-36; Erik Hovenkamp & Herbert Hovenkamp, *Tying Arrangements and Antitrust Harm*, 52 Ariz. L. Rev. 925 (2010).

<sup>22</sup> But see Sreya Kolay, Greg Shaffer & Janusz Ordover, "All-Units Discounts in Retail Contracts," 13 *Journal of Economics & Management Strategy* 429 (2004)



bundled discounts raise unique theoretical questions about the plausibility of a dominant firm's exclusionary strategy—such as whether it would be rational for a firm to use a bundled discount to leverage market power in one market to obtain a monopoly in a second market in light of the fact that raising the price in the second market might reduce sales in the first market if the two goods are complements.<sup>23</sup> Because of these significant distinctions, bundled discounts merit separate consideration from single-product market share or other loyalty discounts and are beyond the scope of this Article.

Market share discounts are the paradigmatic single-product loyalty incentive. They operate by granting the buyer a better price if it purchases specified percentages of its requirements from the seller.<sup>24</sup> Market share discounts are sometime graduated—for

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(discussing potential of even single-product market share discounts to eliminate double marginalization).

<sup>23</sup> See Elhauge, *Tying, Bundled Discounts*, *supra* n. xxx at 403-19. The Chicago School of economic analysis argued that it would be irrational for a firm with a monopoly in market A to attempt to leverage its power into a complementary market B, since increasing the price of one product leads to a diminution in the demand for its complements. Hence, by leveraging monopoly power and attempting to extract a second monopoly profit, the dominant firm would simply be cannibalizing its own profits in the leveraging market. See ROBERT A. BORK, *THE ANTITRUST PARADOX* 372-75, 380-81 (1978); RICHARD A. POSNER, *ANTITRUST LAW* 197-99 (2d ed. 2001); Ward S. Bowman, Jr., *Tying Arrangements and the Leverage Problem*, 67 *Yale L.J.* 19, 20-23 (1957); Aaron Director & Edward H. Levi, *Law and the Future: Trade Regulation*, 51 *Nw. U. L. Rev.* 281, 290-92 (1956). Elhauge argues that the one monopoly profit theory overlooked a number of ways in which leverage could be profitable.

<sup>24</sup> Herbert Hovenkamp, *The Obama Administration and Section 2 of the Sherman Act*, 90 *B.U. L. Rev.* 1611, 1649-50 (2010) (explaining distinctions between quantity and market share discounts). A variation on a market share requirement is a retail shelf placement requirement. In *Church & Dwight Co. v. Mayer Labs., Inc.*, \_\_\_ *F. Supp. 2d* \_\_\_ (N.D. Cal. 2012), for example, a condom manufacturer granted retailers different levels of rebates for maintaining its products in various percentages of the retailer's shelf-space dedicated to condoms, for example a 55% tier (awarding a 4.0% rebate for 55% or more of a retail chain's display space), a 65% tier (awarding a 7% rebate for 65% or more of the display space), and a 70% tier (awarding a 7.5% rebate for 70% or more of the display space).

example, a buyer receives a 5% discount for purchasing 60% or more of its requirements from the seller, a 7% discount for purchasing 75% or more, and a 9% discount for purchasing 90% or more. Also, market share discounts may apply only to incremental dollars (*i.e.*, to all purchases above 60%) or retroactively to the first dollar.<sup>25</sup> A loyalty discount can be given instantaneously at the point of sale or rebated at some later time, such as at year's end.

How loyalty discounts are structured is often significant in determining whether they can have exclusionary effects. For example, first-dollar rebates are usually considered more problematic than incremental dollar discounts, since smaller rivals of the seller have to compete against price concessions given across a far greater swath of sales.<sup>26</sup> Contracts with claw-back features, where the seller grants the buyer a favorable price on the assumption that it will meet a loyalty threshold subject to a repayment obligation in the event the buyer does not meet the threshold, may create particular antitrust risks insofar as buyers may be loath to run the risk of incurring large lump-sum penalties at year's end and hence remain strictly loyal to the seller.<sup>27</sup>

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<sup>25</sup> See Jonathan M. Jacobson, *A Note on Loyalty Discounts*, 9-JUN Antitrust Source 1, 1-2 (2010) (explaining first-dollar discounts); Duncan, *supra* n. xxx at 134 (explaining distinctions between first-dollar and incremental dollar discounts).

<sup>26</sup> Jonathan M. Jacobson, *Towards a Consistent Antitrust Treatment for Unilateral Conduct*, 8-FEB Antitrust Source 1, 6 (2009) (explaining that "first dollar discounts may provide especially strong inducements--in some instances, outright coercion--because they apply not only to the contested volume but to all of the customer's purchases, enhancing a loss if the percentage commitment is not fulfilled"); Robert H. Lande, *Should Predatory Pricing Rules Immunize Exclusionary Discounts*, 2006 Utah L. Rev. 863, 864 (2006) ("Unlike 'regular' discounts, which are almost always procompetitive, retroactive discounts have a strong exclusionary and anticompetitive potential.").

<sup>27</sup> See Jonathan M. Jacobson, *Towards a Consistent Antitrust Policy for Unilateral Conduct*, 8-FEB Antitrust Source 1, 6 (2009) ("Some such discounts, called "first dollar" discounts, may provide especially strong inducements--in some instances, outright coercion--because they apply not only to the contested volume but to all of the customer's purchases, enhancing a loss if the percentage commitment is not fulfilled."). Allegations about claw-back provisions have been at issue in some recent loyalty discount cases. See *Southeast Missouri Hosp. v. C.R. Bard, Inc.*, 642 F.3d 608, 617 (8<sup>th</sup> Cir. 2011).

One of the frequently discussed questions with respect to market share discounts is why a seller who wants to reward high-volume customers should not simply offer a traditional volume discount.<sup>28</sup> Before getting to some of the answers, it is worth noting that sometimes volume and loyalty discounting is substantively equivalent. Volume discounts and loyalty discounts can be identical in operation. Suppose, for example, that the buyer has a stable need for 100 tons of salt per year. If the seller offers the buyer a 5% price reduction for buying 80 tons of salt or 80% of its salt requirements per year, the effect on the buyer's incentives will be identical assuming its buying needs stay constant.<sup>29</sup>

On the other hand, market share discounts often differ from volume discounts in significant ways. In several circumstances, market share discounts may be more advantageous to the buyer than volume discounts.

First, market share discounts have the effect of shifting risks of changing market circumstances from buyers to sellers in ways that volume discounts do not.<sup>30</sup> For example, Herbert Hovenkamp has

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<sup>28</sup> See, e.g., *Evaluating the Competitive Effects of Exclusive Dealing Agreements*, An ABA Section of Antitrust Law and ABA Center for Continuing Legal Education Telesminar, in Cooperation with the Antitrust Section of the Houston Bar Association (Houston, Texas June 24, 2005), 5-NOV Antitrust Source 1, 6 (2005) ([W]hy reward your best customers with a "loyalty" discount? Why not do it instead through a less restrictive alternative like a volume discount?) (comments of Joe Grinstein). On the distinction between market share and loyalty discounts, see *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d 254, 265 n. 6 (3d Cir. 2012) (citing Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law* ¶ 768, at 169 (3d ed. 2008)).

<sup>29</sup> A case in point is then-Judge Breyer's decision in *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2d 227 (1st Cir. 1983), which involved the market for snubbers, safety devices used in nuclear power plants. The defendant then offered a major customer a large discount if it would agree to purchase large quantities of snubbers, amounting to a large share of its expected purchases, over a two-year period. Since the customer's snubber needs were stable and predictable, it probably would have made little difference if the supplier made the discount contingent on loyalty or volume.

<sup>30</sup> Herbert Hovenkamp, *The Federal Trade Commission and the Sherman Act*, 62 Fla. L. Rev. 871, 889 (2010) (explaining that a seller like Intel uses market share discounts rather than volume discounts in order to shift the costs of market

explained Intel's market share discounts as a means of shifting the risk of a weakening market from original equipment manufacturers like Dell and HP to Intel.<sup>31</sup> If the computer market weakens more than expected, Dell and HP might not be able to meet a contractually specified volume threshold and hence might lose a volume-based discount. However, if to obtain Intel's lowest price they must just buy a specified percentage of their central processing unit needs from Intel—say 80%—they can continue to claim the best price even in a weak computer market.

Second, and in a same vein, market share discounts may be used to guarantee the supplier a minimum volume of sales when the requirements of a group of customers are unpredictable.<sup>32</sup> To stay with the computer industry, suppose that Intel will be able to optimize its planning and achieve economies of scale if it knows that it will sell at least one million CPUs in the coming year. Although it makes a fairly strong prediction that the total volume of CPU sales in the market will be around two million, the OEMs are engaged in a fierce market share battle of their own and the CPU requirements of any individual OEM are hard to determine given the vagaries of the market. Intel may identify a group of OEMs that are likely to purchase around 1.25 million collectively, although the distribution of purchases within the group is uncertain. If each of the OEMs in this group agrees to purchase 80% of its requirements from Intel, Intel can count on making a million CPU sales in the coming year from this group of customers. From Intel's perspective, it is beneficial to offer a discount in exchange for a market share commitment so that Intel can plan on the level of sales it will make in the coming year and perhaps optimize its production facilities. From the OEM's perspective, the deal is also beneficial. The OEMs secure

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downturns from its customers to itself: "A quantity discount attaches to a specified number of chips, and if the market becomes weak and the computer maker's sales fall below that number, the computer maker must pay the higher price. By contrast, the market share discount attaches to, say, 90% of the buyer's sales, whatever they happen to be. So the market share discount offers the computer maker the lower price, even if the market becomes weak, provided that the computer maker purchases its requisite percentage of chips from the seller.").

<sup>31</sup> *Id.*

<sup>32</sup> *C.f.* Jacobson, *supra* n. xxx at 3 ("A supplier can offer volume discounts or other price concessions, without loyalty commitments, to generate volume to account for high fixed costs.").

a more favorable price and one that does not require them to commit to a volume of purchases they may be unable to meet.<sup>33</sup>

Third, market share discounts may enable even relatively small buyers who might not qualify for a volume discount to enhance their bargaining position with suppliers and exact pricing concessions. This occurs because the buyer is able to exchange its freedom to pursue variety in its purchases for a lower price. By foregoing its variety preferences and focusing on a single seller, the buyer effectively elasticizes the demand facing the seller and hence can obtain a better price.<sup>34</sup> Developing this model, Ben Klein and Kevin Murphy consider the example of packaged food manufacturers competing for retail shelf space.<sup>35</sup> Each manufacturer would like to secure the most shelf space possible for its products. Retailers are much less interested than the manufacturer as to which brand of spices gets precedence on their shelves. They are competing against other manufacturers to create the optimal basket of product selection, price, and service.<sup>36</sup> The retailer essentially acts as a bargaining agent for the interests of its customers, trading off different characteristics. When the retailer commits to partial or exclusive shelf-space loyalty to a particular brand, it will disappoint some customers who would prefer access to a different brand.<sup>37</sup> But, by foregoing customer's variety preferences, the retailer elasticizes the demand facing the manufacturer.<sup>38</sup> This, in turn, allows the retailer to obtain better wholesale prices and pass them along to customers as better retail prices.<sup>39</sup> Although it entails some loss of consumer surplus—the customers who had strong variety preferences—the aggregate consumer welfare effects due to the lower prices can be significantly positive.<sup>40</sup> Significantly, Klein and Murphy's model

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<sup>33</sup> This effect could be realized even if the buyers do not commit ex ante to purchase 80% of their requirements from the seller but the seller expects that the offer of discount if they do will incentivize them purchase the 80% share. Commitment is just a strong form of expectation.

<sup>34</sup> Benjamin Klein & Kevin M. Murphy, *Exclusive Dealing Intensifies Competition for Distribution*, 75 *Antitrust L.J.* 433, 437-65 (2008).

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 443.

<sup>37</sup> *Id.* at 451.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

shows how even relatively small purchasers with little buying power can deploy loyalty to secure better prices.<sup>41</sup>

Loyal behavior by buyers can have similar properties to the preferred shelf space commitments discussed by Klein and Murphy. Imagine a small, regional hospital that needs to purchase catheters. Assume that there are four major catheter suppliers, and that catheters are somewhat differentiated products. The nurses and other medical professionals who administer catheters have idiosyncratic preferences for different brands. If each hospital ward or unit makes its own purchasing decision, the hospital will end up using all four brands. Suppose, however, that hospital procurement administrators decide to cut costs by centralizing the hospital's purchasing decisions. One effect of this is to increase the volume the hospital can use as leverage in any purchasing negotiation. But even consolidating all of the hospital's buying power may not secure the hospital much leverage. By committing to loyalty—for example deciding to buy 85% of its catheter requirements from a single manufacturer—the hospital elasticizes the demand facing the manufacturers. Nurses may no longer have as easy access to their preferred brand of catheter, but the overall effect on composite patient pricing and quality may be positive.

An obvious objection to this and the shelf space illustrations is that loyalty discounts secure lower prices at the expense of individuals with idiosyncratic needs or preferences—the gourmet cook who highly valued a particular brand of spice or the neonatal unit nurse who believes that a particular brand of catheter is optimal

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<sup>41</sup> *Id.* at 459 (noting that “significantly lower wholesale prices can be achieved by retailers with relatively small market shares as long as the retailer has the ability to influence the share of its customers' purchases in a product category that is obtained by a chosen manufacturer”). At least one federal court has recognized this benefit of market share discounts, without exploring the economic rationale. *See Smith Wholesale Co. v. R.J. Reynolds Tobacco Co.*, 477 F.3d 854, 864-65 (6<sup>th</sup> Cir. 2007) (“Market share discounts theoretically level the playing field by allowing competing purchasers of like commodities to participate on equal terms, regardless of size, because such discounts depend not on volume purchases, but on the percentage of purchases of a particular category of products.”); *see also* Donald Hawthorne & Margaret Sanderson, *Rigorous Analysis of Economic Evidence on Class Certification in Antitrust Cases*, 24-FALL Antitrust 55, 59 (2009) (reporting that Tyco's market share discounts for pulse oximeters allowed small hospitals to achieve lower prices than they could under pure volume discounts).

for her patients' needs. Part of the answer—already told—is that many purchasing decisions made by intermediaries or agents on behalf of others necessarily involve trade-offs between price, variety, quality, and convenience. The other part of the answer is that the use of commercial loyalty devices need not result in complete homogenization of the available product offering. As already discussed—and discussed further below—market share discounts are often partial, providing for the purchase by the buyer of a large portion, but not all, of its requirements.<sup>42</sup> One of the reasons that many loyalty discounts are set at 80 or 85% is to allow some room for the buyer agent or intermediary to honor the variety preferences of the most variety-preferring principals (such as nurses or grocery shoppers). Of course, committing a lower percentage in order to preserve the preferences of the principals with the most inelastic demand diminishes the elasticizing effect of committing to loyalty. But it is these kinds of trade-off decisions that intermediaries and agents routinely make.

## B. Current Legal Treatment

Single-product loyalty inducements have been recently challenged in both the United States and the European Union as exclusionary or otherwise anticompetitive devices. In the United States, they have been principally challenged as restraints of trade under Section 1 of the Sherman Act,<sup>43</sup> monopolizing devices in violation of Section 2 of the Sherman Act,<sup>44</sup> exclusive dealing agreements under Section 3 of the Clayton Act,<sup>45</sup> price discrimination in violation of the Robinson-Patman Act,<sup>46</sup> or violations of Section 5 of the Federal Trade Commission Act.<sup>47</sup> In the European Union, they have been challenged as abridgements of Article 101 on the Treaty on the Functioning of the European Union (“TFEU”), which prohibits restrictive agreements and Article 102 which prohibits abuse of a dominant position. This Article will not discuss the potential differences between these separate legal theories within

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<sup>42</sup> See *supra* text accompanying notes xxx – xxx.

<sup>43</sup> 15 U.S.C. § 1.

<sup>44</sup> 15 U.S.C. § 2.

<sup>45</sup> 15 U.S.C. § 3.

<sup>46</sup> 15 U.S.C. § 13.

<sup>47</sup> 15 U.S.C. § 45.

each legal regime but instead consider the overall treatment of loyalty provisions as a class.

In recent years, loyalty provisions have received a generally hospitable welcome in U.S. the courts, although not so much at the Federal Trade Commission. Private challenges—usually by competitors—have alleged that loyalty discounts result in de facto exclusivity or semi-exclusivity and foreclose smaller rivals' opportunities to enter or expand in the market. Such challenges in a variety of industries, including boat engines,<sup>48</sup> medical devices,<sup>49</sup> pharmaceuticals,<sup>50</sup> automotive sandpaper,<sup>51</sup> wholesale tobacco,<sup>52</sup> condoms,<sup>53</sup> and airline travel,<sup>54</sup> have generally met with failure. Plaintiffs have succeeded in a few cases.<sup>55</sup> Some courts have held that loyalty discounts are price concessions that are not illegal unless they result in the dominant firm pricing below an appropriate

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<sup>48</sup> *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8<sup>th</sup> Cir. 2000).

<sup>49</sup> *Southeast Missouri Hosp. v. C.R. Bard, Inc.*, 642 F.3d 608 (8<sup>th</sup> Cir. 2011); *Allied Orthopedic Appliances Inc. v. Tyco Health Care Group LP*, 592 F.3d 991 (2010).

<sup>50</sup> *J.B.D.L. Corp. v. Wyeth-Ayerst Laboratories, Inc.*, No. 1:01-CV-704, 1:03-CV-781, (S.D. Ohio June 13, 2005).

<sup>51</sup> *NicSand, Inc. v. 3M Co.*, 507 F.3d 442 (2007).

<sup>52</sup> *See Smith Wholesale Co. v. R.J. Reynolds Tobacco Co.*, 477 F.3d 854, 864-65 (6<sup>th</sup> Cir. 2007); *Smith Wholesale Co., Inc. v. Philip Morris USA, Inc.*, 219 Fed. Appx. 298 (6<sup>th</sup> Cir. 2007).

<sup>53</sup> *Church & Dwight*, *supra* n. xxx.

<sup>54</sup> *Virgin Atlantic*, *supra* n. xxx.

<sup>55</sup> *See infra* text accompanying notes xxx – xxx (concerning FTC action against Intel). *See also Masimo Corp. v. Tyco Health Care Group, L.P.*, 250 Fed. Appx. 95 (9<sup>th</sup> Cir. 2009) (finding that legality of market share discounts in truck transmission market was question for jury); *Z.F. Meritor LLC v. Eaton Group*, 769 F. Supp. 2d 684 (D. Del. 2011), *aff'd* 696 F.3d 254 (3d Cir. 2012); *U.S. v. Dentsply Intern., Inc.*, 2006-2 Trade Cases P 75,383, 2006 WL 2612167 (D. Del. April 26, 2006) (prohibiting Dentsply from offering market share discounts to any dealer); *Natchitoches Parish Hosp. v. Tyco Intern., Ltd.*, No. 1:05-CV-12024-PBS., (D. Mass. Nov. 20, 2009); The allegations in the case, *U.S. v. Dentsply Intern., Inc.*, 399 F.3d 181 (3d Cir. 2005), involved pure exclusive dealing and not loyalty discounting.



measure of cost.<sup>56</sup> Since showing below-cost pricing is difficult to establish given contemporary U.S. antitrust jurisprudence,<sup>57</sup> most such challenges have failed. The U.S. Supreme Court has not yet heard a loyalty discount case, and U.S. antitrust jurisprudence has not settled on a consistent, unified approach to the problem.

A brief discussion of the two cases mentioned in the introduction—*Virgin Atlantic* and *Intel*—will illustrate these issues and provide some contrast and comparison to the European treatment of loyalty discounts.<sup>58</sup>

*Virgin Atlantic* arose from one of the many chapters in Sir. Richard Branson's war to break British Airway's ("BA") dominance in trans-Atlantic travel. Virgin entered the trans-Atlantic market in the mid-1980s and soon grew to be a serious competitor to other major U.S.-London carriers, particularly American Airlines and British Airways.<sup>59</sup> In the mid-1990s, partly in response to competition from Virgin, British Airways introduced a series of "Incentive Plans" targeted at travel agents and corporate buyers.<sup>60</sup> Although some of the incentives were based on volume (how much revenue a travel agent pushed in BA's direction), others were based on market share—BA's percentage share of the U.S.-U.K. flights booked by the agent.<sup>61</sup> The discounts were typically "first dollar," meaning that when a customer reached the target threshold, it received a discounted price on earlier purchases.<sup>62</sup> Virgin brought suit, alleging that the incentive agreements, along with BA's ability to prevent Virgin from obtaining necessary slots at London's

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<sup>56</sup> See, e.g., *Concord Boat*, 207 F.3d at 1062 (rejecting district court's holding that plaintiff would not have to show pricing below an appropriate measure of cost in order to establish illegality of market share agreements).

<sup>57</sup> Daniel A. Crane, *The Paradox of Predatory Pricing*, 91 Cornell L. Rev. 1, 7 (2005).

<sup>58</sup> A brief discussion of the treatment of loyalty discounts or rebates outside the United States and European Union can be found in EINER ELHAUGE & DAMIEN GERADIN, *GLOBAL ANTITRUST LAW AND ECONOMICS* 693-94 (2d ed. 2011).

<sup>59</sup> 257 F.3d at 259-60.

<sup>60</sup> 257 F.3d at 261.

<sup>61</sup> 69 F. Supp. 2d at 574 ("Some of the targets are market-share targets (i.e. targets based on British Airways' percentage share of the corporation's U.S.-U.K. flights). . . . Others are total-revenue targets.").

<sup>62</sup> 257 F.3d at 261.

Heathrow airport, were part of an anticompetitive scheme to slow Virgin's growth as a competitor.<sup>63</sup>

The U.S. District Court for the Southern District of New York granted summary judgment for BA<sup>64</sup> and the U.S. Court of Appeals for the Second Circuit affirmed.<sup>65</sup> It first found that Virgin's Sherman Act Section 1 claims failed because Virgin failed to show "actual adverse effects" on consumer welfare.<sup>66</sup> It then affirmed the dismissal of Virgin's attempted monopolization claim on the grounds that Virgin failed to show that the incentive agreements resulted in BA pricing airline tickets below cost—a requirement for predatory pricing claims.<sup>67</sup> In passing, it made the offhand statement quoted at the beginning of this Article: "These kinds of agreements allow firms to reward their most loyal customers. Rewarding customer loyalty promotes competition on the merits."<sup>68</sup>

The European Commission,<sup>69</sup> General Court,<sup>70</sup> and European Court of Justice ("ECJ")<sup>71</sup> reached a very different conclusion on the same facts. In two prior cases, *Hoffman-La Roche*<sup>72</sup> and *Michelin*,<sup>73</sup> the ECJ had adopted a presumption that discounts or rebates offered by dominant firms to induce customer loyalty were incompatible with Articles 101 and 102 of the TFEU. In *British Airways*, the court found that the incentives were prima facie anticompetitive because they had the effect of inducing loyalty to a dominant firm.<sup>74</sup> The court did not cite evidence of actual anticompetitive effects in the

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<sup>63</sup> 257 F.3d at 259.

<sup>64</sup> 69 F. Supp. 2d at 571.

<sup>65</sup> 257 F.3d at 256.

<sup>66</sup> *Id.* at 264.

<sup>67</sup> *Id.* at 265-69.

<sup>68</sup> 257 F.2d at 265.

<sup>69</sup> *British Airways PLC / Virgin Enterprises*, European Commission Prohibition Decision (Dec. 13, 1999), <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2000:030:0001:0024:EN:PDF>.

<sup>70</sup> Case T-219/99 *British Airways PLC v. Commission*, [2003] ECR II-5917.

<sup>71</sup> *British Airways v. Commission*, Case C-95/04 P (March 15, 2007).

<sup>72</sup> Case 85/76, *Hoffman-La Roche & Co. v. Commission*, 1979 E.C.R. 461 PP89-91 (E.C.J.)

<sup>73</sup> Case 322/81, *NV Nederlandsche Banden-Industrie Michelin v. Commission*, 1983 E.C.R. 3461 PP75-86 (E.C.J.)

<sup>74</sup> C-95/04 P (affirming General Court's finding that "the bonus schemes at issue had a fidelity-building effect capable of producing an exclusionary effect").

sense of higher consumer prices or diminished output, finding that evidence of actual anticompetitive effects was unnecessary.<sup>75</sup> Rather, in keeping with ECJ precedents, it focused on the generic exclusionary potential of the loyalty rebates when exercised by dominant undertakings.<sup>76</sup>

Having found the incentive rebates to be suspect fidelity-building devices, the court then considered whether BA had offered an “objective economic justification” sufficient to overcome the prima facie presumption of illegality.<sup>77</sup> BA argued that the rebates were objectively justified because they helped BA fill empty airplane seats and hence contribute toward its high fixed operational costs.<sup>78</sup> The ECJ affirmed the General Court’s rejection of this argument, essentially finding that only direct cost savings from the loyalty program were the kinds of objective economic justifications sufficient to overcome the presumption of illegality for the deployment of fidelity discounts by dominant firms.<sup>79</sup>

The Intel case followed on the heels of Virgin/BA. The computer central processing unit (“CPU”) market has been essentially a duopoly since the 1990s, with Intel controlling roughly 80% and Advanced Micro Devices (“AMD”) controlling the other 15 to 20%.<sup>80</sup> In the late 1990s, Intel began to offer Original Equipment Manufacturers (“OEMs”) financial incentives to purchase specified levels of their CPU requirements—typically around 80 or 85%—from Intel.<sup>81</sup> AMD complained that these loyalty rebates slowed its market share growth and starved it of the capital needed to invest in developing new products.<sup>82</sup> From the early 2000s and continuing to some degree until the present, AMD and Intel waged a global antitrust war over the legal treatment of Intel’s loyalty discounts. To summarize the headlines briefly, AMD secured early decisions

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<sup>75</sup> Case C-95/04 P (“[I]t is not necessary to demonstrate that the abuse in question had a concrete effect on the markets concerned.”).

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> See Daniel A. Crane & Graciella Miralles, *Toward a Unified Theory of Exclusionary Vertical Restraints*, 84 S. Cal. L. Rev. 605, 647-49 (2011) (explaining background to AMD/Intel litigation).

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

against Intel in Japan and Korea, a favorable decision and €1.06 billion (almost \$1.5 billion) fine against Intel from the European Commission, and a \$1.25 billion settlement payment from Intel, and a complaint from the Federal Trade Commission that Intel quickly settled.<sup>83</sup>

Although we have not yet heard the final word from Europe,<sup>84</sup> the Intel case seems to suggest some provisional and fragile rapprochement between the U.S. and EU treatment of loyalty discounts—at least at the level of public enforcement. For its part, the European Commission seemed to back away from the view expressed in *Hoffman La-Roche*, *Michelin*, and *BA* that loyalty discounts by dominant firms should be treated as prima facie illegal and only permitted if the dominant firm can overcome the high hurdle of proving marginal cost efficiencies. The key turn came in a December 2008 “Guidance Paper” on application of Article 102’s prohibition on abuse of dominance, in which the Commission staff suggested determining whether loyalty discounts are anticompetitive using a modified predatory pricing analysis, similar to what some U.S. courts and agencies have suggested.<sup>85</sup> The European antitrust community has understood the Guidance Paper as reflecting a

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<sup>83</sup> *Id.* at 648.

<sup>84</sup> As of this writing, Intel was pressing its appeal from the Commission’s decision in the General Court.

<sup>85</sup> Communication from the Commission — Guidance on the Commission’s enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings, [http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52009XC0224\(01\):EN:NO T](http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52009XC0224(01):EN:NO T) (Dec. 2008). The Commission’s analysis was similar to that in a contemporaneous report on monopolization released by the U.S. Justice Department, *Competition and Monopoly: Single-Firm Conduct Under Section 2 of the Sherman Act* § 6(II) (2008), <http://www.justice.gov/atr/public/reports/236681.htm> (discussing legal and economic standard for judging legality of loyalty discounts). Three Commissioners of the Federal Trade Commission criticized the Justice Department’s report as too protective of dominant firms. FTC Commissioners React to Department of Justice Report, “Competition and Monopoly: Single-Firm Conduct Under Section 2 of the Sherman Act,” <http://www.ftc.gov/opa/2008/09/section2.shtm> (Sept. 8, 2008). The Obama Antitrust Division withdrew the report in one of its first official acts. Justice Department Withdraws Report on Antitrust Monopoly Law, [http://www.justice.gov/atr/public/press\\_releases/2009/245710.htm](http://www.justice.gov/atr/public/press_releases/2009/245710.htm) (May 11, 2009).

movement in the Commission away from a “form-based” analysis and toward an “effects-based” or functional economic analysis.<sup>86</sup> In its Prohibition Decision, the Commission began by invoking the “form-based” precedents (*Hoffman La-Roche*, *Michelin*, and *BA*), but then conducted an “effects-based” modified predation analysis to conclude that Intel’s loyalty rebates had an exclusionary effect on AMD, and hence on competition.<sup>87</sup>

A few months after the Commission decision, the FTC brought its own action against Intel.<sup>88</sup> If the Europeans had moved a few yards in the American direction, the Americans moved at few feet in the European direction. Consistent with U.S. predatory pricing precedent, the Commission alleged that Intel’s rebates would have forced AMD to price below cost in order to compete.<sup>89</sup> However, the Commission also gave notice that it intended to push the boundaries of traditional, pro-defendant predatory pricing law as applied to loyalty discounts. First, the Commission’s complaint alleged that the measure of cost below which Intel priced included “average variable cost plus an appropriate level of contribution towards sunk costs.”<sup>90</sup> Since most U.S. courts consider only variable or marginal costs in predatory pricing cases,<sup>91</sup> this was a direct challenge to the application of a predatory pricing model in bundled discount cases.<sup>92</sup> Second, the Complaint alleged that, while the Commission was prepared to show that Intel was able to recoup its costs of giving

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<sup>86</sup> See Neelie Kroes, Member, European Comm’n in Charge of Competition Policy, Speech at the Fordham Corporate Law Institute: Preliminary Thoughts on Policy Review of Article 82, at 2 (Sept. 23, 2005), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/05/537> (advocating an effects-based approach to Article 82 enforcement).

<sup>87</sup> See Crane & Miralles, *supra* n. xxx at 648-49 (describing Commission’s approach).

<sup>88</sup> In re Intel, FTC Docket No. 9341 (Dec. 16, 2009) (Administrative Complaint), <http://www.ftc.gov/os/adjpro/d9341/091216intelcmpt.pdf>.

<sup>89</sup> *Id.* at ¶ 53.

<sup>90</sup> Administrative Complaint ¶ 53.

<sup>91</sup> III PHILIP AREEDA & HERBERT HOVENKAMP, ANTITRUST Law §§ 739-40 (2007) (explaining application of average variable cost test).

<sup>92</sup> See Daniel A. Crane, *Predation Analysis and the FTC’s Case Against Intel*, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1617364](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1617364) (examining ways in which FTC’s proposed cost definition faced difficulties given prevailing legal standards).

loyalty discounts through supracompetitive pricing, recoupment should not be a mandatory element of an FTC case challenging loyalty discounts.<sup>93</sup> Since recoupment is an element of a predatory pricing case,<sup>94</sup> this statement also signaled the FTC's intention to move away from restrictive predation rules and analogies toward a more interventionist approach toward loyalty discounts. Whether or not these theories would ultimately have held up the *Intel* case cannot inform us, since Intel settled with the Commission a few months later.<sup>95</sup>

If *Intel* signals some convergence between the views of the current European Commission and FTC, it does little to settle the issue in the courts where, when push comes to shove, the issue may ultimately be resolved. At a doctrinal level, the treatment of loyalty discounts remains polarized, with U.S. courts sometimes following a strict predatory pricing approach that plaintiffs (whether private or governmental) will find it hard to meet and the official doctrine of the EU courts remaining hostile to loyalty discounts by dominant firms. In the meanwhile, academic commentators continue to develop new theories about the value and threats of loyalty,<sup>96</sup> and private litigants continue to press their cases in the lower courts in the U.S.<sup>97</sup>

### C. Prior Beliefs, Legal Catechisms, and the Formation of Antitrust Standards

As noted above, the law governing loyalty discounts remains unsettled. European law has not caught up with the dramatic shift from a form-based approach to an effects-based approach tentatively proposed by the Commission.<sup>98</sup> Some U.S. courts have moved in the direction of predatory pricing rules for loyalty discounts, but many of

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<sup>93</sup> Administrative Complaint ¶ 53.

<sup>94</sup> *Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 224 (1993) (“The second prerequisite to holding a competitor liable under the antitrust laws for charging low prices is a demonstration that the competitor had a reasonable prospect, or, under § 2 of the Sherman Act, a dangerous probability, of recouping its investment in below-cost prices.”).

<sup>95</sup> FTC Approves Modified Intel Settlement Order, <http://www.ftc.gov/opa/2010/11/intel.shtm> (Nov. 2, 2010).

<sup>96</sup> See *supra* text accompanying notes xxx – xxx.

<sup>97</sup> See *supra* text accompanying notes xxx – xxx.

<sup>98</sup> See *supra* text accompanying notes xxx – xxx.

the conservative assumptions in these cases are under attack in academic literature, and the Supreme Court has not yet weighed in.<sup>99</sup> Most of the contests over loyalty discounts have occurred in the last decade, which, in the glacial movement of antitrust law, is relatively little time in which to form durable rules. The antitrust law of loyalty remains up for grabs.

Understanding the likely evolution of antitrust law concerning loyalty discounts requires some brief observations into how modern antitrust law is formed in U.S. courts. Although predicated on statutes, antitrust law evolves in an essentially common-law manner, as likely intended by its legislative framers.<sup>100</sup> That is to say, judges announce principles based on analogies from precedent but relatively unconstrained by external sources such as deterministic statutory language,<sup>101</sup> threats of Congressional action to overrule unpopular results,<sup>102</sup> or agency rule-making entitled to some degree of judicial

<sup>99</sup> See *supra* text accompanying notes xxx – xxx.

<sup>100</sup> See *Nat'l Soc'y of Prof'l Eng'rs v. United States*, 435 U.S. 679, 688 (1978) (“Congress ... did not intend the text of the Sherman Act to delineate the full meaning of the statute or its application in concrete situations. The legislative history makes it perfectly clear that [Congress] expected the courts to give shape to the statute’s broad mandate by drawing on common-law tradition.”); I PHILIP AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW* P 103d2 (3d ed. 2006) (stating that the Sherman Act “invest[ed] the federal courts with a jurisdiction to create and develop an ‘antitrust law’ in the manner of the common law courts”); William F. Baxter, *Separation of Powers, Prosecutorial Discretion, and the “Common Law” Nature of Antitrust Law*, 60 *Tex. L. Rev.* 661, 663 (1982) (“Congress adopted what is in essence enabling legislation that has permitted a common-law refinement of antitrust law through an evolution guided by only the most general statutory directions.”); Frank H. Easterbrook, *Statutes’ Domains*, 50 *U. Chi. L. Rev.* 533, 544 (1983) (“The statute books are full of laws, of which the Sherman Act is a good example, that effectively authorize courts to create new lines of common law.”).

<sup>101</sup> See ROBERT H. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 409 (1978) (describing “open-textured” nature of Sherman Act’s language).

<sup>102</sup> In the modern era, Congress has shown little interest in overturning Supreme Court antitrust precedents, as it has done in many other statutory areas. Following the Court’s decision in *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007), which jettisoned a nearly century-old rule of per se illegality for resale price maintenance, there were Congressional threats of a legislative override. *Leegin*-override legislation has passed committees in both houses of Congress, but

deference.<sup>103</sup> Modern antitrust case law development, if not exactly free form, is as free from external constraints as any area of Supreme Court jurisprudence.

When the Supreme Court decides antitrust cases, it of course adopts rules or multi-factor standards. But these legally structured liability determinants are often less important to the decision of future cases than the atmospheric maxims or legal-economic catechisms that the Court announces in the course of adjudication. These maxims, which since the Chicago School revolution of the 1970s have increasingly been drawn from economic theory,<sup>104</sup> announce a set of baseline perspectives or Bayesian prior beliefs about the competitive practice under consideration. Their repetition in future cases serves as a grounding exercise to orient the court's thinking and justify its decision.

The best example of this, and the one most relevant to loyalty discounting, is predatory pricing. In the pre-Chicago era, the courts and antitrust agencies often viewed aggressive price discounting by dominant firms with suspicion.<sup>105</sup> Aggressive price cutting fell into what the Nobel laureate Oliver Williamson once referred to as antitrust's "inhospitability tradition."<sup>106</sup> The ascendant Chicago

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has thus far failed to gain traction in the full Congress. Joanna Anderson, *Senate Judiciary Committee Backs Latest Effort to Ban "Vertical Price Fixing,"* 11/3/11 CQ Today (Nov. 3, 2011).

<sup>103</sup> The Justice Department and Federal Trade Commission have rarely promulgated substantive antitrust rules. See Daniel A. Crane, *Technocracy and Antitrust*, 86 Tex. L. Rev. 1159, 1199 (2008).

<sup>104</sup> See Richard A. Posner, *The Chicago School of Antitrust Analysis*, 127 U. Pa. L. Rev. 925 (1979) (describing economic origins of the Chicago School).

<sup>105</sup> The seminal pre-Chicago case is *Utah Pie Co. v. Cont'l Baking Co.*, 386 U.S. 685 (1967), which condemned aggressive price competition without any showing of adverse anticompetitive effects.

<sup>106</sup> Oliver E. Williamson, *Symposium on Antitrust Law and Economics: Introduction*, 127 U. PA. L. REV. 918, 920 (1979); see also Oliver E. Williamson, *Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach*, 127 U. PA. L. REV. 953, 959 (1979) [hereinafter *Vertical Market Restrictions*]. Williamson attributed this tradition to Donald Turner, then-Assistant Attorney General at the Antitrust Division of the U.S. Department of Justice, who was quoted as stating: "I approach territorial and customer restrictions not hospitably in the common law tradition, but inhospitably in the tradition of antitrust law." Williamson, *Vertical Market*



School, however, largely dismissed the predation theories and argued for far greater tolerance toward unilateral price competition.<sup>107</sup> Over time, the Supreme Court radically altered the reception that unilateral price discounts received in the courts, essentially moving them into a hospitality tradition.<sup>108</sup> It did this in part by announcing restrictive liability rules—the requirement of pricing below an appropriate measure of cost and the recoupment requirement.<sup>109</sup> But the Court accomplished this revolution without investing much effort into fleshing out the content of the liability rules. For example, it has still not decided what is the appropriate measure of cost in a predation case, an issue on which there has been a circuit split for several decades.<sup>110</sup> Instead, the Court spent much of its time expounding atmospheric maxims about why predatory pricing was not likely to be a frequent threat to competition and why punishing it would threaten the welfare of consumers. The litany is now often intoned catechistically in predation cases: “predatory schemes are rarely tried, and even more rarely successful,”<sup>111</sup> because ‘cutting prices in order to increase business often is the very essence of competition

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*Restrictions, supra*, at 959 (quoting N.Y. STATE BAR ASS'N, ANTITRUST LAW SYMPOSIUM 29 (1968) (remarks of Stanley Robinson)).

<sup>107</sup> See ROBERT H. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 144-60 (1978) (critiquing predatory pricing theories and suggesting that predation is unlikely to be a serious problem); John S. McGee, *Predatory Pricing Revisited*, 23 J.L. & Econ. 289, 292 (1980) (arguing that predatory is rare and generally an irrational business strategy); Frank H. Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. Chi. L. Rev. 263, 282-97 (1981) (dismissing predation strategies as unlikely to be attempted).

<sup>108</sup> Crane, *Paradox of Predatory Pricing, supra* n. xxx at 3-4.

<sup>109</sup> *Brooke Group*, 509 U.S. at 222-23 (holding that predatory pricing plaintiffs must show pricing below an appropriate measure of cost and dangerous probability that defendant will subsequently recoup its predatory investment through supracompetitive pricing).

<sup>110</sup> On three occasions, the Supreme Court has declined to decide what is the appropriate measure of cost for predatory pricing cases. *Brooke Group*, 509 U.S. at 222 n.1; *Cargill*, 479 U.S. at 117-18 n.12; *Matsushita*, 475 U.S. at 584-85 n.8.

<sup>111</sup> First intoned in *Matsushita*, 475 U.S. at 589, and repeated in *Cargill*, 479 U.S. at 121 n.17, *324 Liquor Corp. v. Duffy*, 479 U.S. 335, 343 n.5 (1987), *Brooke Group*, 509 U.S. at 226, *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.*, 549 U.S. 312, 323 (2007).

...[;] mistaken inferences ... are especially costly, because they chill the very conduct the antitrust laws are designed to protect;”<sup>112</sup> “Low prices benefit consumers regardless of how those prices are set, and so long as they are above predatory levels, they do not threaten competition.”<sup>113</sup>

The power of these kinds of catechisms lies in their ability to direct a judge’s disposition toward such critical matters as allocations of burdens of proof, her willingness to dismiss cases, grant summary judgment, or otherwise relieve juries of cases, and the exercise of her *Daubert* gate-keeping function as to expert testimony.<sup>114</sup> Predatory pricing cases have become hard to win not primarily because plaintiffs cannot come up with theories of below-cost pricing or recoupment, but because judges have generally begun with a Supreme Court-mandated prior belief that predatory pricing is an implausible theory that will often be invoked by inefficient, rent-seeking competitors that want to increase rather than decrease prices.<sup>115</sup>

If antitrust law proceeds in large part by catechisms, these catechisms need not be uniformly in favor of dominant firms. Throughout much of antitrust history, the currents have run the other way.<sup>116</sup> The Post-Chicago movement in antitrust law is beginning to make in-roads in turning dominant firm practices from the hospitality tradition to at least neutral ground.<sup>117</sup> This is where the

<sup>112</sup> First intoned in *Matsushita*, 475 U.S. at 594, and repeated in *Cargill*, 479 U.S. at 121 n.17, *Brooke Group*, 509 U.S. at 226, *Verizon Communcs., Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 414 (2004); *Pacific Bell Tel. Co. v. linkLine Communcs., Inc.*, 555 U.S. 438, 451 (2009).

<sup>113</sup> First intoned in *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328, 340 (1990), and repeated in *Brooke Group*, 509 U.S. at 223, *State Oil Co. v. Khan*, 522 U.S. 3, 15 (1997); *Weyerhaeuser*, 549 U.S. at 319; *linkLine*, 555 U.S. at 451.

<sup>114</sup> *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579 (1993) (requiring courts to exclude expert testimony that is not the product of reliable principles and methods).

<sup>115</sup> See generally Daniel A. Crane, *The Paradox of Predatory Pricing*, 91 Cornell L. Rev. 1 (2005).

<sup>116</sup> Until it was buried in *Illinois Tool Works Inc. v. Independent Ink, Inc.*, 547 U.S. 28, 35 (2006), the Justice Frankfurter’s maxim that “tying arrangements serve hardly any purpose beyond the suppression of competition,” *Standard Oil Co. v. United States*, 337 U.S. 293, 305-06 (1949).

<sup>117</sup> For example, in [United States v. AMR Corp., 335 F.3d 1109, 1115 \(10th Cir. 2003\)](#), the Tenth Circuit announced that, in light of post-Chicago scholarship on

rubber hits the road for loyalty discounts in the U.S. courts. Post-Chicago theories are chipping away at the Chicago School maxims that justified non-intervention for unilateral pricing decisions by dominant firms. As courts sift through these competing assertions, they will be looking to come up with not only new legal rules—which may end up being as banal and non-predictive as exclusive dealing law’s “substantial foreclosure” test<sup>118</sup>—but with new maxims or catechisms that express the judiciary’s prior beliefs about the likelihood that loyalty discounts are help or harm competition and consumer welfare.

This general pattern is not new, but two conditions of relatively recent vintage may exercise important influence over the evolution of loyalty discounting norms. The first is the increasing complexity of economic models deployed by academic economists and expert witnesses to describe the potential exclusionary effects and procompetitive benefits of various competitive practices, including loyalty discounts. Admittedly, technical economic lingo is not new to antitrust law. Formal economic analysis—theoretic and empirical—has played an important role in shaping antitrust policy since at least the heyday of Harvard School structuralism in the 1950s and 60s.<sup>119</sup> And, the Chicago School that succeeded it was nominally predicated almost entirely on economic analysis.<sup>120</sup> The difference today is that much of the economic scholarship about antitrust issues is no longer expressed in readable prose presenting empirical observations (*i.e.*, firms in concentrated industry earn higher rates of return on capital) or theoretical ideas (*i.e.*, a firm with market power in one market would not engage in tying to obtain power in a complementary market since raising prices in the second market would reduce demand in the first market). Rather, much of the progress being made in technical economics relating to antitrust issues is occurring in papers that engage in complex economic modeling that the average lawyer or judge is unlikely to read or

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predatory pricing, it would no longer approach predatory pricing cases with “the incredulity that once prevailed.”

<sup>118</sup> *Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961) (holding that exclusive dealing contracts are only illegal if they substantially foreclose competition in the relevant market).

<sup>119</sup> See DANIEL A. CRANE & HERBERT HOVENKAMP, *THE MAKING OF COMPETITION POLICY: SELECTED SOURCES* (forthcoming 2012).

<sup>120</sup> *Id.*

understand.<sup>121</sup> Even when the intuitions behind the models are plainly explained, lawyers and judges often find themselves unsure of how much weight to put into any particular model, given the number of restrictive assumptions made to derive the model's results.<sup>122</sup> As a group of economists has explained as to models of loyalty discounting, "[t]he academic literature on loyalty discounts and exclusive dealing demonstrates that the welfare effects of these practices are ambiguous and that market details determine the direction of the effect."<sup>123</sup>

Given this reality, the creation of new legal catechisms is especially important. Since judges will rarely have the ability, time, or disposition to sort through the competing models and theoretical claims on a case-by-case basis (much less submit them unvarnished to juries), they will increasingly look to the catechisms to frame their decision. A maxim like the Second Circuit's *Virgin Atlantic* statement that rewarding customer loyalty through discounts is procompetitive and beneficial might have more influence in the decision of a case than ten new models showing that loyalty discounts can exclude competitors or soften competition. Conversely, judicial adoption of a maxim that loyalty discounts are

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<sup>121</sup> Michael R. Baye & Joshua D. Wright, *Is Antitrust Too Complicated for Generalist Judges? The Impact of Economic Complexity and Judicial Training on Appeals*, 54 J. L. & Econ. 1 (2011) (reporting empirical study suggesting that some antitrust cases are too complicated for generalist judges).

<sup>122</sup> See, e.g., Herbert Hovenkamp, *Antitrust and the Costs of Movement*, 78 Antitrust L. J. 67, 103 (2012) (noting, as to models of exclusionary effects from market share discounts in GPO contracts, that "the assumptions in these models are restrictive and they cannot be applied without significant risk of a false signal in situations that deviate from their assumption"); Joshua D. Wright, *Abandoning Antitrust's Chicago Obsession: The Case for Evidence-Based Antitrust*, 78 Antitrust L. J. 241, 241 (2012) (discussing "model selection problem" arising from "endless number of theoretical models" of causes and welfare consequences of different kinds of competitive behaviors). See also Timothy J. Brennan, *Is Competition the Entry Barrier? Consumer and Total Welfare Benefits of Bundling* (AEI/Brookings Joint Center for Regulatory Studies, Working Paper No. 05-08 2005) (showing large array of very different effects that can extrapolated from models making different assumptions as to product bundling).

<sup>123</sup> Assaf Eilat, Jith Jayaratne, Janusz A. Ordover & Greg Shaffer, *How Loyalty Discounts Can Perversely Discourage Discounting: Comment*, CPI Antitrust Chron., Vol. 4, No. 1 (Spring 2010).

often just concealed disloyalty penalties—a subject explored in the next Part—could have similar power in predisposing the decision of a case, even one in which there was not strong evidence that the discounts functioned to penalize disloyalty. Hence, some of the highest yield in the current debates over loyalty discounts will come from enshrining pro- or anti-loyalty maxims in the catechisms of law.

The second relatively new condition—and one that is probably, for now, less important than the first—is the growing possibility of antitrust comparativism. For most of the Sherman Act’s 120-year history, antitrust law was largely an American peculiarity.<sup>124</sup> The EU arose as a second developed antitrust system in the 1980s, but, until fairly recently, many or most in the U.S. antitrust community viewed EU antitrust law as either primitively formalistic or idiosyncratic because of the European goals of internal market creation.<sup>125</sup> But now, particularly with the ascendance of effects-based economic reasoning, European antitrust law has the potential to provide a serious intellectual counterweight to U.S. antitrust law. Of course, the citation of foreign law precedents in U.S. domestic law decisions remains controversial,<sup>126</sup> but it may be less objectionable to consult foreign legal precedents that are essentially developing economic common law in the manner of Sherman Act jurisprudence than, say, deciding on the meaning of the Eighth Amendment’s prohibition on cruel and unusual punishment. And there is the additional fact that big antitrust cases are increasingly played out on a global scale, with

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<sup>124</sup> ROBERT PITOFSKY, HARVEY J. GOLDSCHMID & DIANE P. WOOD, TRADE REGULATION: CASES AND MATERIALS 6 (6<sup>th</sup> ed. 2010) (discussing period when antitrust was an American peculiarity and subsequent growth of antitrust regimes around the world).

<sup>125</sup> See Spencer Weber Waller & Robert Stoner, *Economists Abroad*, 15 SPG-Antitrust 66 (2001), reviewing SIMON BISHOP AND MIKE WALKER THE ECONOMICS OF EC COMPETITION LAW (1999) (discussing popular view “that EU competition law is an arid formalistic system of rules devoid of economic analysis”); Josef Drexel, *Real Knowledge is to Know the Extent of One’s Own Ignorance: On the Consumer Harm Approach in Innovation-Related Competition Cases*, 76 Antitrust L. J. 677, 697 (2010) (discussing how TFEU goals of enhancing economic integration may push EU law away from consumer welfare goals).

<sup>126</sup> See Daniel A. Farber, *The Supreme Court, The Law of Nations, and Citations of Foreign Law: The Lessons of History*, 95 Cal. L. Rev. 1335, 1335-36 (2007) (discussing controversy around citation of foreign legal decisions in U.S. constitutional cases).

agencies and courts in multiple jurisdictions plying over the same controversies between the same parties. Recall that the Intel case proceeded in Japan, Korea, and Europe before decision at the FTC.<sup>127</sup> In this environment, U.S. courts will find it increasingly difficult to ignore antitrust developments in the courts and agencies of the United States' important trading partners.

It is with these background conditions that the formation of antitrust policy over loyalty discounting will likely play out. Unable or unwilling to process a large number of complex economic models, courts will form judgments based on which theories, in their simplified forms, seem most intuitively plausible. These judgments probably will be internalized in the legal system as maxims similar in style (although not necessarily in orientation) to those deployed in predatory pricing law. As judges make these decisions, they will increasingly be influenced by developments abroad, either because they will take cognizance of foreign cases or because the learning from those cases will infiltrate the U.S. antitrust agency positions, parties' litigation positions, and scholarly literature coming before the courts.

## II. DISLOYALTY PENALTIES AND COMPETITION SOFTENING THEORIES

This Article aims to provide a limited defense of loyalty discounts—to argue in favor of maxims that suggest a favorable judicial disposition toward such discounts. To that end, this Part responds to the two theories positing that loyalty incentives can harm consumer welfare even without excluding rivals: first, that loyalty discounts are often just disguised disloyalty penalties and, second, that the deployment of loyalty provisions softens competition. Because these theories challenge the essential premise of loyalty discounting—that these are real discounting mechanisms—they have the potential to turn into anti-loyalty maxims with the power substantially to erode the use of loyalty-enhancing discounts. However, neither theory is sufficiently robust or generalizable to serve as the basis for adoption of a new legal maxim.

### A. Loyalty Incentives as Disloyalty Penalties

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<sup>127</sup> *Supra* n. xxx at xxx.

Most antitrust experts would agree that loyalty incentives can have long-run exclusionary effects by discouraging customers from switching purchases to rival suppliers, starving the rivals of needed revenues, creating a less competitive market, giving the loyalty-insistent seller market power, and hence enabling that seller to raise prices above competitive levels.<sup>128</sup> However, consistent with the Second Circuit's observation in *Virgin Atlantic* that rebates to loyal customers are a form of reward,<sup>129</sup> many courts and commentators have assumed that the potential long-run threat to competition from loyalty discounts must be balanced against the short-run benefit to customers from the lower price granted for their fidelity.<sup>130</sup> This view is consistent with the Supreme Court's jurisprudence on predatory pricing, which characterizes the short-run pricing discount offered by a dominant firm as a substantial benefit to consumers that should make courts cautious about imposing antitrust liability based on the potential that such pricing could eventually exclude rivals and prevent monopolistic pricing at a later time.<sup>131</sup> Much of the

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<sup>128</sup> Even the Bush Administration's monopolization report, which as noted was roundly criticized as too protective of dominant firms, acknowledged this potential. *Single Firm Conduct*, supra n. xxx at 6(II) ([A]s with predatory pricing, single-product loyalty discounts may be anticompetitive in certain circumstances, such as where the resulting price of all units sold to a customer is below an appropriate measure of cost. Further, commentators and panelists generally agree that even where a single-product loyalty discount is above cost when measured against all units, such a discount may in theory produce anticompetitive effects, especially if customers 'must carry a certain percentage of the leading firm's products' and the discount is structured to induce purchasers to buy all or nearly all needs beyond that 'uncontestable' percentage from the leading firm.")

<sup>129</sup> See supra text accompanying note xxx – xxx.

<sup>130</sup> See, e.g., *Southeast Missouri Hospital*, 642 F.3d at 615 (noting that cutting prices in order to increase business often is the very essence of competition" and repeating Supreme Court's caution on acceptance of unfair pricing claims); *Concord Boat*, 207 F.3d at 1060 (quoting, in context of market share discount analysis, Supreme Court statement "[l]ow prices benefit consumers regardless of how those prices are set, and so long as they are above predatory levels, they do not threaten competition. Hence, they cannot give rise to antitrust injury") (citation omitted).

<sup>131</sup> *Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 223 (1993) (explaining that price discounting is generally beneficial to consumers and

hospitality tradition toward unilaterally determined prices comes from a belief that “[l]ow prices benefit consumers regardless of how they are set, and so long as they are above predatory levels, they do not threaten competition.”<sup>132</sup>

A growing line of criticism charges that loyalty incentives are often not price discounts at all but rather disguised taxes on disloyalty.<sup>133</sup> Although this critique has mostly appeared in academic literature, it is beginning to appear in judicial decisions as well. For example, in affirming a plaintiff’s jury verdict based on a claim of exclusion through loyalty discounts, the Third Circuit recently described threatened losses of market share discounts as “financial penalties.”<sup>134</sup> The court relied on this characterization in upholding a jury verdict finding that the defendant’s market share discounts were illegal even though the defendant had not priced above cost.<sup>135</sup> The court apparently believed that penalizing disloyalty was different in kind for purposes of antitrust analysis than rewarding loyalty.

Analytically, whether something is a loyalty discount or disloyalty penalty depends critically on the baseline, just as the distinction between rewards and punishments depends on the

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expressing concerns about chilling such price discounting through excessive predatory pricing liability).

<sup>132</sup> *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328, 340 (1990).

<sup>133</sup> See Einer Elhauge, *Why Above-Cost Price Cuts to Drive Out Entrants Are Not Predatory—And the Implications for Defining Costs and Market Power*, 112 Yale L. J. 681, 698 n. 53 (2003) (“If loyalty rebates were never illegal unless the resulting price were below cost, then any firm could immunize its exclusive-dealing agreements from antitrust scrutiny by the simple expedient of inflating the price and then offering a rebate conditioned on exclusivity.”); Joseph Farrell, Director, Federal Trade Commission, Bureau of Economics, *Problems with Loyalty Pricing*, address at the Fourth Annual Searle Research Symposium on Antitrust Economics and Competition Policy, Northwestern University (Sept. 23, 2011) (describing loyalty discounts as a tax on purchases from competitors); Aaron Edlin & Joseph Farrell, *Freedom to Trade and the Competitive Process*, NBER Working Paper No. 16818 (Feb. 2011), <http://www.nber.org/papers/w16818> (describing loyalty incentives in multi-product discounting context as taxes on trading with an alternative supplier); Fiona Scott-Morton, Deputy Assistant Attorney General, Antitrust Division, *Contracts that Reference Rivals*, (April 5, 2012), at 9 <http://www.justice.gov/atr/public/speeches/281965.pdf> (discussing literature showing that loyalty discounting serves as a tax on purchasing from rivals); Jacobson, *supra* n. xxx at 2 (“In some instances, moreover, the ‘discount’ might in fact be a disguised penalty for ‘disloyal’ buyers.”).

<sup>134</sup> *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d 254, 277 (3d Cir. 2012).

<sup>135</sup> *Id.*



baseline.<sup>136</sup> The “discounts as penalties” assertion assumes that the baseline price—the price the customer would receive if she refused the loyalty discount—is an artificially inflated penalty price and that the loyalty discount merely brings the price back to the profit-maximizing monopoly level. For purposes of stylizing the disloyalty penalty claim, assume that the price the customer would receive absent the loyalty incentive is  $x$  and the loyalty incentive is 1. Under a discount or reward view, the customer who meets the loyalty criteria pays a price of  $x-1$ , and hence improves her position as compared to the world with no loyalty incentive (putting aside the potential of long-run exclusionary effects). Under the penalty view, however, the seller increases his price to  $x+1$  and then offers a “discount” of 1 in exchange for loyalty. The customer who accepts the discount achieves merely the but-for price absent the loyalty discount; the customer who refuses it pays a disloyalty penalty of 1.

The penalty view, if widely accepted, would have severe consequences for antitrust policy concerning loyalty discounts. It would alter the baseline view of loyalty incentives as price concessions that benefit consumers and should only be prohibited if they have long-run exclusionary effects. This would shift loyalty incentives out of the broad safety zone for non-predatory unilaterally determined prices established in existing case law, just as the Third Circuit did in *ZF Meritor*.<sup>137</sup>

But the view that loyalty discounts are actually disloyalty penalties encounters significant analytical difficulties. In most circumstances, it is doubtful that a seller can successfully threaten or implement a disloyalty penalty without impairing its own interests far more than those of its customers. Since a disloyalty penalty would usually inflict far more loss to the seller than to the buyer, it is not plausible that sellers routinely impose disloyalty penalties.

To see why, begin with a seller in a competitive market. Such a seller clearly cannot impose a disloyalty penalty on the customer who chooses to buy forbidden fruits from the seller’s rival. In this

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<sup>136</sup> See Daryl J. Levinson, 56 Stan. L. Rev. 345, 377, 377 n. 154 (2003) (observing that whether something is a punishment or a reward depends on the baseline); see also *McKune v. Lile*, 536 U.S. 24, 46 (2002) (“The answer to the question whether the government is extending a benefit or taking away a privilege rests entirely in the eye of the beholder.”).

<sup>137</sup> *Supra* n. xxx.

example,  $x$  is a competitive market price. If a seller in a competitive market raises its baseline price above the competitive price, customers can simply switch to rival sellers. If the seller offers to reduce its price back to the competitive price if the customer remains loyal, that will not work either. From the customer's perspective, a requirement of loyalty is an impairment of its freedom to mix and match its purchases from different sellers as it prefers. The seller's offer of a price of  $x$  conditioned on loyalty is less attractive than a competitor's offer of a price of  $x$  not conditioned on loyalty. The only way that the seller can successfully use a loyalty incentive is to provide a true discount from  $x$ —to go back to the standard assumption that a loyalty incentive results in  $x-1$ .<sup>138</sup>

Now consider a monopoly seller. Assuming that he has exercised his monopoly power,  $x$  will be the profit-maximizing monopoly price.<sup>139</sup> Any disloyalty penalty he would try to set would have to be above that price, and hence by definition be less profitable to the monopolist than  $x$ . The mere fact that the monopolist might threaten to charge an unprofitable price in order to coerce compliance is not itself an objection to the disloyalty penalty view. The basic model of monopoly pricing posits that the monopolist threatens something unprofitable to itself— withholding sales above marginal cost—if the customer refuses to pay the monopoly price.<sup>140</sup> The difference here is that the monopolist who is already charging the profit-maximizing monopoly price is operating in the elastic portion of his demand curve.<sup>141</sup> At this price, customers are willing to consider other products or services as substitutes for the monopolist's product or service. Indeed, the very reason that the monopolist does

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<sup>138</sup> It is a standard assumption in the economic literature that the seller must pay the buyer to accept an exclusivity condition. Ramusen, Ramseyer & Wiley, *supra* n. xxx at xxx (discussing price monopolist must pay buyers to accept an exclusivity commitment upon the threat of new entry).

<sup>139</sup> W. KIP VISCUSI, JOSEPH E. HARRINGTON, JR. & JOHN M. VERNON, *ECONOMICS OF REGULATION AND ANTITRUST* 82 (4th ed. 2005) (explaining how monopolist sets a profit-maximizing price by equating marginal cost with marginal revenue).

<sup>140</sup> Mancur Olson, *Collective Action*, in 1 *THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS* 474 (John Eatwell et al. eds., 1994); Mancur Olson, *THE LOGIC OF COLLECTIVE ACTION* (2d ed. 1971) [MORE].

<sup>141</sup> William H. Landes & Richard A. Posner, *Market Power in Antitrust Cases*, 94 *Harv. L. Rev.* 937, 961 (1981) (explaining that “every monopolist faces an elastic demand [] at its profit-maximizing output and price).

not charge a price higher than  $x$  is that, if it did, customers would substitute to other suppliers.

If the monopolist threatens a price above his profit-maximizing monopoly price, he is threatening to damage himself far more than he harms the customer. Most or all customers who reject the monopolist's insistence on loyalty will not actually incur the disloyalty penalty. They will substitute to other products.<sup>142</sup> Although they would prefer to purchase from the monopolist at  $x$ , the difference to them in utility between buying the monopolist's product at  $x$  and substituting to other products is small. The harm to consumers from calling the monopolist's bluff is slight.

By contrast, the harm to the monopolist of losing customers to substitution to other products is large. The sales that the monopolist makes at the profit-maximizing, elastic portion of its demand curve are its most profitable. When customers substitute to other products, the monopolist loses not only market share, but sales at a monopoly price. Further, by inducing its customers to substitute to goods or services the customers did not consider good substitutes at a price of  $x$ , the monopolist runs the risk of losing the customer entirely or forever. Customers who experiment with the goods or services of a rival may decide that they prefer the rival's offerings. Even if the monopolist eventually stops threatening a disloyalty penalty, they may choose not to return.

Monopolists who play a disloyalty penalty game in the elastic part of their demand curve will usually be taking an unwise risk. By pricing at the profit-maximizing monopoly level, they fully spent their market power. The threat of a yet higher price will usually be hollow.

Einer Elhauge, one of the leading proponents of the disloyalty penalty theory, has responded to this view that the monopolist lacks the power credibly to threaten an above  $x$  disloyalty penalty.<sup>143</sup> Elhauge claims that this argument misunderstands the fundamental premise of monopoly pricing and, that if it were true, "the seller threat under monopoly pricing would not be credible because, if the buyer threatened not to buy the product unless the monopolist

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<sup>142</sup> This is mathematically a function of the fact that the profit-maximizing monopoly price is the highest price the monopolist can charge without seeing its customers substitute to other products.

<sup>143</sup> Einer Elhauge, *The Failed Resurrection of the Single Monopoly Profit Theory*, Competition Policy Int'l, Spring 2010 155 (2009).

lowered the price below the monopoly price to some above-cost level, the monopolist would find it more profitable to sell at that above-cost price than to forego sales and lose all profits to that buyer.”<sup>144</sup> Since we know that monopoly pricing actually works, both in theory and in practice, Elhauge claims that there must be a fundamental error in the premise that threatening a price above the monopoly level will not work.<sup>145</sup> Elhauge argues that the buyer who is threatened with a disloyalty penalty will accede to loyalty so long as her surplus from accepting the monopolist’s demand exceeds her surplus from rejecting it.<sup>146</sup> Even if the customer is harmed less than the monopolist by the imposition of the threatened disloyalty penalty, collective action problems prevent her from calling the monopolist’s bluff.<sup>147</sup>

Three responses are in order. First, the consumer’s surplus may not be greater if she stays loyal to the monopolist at price  $x$  and subject to a loyalty restraint rather than switching to a different supplier. The imposition of an onerous contractual term is economically equivalent to a price increase.<sup>148</sup> If, as hypothesized,  $x$  without a loyalty constraint is the profit-maximizing monopoly price, then a price of  $x$  plus loyalty constraint, which is a cost to the buyer insofar as it deprives her of her freedom of choice, is an effective price increase. Under standard economic assumptions, a price increase above the profit-maximizing monopoly price causes customers to substitute to new products and services because doing so increases their surplus.<sup>149</sup> Hence, customers will find it preferable to substitute to other goods or services rather than to pay the full monopoly price *and* become subject to a restrictive loyalty requirement.

Second, even if the customer would enjoy slightly more surplus by purchasing at  $x$  (with the loyalty restraint) than by substituting to a rival’s offering, it is far from clear that collective action problems will make her unwilling to call the monopolist’s bluff. The asymmetries between the losses to the monopolist and to the customer from customer substitution are large. If the customer

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<sup>144</sup> *Id.* at 178.

<sup>145</sup> *Id.*

<sup>146</sup> *Id.* at 177.

<sup>147</sup> *Id.*

<sup>148</sup> DENNIS W. CARLTON & JEFFREY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 57 (4th ed. 2005).

<sup>149</sup> Thomas G. Krattenmaker et al., *Monopoly Power and Market Power in Antitrust Law*, 76 Geo. L.J. 241, 256 (1987).

realizes that she has little to lose by calling the monopolist's bluff and that the monopolist has much to lose, she may push back on the monopolist's demand.

Finally, it bears returning to the point made a few moments ago that a seller in a competitive market cannot impose a disloyalty penalty. Economists and antitrust scholars have long recognized that the monopolist who has charged a profit-maximizing monopoly price has effectively priced itself into a competitive market and faces competition from products that would not be substitutes at a lower price point. The classic exposition of this point arises in the context of a fundamental error in economic reasoning—widely known as the “cellophane fallacy”—made in a Supreme Court case on market definition in the *DuPont* case.<sup>150</sup> In *DuPont*, the question was whether the relevant market should be considered just cellophane, in which event DuPont would have a monopoly, or whether there was a wider market including other flexible packaging materials like Pliofilm, glassine, foil, polyethelylene, waxed paper, and Saran wrap.<sup>151</sup> The Court concluded that the market included all flexible wrapping materials because there was evidence of substantial cross-elasticity of demand<sup>152</sup> between cellophane and the other materials.<sup>153</sup> As numerous courts and commentators have pointed out since, the fact that consumers considered cellophane and other flexible wrapping materials substitutes at prevailing prices did not negate the possibility that cellophane was its own relevant market.<sup>154</sup> If DuPont had monopolized the cellophane market and then raised the price of

<sup>150</sup> U.S. v. E.I. du Pont de Nemours & Co., 351 U.S. 377 (1965).

<sup>151</sup> *Id.* at 380.

<sup>152</sup> Cross-elasticity of demand refers to the increase in demand for one product caused by an increase in the price of another. F.M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE, Third Ed. 75 (3d. ed. 1990).

<sup>153</sup> 351 U.S. at 400.

<sup>154</sup> RICHARD A. POSNER, ANTITRUST LAW: AN ECONOMIC PERSPECTIVE 128 (1976); ABA Section of Antitrust Law, Market Power Handbook: Competition Law and Economic Foundations 59-60 (2005); Jonathan Baker, *Market Definition: An Analytical Overview*, 74 ANTITRUST L.J. 129, 162-65 (2007); Lawrence J. White, *Market Power and Market Definition in Monopolization Cases: A Paradigm is Missing*, in ISSUES IN COMPETITION LAW AND POLICY (Wayne D. Collins ed., A.B.A. Sec. of Antitrust Law 2008); Robert Pitofsky, *New Definitions of Relevant Market and the Assault on Antitrust*, 90 COLUM. L. REV. 1805, 1814 (1990); 2B Areeda & Hovenkamp, *supra* note xxx, ¶ 539; Gene C. Schaerr, *The Cellophane Fallacy and the Justice Department's Guidelines for Horizontal Mergers*, 94 Yale L.J. 670 (1985).

cellophane to the profit-maximizing monopoly level, other flexible wrapping materials would become good substitutes for cellophane at the monopoly price.

As the cellophane case illustrates, the monopolist who has charged the profit-maximizing price is operating in a competitive-like environment, one where the monopolist faces meaningful constraints on its pricing and output decisions because consumers have meaningful choices at prevailing prices. In such a circumstance, the monopolist has no more power to threaten a disloyalty penalty than any other seller in an ordinary competitive market.

Thus far, we have considered firms in competitive markets and monopolists charging the profit-maximizing monopoly price. Three more circumstances warrant mention: sellers with some degree of market power in oligopoly markets, sellers of any kind engaging in price discrimination, and monopolists engaged in limit pricing.

Putting aside for a moment the competition softening theories discussed in the next part, the case of the oligopolist is just a weaker version of the case of the monopolist. Like the monopolist, the oligopolist maximizes its profits by equating marginal revenue to marginal cost and is constrained to raise its price any further because consumers will substitute to rival sellers.<sup>155</sup> Oligopolists, like monopolists, price in the elastic part of their demand curve where they have essentially spent all of their market power. Indeed, under a conventional kinked demand curve model of oligopoly pricing, the demand above the prevailing oligopoly price is so elastic that the oligopolist who unilaterally raises his price will lose nearly all of her sales.<sup>156</sup> Hence, absent collusion between oligopolists (discussed next), an oligopolist cannot credibly threaten a disloyalty penalty if it is already charging the profit-maximizing oligopoly price.

The same is true of a firm that is engaging in price discrimination—charging different prices to different buyers based on their different willingness to pay.<sup>157</sup> As to disloyalty penalties,

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<sup>155</sup> DANIEL S. PINDYCK & DANIEL L. RUBINFELD, MICROECONOMICS 457-58 (6<sup>th</sup> ed. 2005) (discussing oligopoly pricing).

<sup>156</sup> In the model, the kink occurs because each firm believes that if it raises its price above the current price none of its competitors will follow suit. Conversely, each oligopolist also believes that if it lowers its price, all other firms will also lower theirs. *But see* George J. Stigler, *The Kinky Oligopoly Demand Curve and Rigid Prices*, 55 J. POL. ECON. 432 (1947) (providing theoretical criticisms of the kinked curve model).

<sup>157</sup> Pindyck & Rubinfeld, *supra* n. xxx at 383 (defining price discrimination).

price discrimination is just a microcosm of monopoly pricing. The seller sets its price to each buyer based on its perception of the buyer's maximum willingness to pay.<sup>158</sup> Instead of having a unified  $x$ , we have instead a series of  $x$ s corresponding to buyers' separate reservation prices. If the monopolist imposes a loyalty condition on top of  $x$ , he will lose the sale because he has exceeded the buyer's reservation price. Loyalty prices must thus be below  $x$  in order to stick.

Finally, we come to the firm with market power that is engaging in limit pricing—a price below the short-run profit-maximizing price designed to discourage new entry or substitution to rivals.<sup>159</sup> This is the one circumstance where the seller might realistically threaten a disloyalty penalty above  $x$ . By holding back from the profit-maximizing monopoly price, the seller has reserved some of its market power and can hence impose a penalty above  $x$  without triggering substitution to rivals and the loss of profitable sales. Still, even this strategy will be risky for the limit-pricing seller who, by definition is concerned that approaching the monopoly price will facilitate new entry or the expansion of competitors.

In sum, it is not impossible for sellers to threaten disloyalty penalties, just risky and unlikely in most circumstances. As a baseline view or Bayesian prior belief, it is far more likely that most loyalty discounts are true discounts—prices below  $x$ .

## B. Competition Softening

A second strand of the anti-loyalty discount literature attacks loyalty inducement as a means of softening competition between oligopolists. Competition softening refers to the effect resulting from the adoption of practices by one or more oligopolists that deter their rivals from competing as aggressively as they otherwise would.<sup>160</sup>

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<sup>158</sup> *Id.* at 383-93.

<sup>159</sup> See Paul Milgrom & John Roberts, *Limit Pricing and Entry Under Incomplete Information: An Equilibrium Analysis*, 50 *Econometrica* 443, 444-45 (1982); Joe Bain, *A Note on Pricing in Monopoly and Oligopoly*, 39 *Am. Econ. Rev.* 448, 454 (1949); F.M. SCHERER & DAVID ROSS, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 356-66 (3d ed. 1990); JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 367-74 (1992); Viscusi, *supra* n. xxx at 177-90.; Clark, *Toward a Concept of Workable Competition*, 30 *AMER. ECON. REV.* 241, 247-48 (1940).

<sup>160</sup> Kaplow & Shapiro, *supra* n. xxx at xxx.

Examples of practices that have been accused of softening competition include contracts that reference rivals,<sup>161</sup> resale price maintenance,<sup>162</sup> product differentiation,<sup>163</sup> price-matching clauses,<sup>164</sup> and most favored nations clauses.<sup>165</sup> Unlike theories that rely on the exclusion of a rival to produce anticompetitive effects, competition softening theories allow for entry and competition by rivals, but with diminished incentives to engage in aggressive price competition.

Commentators have postulated that loyalty discounts can have competition softening effects.<sup>166</sup> Elhauge and Wickelgren offer the fullest explanation.<sup>167</sup> In their model, when a monopolist reacts to the possibility of new entry by offering a loyalty discount and this results in some buyers who are committed to the monopolist and other buyers who are not and therefore are “free,” the monopolist faces a diminished incentive to match the new entrant’s prices for “free” buyers since that would further undermine the monopolist’s price to

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<sup>161</sup> *Interview with Fiona Scott Morton, DAAG for Economic Analysis at the DOJ*, 26-SPG Antitrust 14, 17 (2012) (asserting that contracts that reference rivals can both exclude new entrants and soften competition).

<sup>162</sup> Avishalom Tor & William J. Rinner, *Behavioral Antitrust: A New Approach to the Rule of Reason After Leegin*, 2011 U. Ill. L. Rev. 805, 812 (2011); Patrick Rey & Joseph Stiglitz, *The Role of Exclusive Territories in Producers' Competition*, 26 RAND J. Econ. 431, 432 (1995).

<sup>163</sup> JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 286 (1988) (“Firms want to differentiation to soften price competition.”).

<sup>164</sup> Stephen C. Salop, *Practices That (Credibly) Facilitate Oligopoly Coordination*, in *NEW DEVELOPMENTS IN THE ANALYSIS OF MARKET STRUCTURE* 279-82 (Joseph E. Stiglitz & G. Frank Mathewson eds., Macmillan 1986).

<sup>165</sup> Aaron S. Edlin, *Do Guaranteed-Low-Price Policies Guarantee High Prices, and Can Antitrust Rise to the Challenge?*, 111 HARV. L. REV. 528 (1997); Jonathan B. Baker, *Vertical Restraints with Horizontal Consequences: Competitive Effects of “Most-Favored-Customer” Clauses*, 64 ANTITRUST L.J. 517 (1996); Thomas E. Cooper, *Most-Favored-Customer Pricing and Tacit Collusion*, 17 RAND J. Econ. 377 (1986).

<sup>166</sup> See Faella, *supra* n. xxx at 381 (discussing potential of antitrust claim based on competition-softening effects of loyalty discounts).

<sup>167</sup> Elhauge & Wickelgren, *Anti-competitive Exclusion*, *supra* n. xxx at 3.



committed buyers.<sup>168</sup> Elhauge and Wickelgren believe that this would occur because they understand the loyalty discount as a discount off of the price offered to buyers who did not agree to the loyalty contract—what is often referred to as the list price.<sup>169</sup> They apparently assume that the incumbent would have to respond to the new entrant’s solicitation of free buyers by lowering its list price, which would trigger an unprofitable reduction of its prices to its committed buyers as well.

This assumption is counterfactual, or at least not generalizable. There is nothing to say that a firm offering loyalty discounts to committed buyers has to lower its list price to attract free buyers when an entrant begins to compete for their business. In most interactions between corporate buyers and sellers, list prices are understood to be nominal—the starting place for further negotiation and discounting.<sup>170</sup> Prices are set to individual buyers by a combination of terms, discounts, rebates, incentives, and side deals.

Consider two examples. First, consider a typical pricing structure for a medical device—in this case a catheter.<sup>171</sup> A hospital that wants to buy catheters will usually belong to at least one GPO, but often it will decide to join several GPOs in order to be able to select the best starting prices it can on a product-by-product basis.<sup>172</sup> Access to a GPO contract generally involves no commitment by the buyer to purchase anything from the seller.<sup>173</sup> Often, a GPO contract will list

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<sup>168</sup> *Id.* at 3 (“Price-matching clauses instead involve seller commitments to match rival prices, whereas loyalty discounts involve no such seller commitment to match and indeed have the opposite effect of discouraging sellers from matching rival prices for free buyers.”).

<sup>169</sup> *Id.* at 8 n.10 (“[A]greeing to a loyalty discount simply means that the buyer receives a discount from the price (often called a ‘list price’) offered to buyers who did not agree to a loyalty contract.”).

<sup>170</sup> See, e.g., *St. Francis Med. Ctr. v. C.R. Bard, Inc.*, 657 F. Supp. 2d 1069, 1078 (E.D. Mo. 2009) (describing GPO prices as “helpful in establishing the market price for a particular product and in establishing a starting point for negotiations for lower-priced commodity products.”).

<sup>171</sup> The following facts are largely taken from *St. Francis Medical*, 657 F. Supp. 2d at 1069.

<sup>172</sup> *Id.* at 1079 (noting that “hospitals can often belong to more than one GPO and often switch from one GPO to another”).

<sup>173</sup> *Id.*

a number of sellers of the same product from whom the hospital can choose to buy.<sup>174</sup> Prices under the GPO contract are ascertained by tiers that combine volume and market share requirements—for example, a requirement that the hospital buy at least \$100,000 and 85% of its requirements within the product category from the vendor.<sup>175</sup> Sometimes, the more advantageous tiers require that the hospital purchase from the seller across multiple product lines, thus injecting an element of bundling into the equation.<sup>176</sup> Although a member of the GPO is entitled to purchase under the GPO contract, nothing requires the hospital to do so. Hospitals may, and often do, elect to negotiate directly with suppliers.<sup>177</sup> Even hospitals that buy under GPO contracts sometimes negotiate side-deals for extra discounts or rebates on top of the GPO contracts. GPO contracts do not force hospitals to purchase in any particular way, nor do they guarantee that the manufacturer will not offer other customers lower prices outside of the GPO contract.

Or consider the way that Intel set its computer chip prices to OEMs, as described in the European Commission’s prohibition decision. Like the medical device manufacturers, Intel started with a “Customer Authorized Price,” essentially a list price, which then became a target for OEMs to dicker for price reductions.<sup>178</sup> Intel then offered a series of discounting, rebating, or funding possibilities based on a variety of criteria such as the introduction of new technologies or an OEM’s efforts to promote Intel products.<sup>179</sup> These were just Intel’s formal pricing programs. When it came to real pricing, Intel negotiated individually with OEMs and retailers over tailored pricing concessions. For example, Dell received discounts or rebates pursuant to a program formally structured by Intel for Dell, various short-term price concession agreements, and one-off deals.<sup>180</sup>

As these examples illustrate, corporate-to-corporate price setting is rarely as simple as setting a list price and a schedule of discounts

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<sup>174</sup> *Id.* (reporting that the Premier GPO included four competitors selling catheters in its GPO contract).

<sup>175</sup> *Id.* at 1080.

<sup>176</sup> *Id.* at 1080-81.

<sup>177</sup> *Id.* at 1081-82.

<sup>178</sup> *Intel Prohibition Decision*, *supra* n. xxx at ¶ 175.

<sup>179</sup> *Id.* at ¶¶ 177-78.

<sup>180</sup> *Id.*

for loyal customers. Sellers and buyers—both committed and free—constantly bargain over price and loyalty, adjusting their bargains as market and competitive conditions change. Effective prices are often hidden under layers upon layers of contracts, schedules, side-letters, and one-off pricing deals.

Given these conditions, it is difficult to see how loyalty discounting softens competition or contributes to oligopolistic pricing coordination. When new firms or technologies enter the market, all buyers—whether committed or uncommitted—will scramble to deploy their added leverage to exact additional concessions from the monopolist seller. The monopolist need not respond by offering a uniform set of prices and pricing concessions for loyal and disloyal customers. Rather, it will continue to do what it did before there was new entry—try to exact the maximum price it can from each customer given market realities and try to disguise its most favorable prices to its customers with the greatest buying power so that other customers will not clamor for similar discounts.

Further idiosyncrasies with Elhauge and Wickelgren’s model render it inapplicable to the large majority of recently contested loyalty discount cases. They assume a market with an incumbent monopolist and only one potential rival,<sup>181</sup> a scenario that matches virtually none of the recently contested loyalty discount cases.<sup>182</sup> They assume that a loyalty contract entails a commitment by the buyer to purchase 100% of its requirements from the seller.<sup>183</sup> But in most contemporary loyalty discount situations, the buyer can achieve the seller’s best price by buying some lesser amount than its full requirements from the seller.<sup>184</sup> For example, in *Concord Boat*, customers obtained the maximum market share discount by buying 70% of their boat engine requirements from the defendant, Brunswick.<sup>185</sup> Intel generally required computer manufacturers to

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<sup>181</sup> Elhauge & Wickelgren, *supra* n. xxx at 42.

<sup>182</sup> See *supra* text accompanying notes xxx - xxx.

<sup>183</sup> *Id.* at 8 (positing that “buyers commit to buy only from the incumbent in exchange for receiving a discount . . . off the price that [the incumbent] offers to buyers who do not sign the contract”).

<sup>184</sup> See *supra* text accompanying notes xxx - xxx.

<sup>185</sup> 207 F.3d at 1044. Of note, when Brunswick attempted to increase the loyalty level to 95% in 1994, its effort was beaten back “due to serious backlash from boat builders.” *Id.* at 1044-45.

make 80%-95% of their purchases from Intel to secure a loyalty rebate.<sup>186</sup> In the GPO cases, customers generally maximize their loyalty discount with a purchase of 80-85% of their requirements from the seller and can still obtain loyalty discounts at rates as low as 50%.<sup>187</sup> R.J. Reynolds required an 85% market share for its best price.<sup>188</sup> The fact that loyalty discounts are often awarded for less than full loyalty is significant, because smaller rivals or new entrants have an opportunity to obtain significant sales from customers without increasing the price the customer pays for its purchases from the dominant seller.<sup>189</sup> Finally, although Elhauge and Wickelgren consider models where the customer contractually commits to purchase under the loyalty discount program and ones where the customer can obtain the loyalty discount without making any ex ante commitment, they obtain much stronger results when the buyer is required to make an ex ante commitment.<sup>190</sup> As already noted, a

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<sup>186</sup> Paul Jones, *American Antitrust Jurisprudence Applied to European Commission v. Intel*, 7 B.Y.U. Int'l L. & Mgmt. Rev. 52, 55-56 (2010) (summarizing Intel's market share discount provisions to OEMs).

<sup>187</sup> See *Southeast Missouri Hospital*, 642 F.3d at 610-11 (reporting that hospitals achieved the maximum market share rebate at 85% of their catheter requirements and received loyalty rebates for purchasing as few as 50% of their requirements from C.R. Bard);

<sup>188</sup> 477 F.3d at 858.

<sup>189</sup> Greg Shaffer and Zhijun Chen have argued that partial exclusive dealing can threaten competition even more than pure exclusive dealing since the monopolist must pay customers to enter into exclusive dealing relationships and can do so more cheaply by purchasing only partial loyalty. Zhijun Chen & Greg Shaffer, *Naked Exclusion and Minimum-Share Requirements*, Presentation at University of East Anglia (June 2010), available at [http://competitionpolicy.ac.uk/documents/107435/107590/greg\\_shaffer\\_new\\_slides.pdf](http://competitionpolicy.ac.uk/documents/107435/107590/greg_shaffer_new_slides.pdf). While their model is intriguing as an explanation for how monopolists might afford a campaign to exclude rivals, it does not respond to the observation that partial exclusivity commitments foreclose less of the market than pure exclusive dealing and therefore may leave rivals room to enter or expand in the market. See Daniel A. Crane & Graciella Miralles, *Toward a Unified Theory of Exclusionary Vertical Restraints*, 84 S. Cal. L. Rev. 605, 638-46 (2011) (discussing economic meaning of exclusive dealing law's substantial foreclosure requirement).

<sup>190</sup> *Id.* at 27-40.

buyer commitment to future loyalty was not at issue in most of the contemporary loyalty discount cases.

There is another peculiarity about thinking of loyalty discounts as competition-softening devices. Competition-softening theories generally assume that the function of a competition-softening device is to facilitate supra-competitive pricing by oligopolists.<sup>191</sup> Oligopolists generally benefit from competition-softening devices at the expense of consumers. If a loyalty discount operated to make the incumbent monopolist less willing to match a new entrant's prices to "free" customers, then this should benefit the new entrant. In that case, we should not expect to see many cases in which smaller rivals complain about their dominant competitor's use of loyalty discounts. But that is exactly what we observe in virtually all of the recently contested loyalty discount cases.<sup>192</sup> The fact that competitors are the chief complainants about loyalty discounts does not mean that these devices are not anticompetitive—they could still be exclusionary. But it does mean that they are unlikely to be competition softening devices, as that concept is usually understood.

In sum, it is possible to create models in which the use of loyalty clauses softens competition. It is unlikely, however, that these models are useful in describing the key questions that antitrust law needs to address today.

Even if the disloyalty penalty and competition softening claims are not generalizable, this does not mean that loyalty incentives are always pro-competitive. Rather, it means that loyalty discounts should continue to be evaluated for exclusionary effects—generally, the foreclosure of rivals' ability to compete in the market.<sup>193</sup>

### III. LOYALTY AND THE CUSTOMER PERSPECTIVE

The previous Part responded to two criticisms of loyalty discounting and hence played a defensive role with respect to loyalty incentives. This final Part presents an affirmative case for loyalty discounting from the buyer's perspective. It does not attempt an

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<sup>191</sup> See, e.g., Salop & Cooper, *supra* n. xxx (discussing use of matching the competition clauses as facilitating practices that soften competition in concentrated markets).

<sup>192</sup> See *supra* text accompanying notes xxx-xxx.

<sup>193</sup> On the meaning of the foreclosure requirement, see Crane & Miralles, *supra* n. xxx at 633-45.

exhaustive catalog of the ways that loyalty discounts benefit buyers, some of which were already discussed in the context of distinguishing loyalty and volume-based discounts in Part I(A). Rather, it shows that the conduct of buyers in not only accepting, but in some cases in soliciting, loyalty discounts is an important piece of empirical evidence in considering their effects on buyers. To that end, this Part first discusses why buyer initiation should be relevant to the antitrust inquiry and responds to critics who claim that it should not. It then provides examples of loyalty discounts that have been solicited or approved by dominant buyers who are unlikely to be the victims of the sorts of collective action problems that could lead buyers to grudgingly accept contractual provisions that are not in their collective interests. Finally, it considers the relevance of a strand of management literature discussing the benefits to buyers of entering into loyalty relationships with suppliers.

#### A. The Relevance of Buyer Demand for Loyalty Discounts

Antitrust suspicion of loyalty incentives is motivated by the fear that such incentives could harm the interests of buyers by enabling sellers to obtain market power and to charge higher prices. Hence, evidence that buyers affirmatively seek or approve of loyalty discounts could provide some counter-evidence to this suspicion.<sup>194</sup> And, indeed, buyers are often the instigators in seeking loyalty discounts or other contractual terms that restrict their ability or incentives to purchase from alternative suppliers<sup>195</sup>

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<sup>194</sup>See Richard M. Steuer, *Customer-Instigated Exclusive Dealing*, 68 ANTITRUST L.J. 239 (2000) (arguing that buyer-initiated exclusive dealing should sometimes be treated more favorably than seller-initiated ones, on the theory that buyer initiation provides some evidence that the contract is not against the buyer's interests).

<sup>195</sup>See, e.g., *NicSand*, 507 F.3d at 454 (observing that “[a]ccording to NicSand’s own complaint, all but one of the large retailers made exclusivity a *condition* for doing business with a new supplier .... If *retailers* have made supplier exclusivity a barrier to entry, one cannot bring an antitrust claim against a *supplier* for acquiescing to that requirement”); *White & White, Inc. v. American Hospital Supply Corp.*, 540 F. Supp. 951 (W.D. Mich. 1982), *rev’d on other grounds*, 723 F.2d 495 (6th Cir. 1983) (upholding arrangement where twenty-nine hospitals formed a purchasing group and agreed to purchase from a single medical products supplier offering nationwide distribution).

Nonetheless, the mere fact that buyers are sometimes complicit in loyalty discount schemes is not, in itself, conclusive evidence in support of loyalty discounts' procompetitive potential. Einer Elhauge, one of loyalty discounts' leading critics, has argued that buyer-initiation of loyalty discounts is irrelevant.<sup>196</sup> Elhauge observes that buyers who enter into anticompetitive loyalty contracts impose externalities on other buyers and that buyer face collective action problems in minimizing these externalities.<sup>197</sup> Elhauge argues that these effects are exacerbated if the buyer is an intermediary purchaser that can pass along most of any anticompetitive overcharge to its own downstream buyers.<sup>198</sup> Fleshing out this intuition, Elhauge and Wickelgren propose a model under which there exists no equilibrium in which all buyers reject the seller's offer of a loyalty inducement; hence the seller's offer becomes coercive.<sup>199</sup> Buyers have no choice but to accept, because they will feel the exclusionary effect whether or not they do and are better off at least taking the crumbs offered under the guise of a loyalty discount.

Once again, it is questionable whether the assumptions underlying this model are sufficiently general to make the model analytically useful in deriving antitrust rules for the sorts of loyalty discounts at issue in contemporary antitrust litigation. Elhauge and Wickelgren assume that in order to secure loyalty commitments, the buyer must contractually commit to purchase only from the seller.<sup>200</sup> That assumption does not generally hold for two reasons. First, most of the loyalty discounts at issue in recent cases did not involve any contractual commitment of loyalty by the buyer. Usually, the buyer remained contractually free to purchase goods from whomever it chose, but received a better price for exhibiting loyalty to the seller.<sup>201</sup> Second, Elhauge and Wickelgren assume that, in order to secure the loyalty discount, the buyer must agree not to purchase goods from any of the seller's rivals—that is to say, they assume pure

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<sup>196</sup> Elhauge, *Failed Resurrection*, *supra* n. xxx at 183.

<sup>197</sup> *Id.*

<sup>198</sup> *Id.*

<sup>199</sup> Elhauge & Wickelgren, *Robust Exclusion*, *supra* n. xxx at 3.

<sup>200</sup> *Id.* at 4.

<sup>201</sup> See *supra* text accompanying notes xxx – xxx.

exclusive dealing.<sup>202</sup> As noted earlier, however, most of the loyalty discounts challenged in recent cases have required only partial loyalty commitments—often in the 80-90% range.<sup>203</sup>

There is a more general point about the collective action explanation for buyers' acceptance of loyalty discounts. Collective action problems would explain why buyers who cannot coordinate with other buyers and are price takers would succumb to loyalty discounts. It would not explain why dominant buyers who can and do coordinate with other buyers or who have the power independently to shape the seller's pricing conduct would accept loyalty discounts. Thus, evidence that dominant buyers or buyers who coordinate with other buyers actively solicit loyalty discounts undermines any claim that loyalty discounts are generally explicable because of cost externalization and buyer collective action problems.

As with any of the claims discussed in this paper, evidence of loyalty discount solicitation or approval by dominant or coordinating buyers does not eliminate the possibility that loyalty discounts are anticompetitive. They could still be anticompetitive in circumstances where buyers are price takers or cannot coordinate. But evidence that powerful buyers affirmatively seek loyalty discounts does suggest that loyalty discounts may provide important benefits to all buyers. As courts decide whether to treat loyalty discounts with hospitality or inhospitality, evidence of buyer solicitation may be significant. With that background, we turn to two examples of dominant or coordinating buyers who actively use loyalty incentives to reduce their acquisition costs.

## B. Examples of Loyalty Discounts Sought by Dominant Buyers

### 1. The Federal Government

The federal government is the world's largest purchaser.<sup>204</sup> In recent years, federal government procurement administrators have emphasized the importance of leveraging the federal government's

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<sup>202</sup> Elhauge & Wickelgren, *Robust Exclusion*, *supra* n. xxx at 4 (“[W]e do not consider discounts based on partial loyalty. We assume loyalty discount contracts require the buyer to not purchase any goods from the rival.”).

<sup>203</sup> *Supra* text accompanying notes xxx – xxx.

<sup>204</sup> Peter Orszag, Director, Office of Management and Budget, *Buying in Bulk*, <http://www.whitehouse.gov/omb/blog/10/06/30/Buying-in-Bulk> (June 30, 2010).



massive spending power to reduce acquisition costs and save taxpayers money.<sup>205</sup> For example, in a statement to the Senate Budget Committee, the Administrator for Federal Procurement in the Office of Management and Budget listed the procurement initiatives federal agencies had recently implemented in order to more efficiently use taxpayer resources.<sup>206</sup> Included in these was a strategic sourcing initiative, in which agencies leverage their collective buying power in order to secure better discounts from contractors. In order to do this, agencies necessarily have to give up some amount of individual choice in supplier and start using certain types of products agency-wide or government-wide (such as office supplies). The Administrator gave one example of DHS switching over to a standardized department-wide operating system, and then negotiating one contract for the full suite of desktop services at a substantial savings.<sup>207</sup>

Federal procurement administrators have stressed the desirability of using the Government's massive spending power to negotiate substantial discount terms. Among the cost-lowering tools urged by procurement officers are Blanket Purchase Agreements ("BPAs"), which secure supplier commitments to supply to federal buyers at reduced costs.<sup>208</sup> Although federal administrators stress the importance of supplier competition at the contract negotiation

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<sup>205</sup> *Id.* (explaining the importance of leveraging the federal government's spending power to lower acquisition costs).

<sup>206</sup> Statement of the Honorable Daniel I. Gordan, Administrator for Federal Procurement, Office of Management & Budget, Before the Senate Committee on the Budget (July 15, 2010), *available at* [http://www.whitehouse.gov/sites/default/files/omb/legislative/testimony/ofpp/Gordon\\_testimony\\_715.pdf](http://www.whitehouse.gov/sites/default/files/omb/legislative/testimony/ofpp/Gordon_testimony_715.pdf); Paul A. Denett, Administrator for Federal Procurement, Office of Management & Budget, Memorandum, Guidance on Agency Fiscal Year 2007 Strategic Sourcing Reports (Mar. 11, 2008), *available at* [http://www.whitehouse.gov/sites/default/files/omb/procurement/strat\\_sourc/2007\\_report\\_guidance.pdf](http://www.whitehouse.gov/sites/default/files/omb/procurement/strat_sourc/2007_report_guidance.pdf).

<sup>207</sup> *Id.* at 4 ("For example, the Department of Homeland Security (DHS) expects to save more than \$87 million during the next six years by having standardized department-wide desktop operating systems, e-mail, and office automation and then negotiating a department-wide BPA for the full suite of products at a substantial savings.").

<sup>208</sup> Daniel I. Gordon, Administrator for Federal Procurement, Office of Management & Budget, Memorandum, Achieving Better Value from Our Acquisitions (Dec. 22, 2009), *available at* [http://www.whitehouse.gov/sites/default/files/omb/assets/procurement\\_memo/Achieving\\_Better\\_Value\\_from\\_Acquisitions.pdf](http://www.whitehouse.gov/sites/default/files/omb/assets/procurement_memo/Achieving_Better_Value_from_Acquisitions.pdf).

stage,<sup>209</sup> they also acknowledge the discount benefits of strategic sole-source contracting.<sup>210</sup> Federal law permits sole source contracting under some circumstances<sup>211</sup> and federal administrators have defended it as a means of securing superior contractual terms.<sup>212</sup>

Although the federal government often simply leverages its buying volume to secure superior prices, it also engages in the loyalty-bargaining strategy of trading government market share for superior pricing. Airline travel is a case in point. The Government Services Agency (“GSA”) negotiates price schedules with airlines for various routes that are contingent upon the federal government’s delivery of minimum market share of federal travel. As the GSA explains:

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<sup>209</sup> Better Value from Our Acquisitions (Dec. 22, 2009), *available at* [http://www.whitehouse.gov/sites/default/files/omb/assets/procurement\\_memo/Achieving\\_Better\\_Value\\_from\\_Acquisitions.pdf](http://www.whitehouse.gov/sites/default/files/omb/assets/procurement_memo/Achieving_Better_Value_from_Acquisitions.pdf) (“The GAO found that agencies did not take advantage of opportunities for competition in establishing BPAs – a sure way to get better deals – and often considered only one vendor. Frequent use of single award BPAs resulted in a lack of competition on resulting orders.”). *See also* Government Services Administration, Frequently Asked Questions (FAQs) Sheet, Federal Strategic Sourcing Initiative (FSSI), Office Supply Blanket Purchase Agreements (BPAs), *available at* <http://www.dm.usda.gov/procurement/toolkit/FSSIOfficeSupplyBPAsFAQs.pdf> (last accessed Nov. 5, 2011).

<sup>210</sup> *Id.* (“Seek discounts when establishing schedule BPAs and, as appropriate, when placing orders, especially large dollar orders. Discounts may be sought in a number of ways, such as in the request for quote when establishing the BPA or during negotiations. Agencies should consider making the offer of a discount by the contractor a condition for awarding the BPA. For existing BPAs, focus on those for which no discount has been sought, especially for products and where only one BPA has been awarded. If, upon review, the agency determines that renegotiation of a BPA could lead to discounts—or deeper discounts—for agency buyers, explore, in consultation with agency counsel, what options are immediately available.”).

<sup>211</sup> Competition in Contracting Act (“CICA”), 41 U.S.C. § 3301 (2006). Sole source contracting bears greater risks to competition than contractual terms rewarding loyalty, since under sole-source contracting there is neither competition *for* the contract nor competition *under* the contract.

<sup>212</sup> Joseph Jordan, Senate Subcommittee on Contracting Oversight, Contracting Preferences for Alaska Native Corporations (July 16, 2009) (“In terms of sole source authority not providing the best value, I do somewhat reject that on its premise...in every contract, and this also applies to all sole source contracts, the contracting office must certify that the government got fair and reasonable value and it must monitor performance of that contract and can terminate it if the contracting officer sees fit. So to say that the government did not get the best value because it was sole sourced is, or should be, inaccurate.”).

GSA concentrates on the government's market share to make the most of the competition available. The government traveler's responsibility is to use the contract carrier. The government's delivery of market share drives the program. So, to ensure the fares stay favorable, we encourage federal travelers to use the contract carrier.<sup>213</sup>

It is hard to imagine that the federal government, whose employees probably fly hundreds of millions of miles a year, is a victim of a collective action problem that forces the GSA to offer market share commitments in exchange for not being penalized by disloyalty discounts. A far more plausible explanation is that the federal government is a big, powerful, and sophisticated buyer that has figured out how to offer market share (*i.e.*, loyalty)—and not just volume—as a bargaining chip to decrease its input acquisition costs.

## 2. Buying Organizations

Another piece of evidence pointing against the claim that buyer initiation or approval of loyalty discounts does not count since buyers face intractable collective action problems is the pervasive deployment of loyalty discounts by buyers' organizations that come into being precisely in order to coordinate buyer decisions and hence solve collective action problems. These are matters of degree, since coordinated action by just a few buyers in a market with many buyers would not overcome buyer-wide collective action problems. However, when buyers create buying organizations representing large percentages of the buyers in a market expressly for the purpose of leveraging buyer power and driving down prices and those organizations then bargain for loyalty discounts, the cost externalization/collective action story becomes much less persuasive.

Buyers' organizations in various health care fields provide strong examples of power buyers deploying their bargaining power to exact loyalty discounts.<sup>214</sup> Take, for instance, Pharmacy Benefit Managers

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<sup>213</sup> U.S. General Services Administration, Information for Federal Travelers, Frequently Asked Questions, <http://www.gsa.gov/portal/content/103835>.

<sup>214</sup> A number of the recent loyalty discount cases have occurred in the medical devices industry, where large GPOs, representing large aggregations of hospitals, pervasively bargain for market share and other loyalty discounts. Hovenkamp, *Antitrust and the Costs of Movement*, *supra* n. xxx at 103. GPOs are designed in

(“PBMs”) which have recently come under scrutiny for their contracting practices.<sup>215</sup> PBMs manage the pharmacy benefits of group health plans sponsors such as HMOs, self-insured employees, indemnity plans, labor union plans, and public employee plans.<sup>216</sup>

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large part to solve collective action problems and leverage buyer power, John B. Kirkwood & Richard O. Zerbe, Jr., *The Path to Profitability: Reinvigorating the Neglected Phase of Merger Analysis*, 17 Geo. Mason L. Rev. 39, 94 (2009) (discussing how retail pharmacies have solved collective action problems by forming group purchasing organizations). Hence might provide a counter-story to the claim that buyer collective action problems undermine the evidence that buyers solicit loyalty discounts. However, GPOs have come under criticism for failing to serve the interests of their member hospitals, S. PRAKASH SETHI, GROUP PURCHASING ORGANIZATIONS: AN UNDISCLOSED SCANDAL IN THE U.S. HEALTHCARE INDUSTRY (2009); Einer Elhauge, *The Exclusion of Competition for Hospital Sales Through Group Purchasing Organizations* (June 25, 2002), [http://www.law.harvard.edu/faculty/elhauge/pdf/gpo\\_report\\_june\\_02.pdf](http://www.law.harvard.edu/faculty/elhauge/pdf/gpo_report_june_02.pdf). But see Herbert Hovenkamp, *Group Purchasing Organization (GPO) Purchasing Agreements and Antitrust Law* (January 2004), [http://higpa.site-ym.com/resource/resmgr/press\\_releases\\_2004/2004hovenkampgposandantitrust.pdf](http://higpa.site-ym.com/resource/resmgr/press_releases_2004/2004hovenkampgposandantitrust.pdf) (arguing that GPO arrangements can lower prices and provide procompetitive benefits); Department of Justice & Federal Trade Commission, *Improving Health Care: A Dose of Competition* (July 2004) <http://www.ftc.gov/reports/healthcare/040723healthcarerpt.pdf> (Chapter 4) (considering both procompetitive and potentially anticompetitive aspects of GPO agreements), so this example would require a longer exploration.

<sup>215</sup> Elhauge has extended his criticisms of GPOs to PBMs, arguing that “[t]he largest PBM has a smaller market share than the largest GPO and thus would externalize even more of the market harm that would be caused if it agreed to an anticompetitive loyalty agreement” Elhauge, *Failed Resurrection*, *supra* n. xxx at 184. Elhauge’s comments have been overtaken by subsequent events. Following the Express-Scripts/MedCo merger, the combined company had a market share over 40% and was effectively in a duopoly situation with CVS Caremark. Daniel Weiss, *FTC Approves Express Scripts-Medco Merger*, Pharmacy Times (April 3, 2012), <http://www.pharmacytimes.com/news/FTC-Approves-Express-Scripts-Medco-Merger>.

<sup>216</sup> See United States General Accounting Office, Report to the Hon. Byron L. Dorgan, U.S. Senate, *Federal Employees’ Health Benefits: Effects of Using Pharmacy Benefit Managers on Health Plans, Enrollees, and Pharmacies* (January 2003), <http://www.gao.gov/assets/240/236828.pdf>; Department of Justice &

Ninety-five percent of patients with prescription drug coverage receive their benefits through a PBM.<sup>217</sup> PBMs play several roles on behalf of plans. They determine what drugs should be on the plan formulary and negotiate with retailers for reimbursement rates when drugs on the formulary are dispensed at retail.<sup>218</sup> PBMs also negotiate with drug manufacturers for discounts or rebates on brand name or generic drugs.<sup>219</sup>

Market share discounts are a large part of the PBM's strategy to drive down prices from drug manufacturers. Both the FTC and GAO noted that manufacturer rebates were driven in large part by the PBM's ability to increase the manufacturer's market share.<sup>220</sup> The FDA has noted that PBM rebates from manufacturers are predicated on the PBM "moving market share" to the manufacturer.<sup>221</sup> Because a few large PBMs are effectively bargaining agents on behalf of tens of millions of patients, they exercise substantial leverage in these negotiations.

Both the General Accounting Office and FTC have studied the effect of PBMs on drug prices and found them to lower prices. For

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Federal Trade Commission, *Improving Health Care: A Dose of Competition* (July 2004), <http://www.ftc.gov/reports/healthcare/040723healthcarerpt.pdf> (Chapter 7).

<sup>217</sup> FTC Report at 11.

<sup>218</sup> *Id.* at 13-14.

<sup>219</sup> *Id.* at 11.

<sup>220</sup> GAO report at 11 ("Drug manufacturers provide PBMs certain rebates depending not only on inclusion of their drugs on a plan's formulary but also on the PBMs' ability to increase a manufacturer's market share for certain drugs."); FTC Report at 14 ("[T]he contract negotiated with the pharmaceutical manufacturer may provide a rebate off the fees owed by the PBM based on (a) a percentage of AWP or some other wholesale benchmark, (b) achieving certain specified sales or market share targets, (c) preferred placement of certain drug products on the PBMs' formulary, or (d) a combination of items (a) - (c)").

<sup>221</sup> U.S. Food and Drug Administration, Regulatory Information, §2.2, <http://www.fda.gov/RegulatoryInformation/Legislation/FederalFoodDrugandCosmeticAct/FDCA/SignificantAmendmentsToTheFDCA/PrescriptionDrugMarketingActof1987/ucm256484.htm>; see also Lawrence W. Abrams, *Pharmacy Benefit Managers as Bargaining Agents*, [http://www.nu-retail.com/pbm\\_bargaining\\_paper.pdf](http://www.nu-retail.com/pbm_bargaining_paper.pdf) (discussing PBMs' use of market share discounts).

example, the GAO found that prices federal employees paid under PBM contracts was 18% the price paid by patients without third party coverage.<sup>222</sup> The GAO attributed this in part to the manufacturer rebates.<sup>223</sup> In a subsequent report to Congress, the FTC found that private-sector employers that offer prescription drug coverage pay less when using a mail-order pharmacy owned by a PBM, as opposed to using a mail-order or retail pharmacy that the PBM does not own.<sup>224</sup>

Although PBMs have been criticized for not fully passing on their rebates and cost savings to plans or insureds, there is little question that PBMs have effectively reduced retail drug prices. If anything, the primary criticism of PBMs is that they leverage *too much* buyer power on behalf of insurance companies, squeezing discounts, rebates, and other incentives out of retailers.<sup>225</sup> As is well recognized in economic theory, cooperative buying arrangements can create monopsony power and thereby allow the purchasers to suppress prices below the competitive level.<sup>226</sup> Tellingly, the National Association of Chain Drug Stores opposed the merger of two large PBMs, Express Scripts and Medco, apparently fearing that a powerful mega-PBM could squeeze prices even further.<sup>227</sup> Monopsonization or oligopsonization by group purchasing organizations may be an independent reason to fear loyalty discounts, but it is the opposite of the one at issue in virtually of the contemporary loyalty discounting cases. What the PBM story quite

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<sup>222</sup> GAO Report introduction.

<sup>223</sup> GAO report at 9.

<sup>224</sup> *Pharmacy Benefit Managers: Ownership of Mail-Order Pharmacies*, FTC Report (August 2005), <http://www.ftc.gov/reports/pharmbenefit05/050906pharmbenefitrpt.pdf>.

<sup>225</sup> GAO Report at introduction (Pharmacy associations report that the PBMs' large market shares leave some retail pharmacies with little leverage in negotiating with PBMs. Retail pharmacies must accept discounted reimbursements from PBMs they contract with and perform additional administrative tasks associated with claims processing.'').

<sup>226</sup> ROGER D. BLAIR & JEFFREY L. HARRISON, *MONOPSONY IN LAW AND ECONOMICS* 106-22 (2010).

<sup>227</sup> NACDS White Paper, *The Proposed Merger of Express Scripts and Medco*, (Oct. 2011, rev'd Feb. 2012), [http://www.nacds.org/user-assets/pdfs/2011/comm/nacds-white-paper\\_proposed-pbm-merger.PDF](http://www.nacds.org/user-assets/pdfs/2011/comm/nacds-white-paper_proposed-pbm-merger.PDF).

clearly shows is that coordinating buyers can use loyalty discounts to drive down prices.

Evidence of loyalty discounts sought by coordinating buyers does not mean that buyers never face collective action problems that dominant sellers exploit through offering loyalty discounts. But the fact that buyers who can and do coordinate over large segments of the market erodes the claim that buyers would *only* accept loyalty discounts because of collective action problems. Some buyers may find themselves in the position of accepting loyalty discounts that they know injure buyers collectively, but that is far characteristic of loyal buyers as a whole.

### C. The Value of Buyer-Seller Loyalty

Having established that buyers at least sometimes seek loyalty discounts in order to drive down their prices, we come finally to the question of how loyalty discounts fit into broader issues of loyalty between seller and buyer. For this, we turn to the management literature on loyalty in buyer-seller relations.

A conventional model of business procurement holds that buyers should deliberately *not* exhibit loyalty—that they should seek to generate competition between rival sellers in order to obtain the lowest possible prices and the best terms of purchase. Michael Porter, for example, argues that total procurement costs will be minimized by introducing and maintaining competition among suppliers, which can only be realized if the buyer procures from multiple sources.<sup>228</sup> In Porter's view, the threat of losing business to another supplier who already has an established relationship with the buyer incentivizes suppliers to deliver product quality at low cost.<sup>229</sup>

By contrast, a wide business management literature stresses the benefits to buyers of entering into long-term monogamous or semi-monogamous relationships with suppliers—of pursuing loyal relationships.<sup>230</sup> Among the frequently cited benefits of buyer-seller

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<sup>228</sup> MICHAEL PORTER, *COMPETITIVE ADVANTAGE* (1985); *see also* Richard G. Newman, *Single Sourcing: Short-Term Savings Versus Long-Term Problems*, 25 J. SUPPLY CHAIN MGMT. 20 (1989) (discussing short-term benefits of sole-source contracting but observing that in the long run there can be negative effects, such as reduced innovation and source dependency).

<sup>229</sup> Porter, *supra* n. xxx.

<sup>230</sup> *See* C. Jay Lambe, C. Michael Wittman & Robert E. Spekman, *Social Exchange Theory and Research on Business-to-Business Relational Exchange*, 8 J. BUS.-TO-BUS. MKTG. 1 (2001); Michael R. Leenders, Jean Nollet & Lisa M. Ellram,

loyalty is trust-building.<sup>231</sup> A long-term loyal relationship decreases the likelihood of seller opportunism.<sup>232</sup> The procurement literature also stresses a number of other benefits to buyers of concentrating purchases on a small number of sellers. Among these are minimizing search and transaction costs,<sup>233</sup> driving down acquisition costs through the leverage of buying power, avoiding supply chain disruptions,<sup>234</sup> achieving economies of scope or scale,<sup>235</sup> and

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*Adapting Purchasing to Supply Chain Management*, 24 INT'L J. PHYSICAL DISTRIBUTION & LOGISTICS MGMT. 40 (1994); W. Deming, *Out of the Crisis*, MIT Center for Advanced Engineering Study (1986); F. Robert Dwyer, Paul H. Schurr & Sejo Oh, *Developing Buyer-Seller Relationships*, 51 J. MKTG. 11 (1987); Achim Walter, Thilo A. Mueller & Gabriele Helfert, *The Impact of Satisfaction, Trust, and Relationship Value on Commitment: Theoretical Considerations and Empirical Results*, Industrial Marketing and Purchasing Group Conference Proceedings (2000), available at <http://www.impgroup.org/uploads/papers/131.pdf>; Michael J. Dorsch, Scott R. Swanson & Scott W. Kelley, *The Role of Relationship Quality in the Stratification of Vendors as Perceived by Customers*, 26 J. ACAD. MKTG. SCI. 128 (1998).

<sup>231</sup> Lambe, *supra* n. xxx at 10-11, 21-22 (explaining how “trust [] enables firms to become committed and look past short-term opportunities for the long-term benefits available from the relationship”); Leeders, *supra* n. xxx at 23 (“Exchange participants begin to expect that their partners will participate in cooperative behaviors that benefit the firms. As these cooperative behaviors become common, expected and acceptable either implicitly or explicitly, cooperation becomes a norm.”);

<sup>232</sup> Hawkins, *supra* n. xxx at xxx (noting that for-profit firms “frequently rely upon the expected long-term duration of the relationship between a buyer and supplier to decrease opportunism”).

<sup>233</sup> Wedad J. Elmaghraby, *Supply Contract Competition and Sourcing Policies*, 2 MFG. & SERV. OPERATIONS MGMT. 350, 351 (2000) (“By pouring time and energy into establishing one strong and lasting relationship, a buyer is able to cut down on costs by avoiding downtime, rework, and excessive administration and increase quality by establishing a relationship that is responsive to the buyer’s needs and demands.”);

<sup>234</sup> Eggert, *supra* n. xxx at 154 (“The advantages of working with fewer suppliers are well documented in the purchasing and supply chain management literature. From a cost perspective, placing a great emphasis on fewer suppliers allows a customer to concentrate order volumes and gain more influence over vendors.”); Elmaghraby, *supra* n. xxx at 351 (“[B]uyers who employ a single sourcing strategy feel that the chance of a supply disruption is reduced when a buyer develops a strong relationship with a single supplier.”); Mark Treleven & Sharon Bergman Schweikhart, *A Risk/Benefit Analysis of Sourcing Strategies: Single vs. Multiple Sourcing*, 7 OPERATIONS MGMT. 93 (1988) (“[B]uyers who employ a single sourcing strategy feel that the chance of a supply disruption is reduced when a buyer develops a strong relationship with a single supplier.”).



contributing to product quality improvement by securing the seller's attention to the buyer's needs.<sup>236</sup>

All of this sounds good for buyer *loyalty*, but raises a question about loyalty *discounts*: If loyalty is so valuable to buyers, then why do sellers have to pay them to stay loyal? If buyers gain so much by staying loyal to a single seller, then why wouldn't we observe buyers seeking exclusive or semi-exclusive relationships with suppliers without the need for any inducement by the seller?

There is an easy answer and a harder one. The easy answer is that one of the benefits to buyers identified in the procurement literature is price reductions.<sup>237</sup> In other words, part of the gains to buyers from loyal relationships comes from the fact that their loyalty allows them to obtain lower prices from sellers.

The harder answer has to do with the fact that loyal buyer-seller relationships can simultaneously benefit both buyers and sellers.<sup>238</sup> Some of their gains from loyalty—such as transaction cost reduction, achieving scale economies, or enhancing business planning—may be joint. In that case, the seller and buyer's relative bargaining positions determine how they allocate their mutual gains between themselves. Other aspects of a customer's loyalty may benefit one party at the expense of the other, or may provide the parties asymmetric benefits and costs. If a loyalty commitment elasticizes the buyer's demand

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<sup>235</sup> Elmaghraby, *supra* n. xxx at 351 (“In addition, buyers feel that they receive the best price from their single supplier because of the economies of scale achieved from being awarded all of the buyer's business.”); Manohar U. Kalwani & Narakersari Narayandas, *Long-Term Manufacturer Relationships: Do They Pay Off for Supplier Firms?*, 59 J. MKTG. 1 (1995) (“From a customer's point of view, supplier relationships should be built in order to achieve increased cost efficiency, increased effectiveness, enabling technologies and increased competitiveness.”).

<sup>236</sup> Eggert, *supra* n. xxx at 154 (explaining how loyal buyers can induce sellers to pay greater attention to their needs and contribute to lowering production costs and influence product innovation).

<sup>237</sup> *Supra* n. xxx.

<sup>238</sup> Amy Zhaohui Zeng, *A Synthetic Study of Sourcing Strategies*, 100 INDUSTRIAL MANAGEMENT & DATA SYSTEMS 219 (2000) (“It can be noticed that the overlapped benefits for both buyer and supplier are revealed in cost reduction, improved communication, flexibility, and stability.”); F. Robert Dwyer, Paul H. Schurr & Sejo Oh, *Developing Buyer-Seller Relationships*, 51 J. MKTG. 11 (1987) (discussing possibility of possibility of “significant gains in joint-and consequently individual-payoffs as a result of effective communication and collaboration to attain goals.”).

and thereby enhances its ability to demand a lower price, the seller loses.<sup>239</sup>

Loyalty is a bargaining chip with varied consequences for sellers and buyers. Without examining the circumstance facing the parties in a particular case, it is impossible to determine how the chips will land for each side. It is clear, however, that loyalty is an important part of the bargain in many cases and has the potential to increase the welfare of buyers, sellers, or both. An antitrust policy that discouraged or restricted the use of loyalty provisions could reduce buyer welfare and social welfare overall.

### CONCLUSION

Loyalty incentives can be exclusionary if they prevent the seller's rivals from competing for loyal customer business and foreclose so

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<sup>239</sup> See Klein & Murphy, *supra* n. xxx. Elhauge has argued that the Klein-Murphy model of demand elasticization through loyalty commitments is implausible because, if it were true, sellers with market power would avoid contracts with loyalty provisions. Elhauge, *Failed Resurrection*, *supra* n. xxx at 185 (“Under [the Klein-Murphy] model, the two sellers in a differentiated market would sell at cost and earn zero profits if they used exclusive contracts, but would sell at prices that were double their cost if they did not. Given that premise, it is hard to see why the sellers would be willing to bid on an exclusive basis, let alone why, as Klein and Murphy assert, sellers would have “the exact same motivation” as retailers to initiate exclusive bidding. Under their model, exclusive contracts harm the sellers and thus any seller with market power would avoid them.”). But that argument ignores the multifaceted nature of the benefits and costs to both sellers and buyers of loyalty inducements. Sellers may obtain other benefits from loyalty commitments—such as expanding their market share, leveraging fixed costs over more dollars of revenue, achieving scale economies, and optimizing planning—that offset any losses from facing a more elastic demand curve. Further, Elhauge’s argument begins with the assumption that loyalty discounts are always seller-driven strategies, or that sellers have the power to resist them. In fact, as noted, buyers are often the instigators. Sellers would obviously like buyer loyalty without awarding discounts, but faced with a buyer demand for a discount in exchange for loyalty, they may not have the power to say no, particularly if the buyer has decided to award the bulk of its purchases to a single seller and a refusal to entertain a demand for loyalty discount means losing the bulk of the customer’s business. Sellers bargain for loyalty and buyers bargain for discounts; loyalty discounts are the marriage of these countervailing pressures.

much of the relevant market that the rivals are unable to compete. But that usually is not the case. To the contrary, loyalty discounts are often granted in robustly competitive markets and have no exclusionary effects. They bring lower prices to customers willing to forgo their variety preferences and consolidate a majority of their purchases in a single supplier.

This Article has not proposed a comprehensive legal or economic framework within which to assess loyalty incentives. Rather, it has suggested that, as a starting point, courts and antitrust agencies think about loyalty discounts as true discounts—as price reductions below the price the buyer would have to pay if it decided not to behave loyally. As such, loyalty discounts belong squarely within antitrust’s hospitality tradition for unilateral, non-predatory price discounts, even those that cause discomfiture to competitors.

Loyalty is considered a virtue in most areas of law. Antitrust should be no exception.