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Antitrust Restrictions on Bundled Discounts: Cascade Health Solutions v. PeaceHealth

On September 4, 2007, the Court of Appeals for the Ninth Circuit issued its much-anticipated opinion in *Cascade Health Solutions (f/k/a McKenzie Williamette Hospital) v. PeaceHealth*, No. 05-35627. *PeaceHealth* addresses the important issue of whether a dominant health care provider's bundled discounts can constitute anticompetitive acts in violation of Section 2 of the Sherman Act. The Ninth Circuit, largely adopting the analysis of bundling set forth in the recent report of the Antitrust Modernization Commission, held that bundled discounts are anticompetitive only if the discount results in below-cost pricing.

Case Background

PeaceHealth was an appeal from a $16.2 million jury verdict in favor of plaintiff McKenzie-Williamette Hospital (McKenzie) and against defendant PeaceHealth. McKenzie and PeaceHealth operated all of the competing hospitals in Lane County, Oregon.

McKenzie sued PeaceHealth, alleging, among other things, that PeaceHealth had violated the federal antitrust laws by offering payors bundled or packaged discounts. According to McKenzie, PeaceHealth offered payors substantial discounts on tertiary services if the payors made PeaceHealth their sole preferred provider for all hospital services. These bundled discounts created a strong financial incentive for payors to make PeaceHealth their sole preferred provider and thereby to exclude McKenzie. The jury found that PeaceHealth did in fact offer these bundled discounts and concluded that the bundled discounts violated the Sherman Act's prohibition on attempted monopolization.

Attempted Monopolization and Bundled Discounts

To prevail on an attempted monopolization claim, a plaintiff must show (1) that the defendant engaged in predatory or anticompetitive behavior, (2) with a specific intent to monopolize a market, and (3) a dangerous probability of achieving monopoly power. In *PeaceHealth*, the issue on appeal was whether the first element of the claim had been established, that is, whether PeaceHealth's bundled discounts constituted predatory or anticompetitive behavior.

In evaluating McKenzie's antitrust theory, the court first noted that bundled discounts are pervasive in many industries and that both sellers and buyers may benefit from the practice. Thus, the court concluded, "We should not be too quick to condemn price-reducing bundled

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discounts as anti-competitive, lest we end up with a rule that discourages price competition."

The court nevertheless recognized that "It is possible, at least in theory, for a firm to use a bundled discount to exclude an equally or more efficient competitor and thereby reduce consumer welfare in the long run." *(Id.)* The macro-level concern is that the bundled discounter can exclude competitors that do not sell a full range of products without having to price particular products below cost so that the practice would be unprofitable. In *PeaceHealth*, McKenzie claimed that it could provide primary and secondary hospital services at a lower cost than PeaceHealth, but, because it did not offer tertiary services, it could not compete with PeaceHealth's bundled discounts, and thus would be forced out of the market to the detriment of consumers of health care services in Lane County, Oregon.

In determining whether the bundled discounts offered by PeaceHealth were prohibited anticompetitive conduct, the central legal issue the court had to decide was whether the district court erred by instructing the jury that "bundled price discounts may be anti-competitive if they are offered by a monopolist and substantially foreclose portions of the market to a competitor who does not provide an equally diverse group of services and who therefore cannot make a comparable offer." PeaceHealth contended that this instruction, which was based on the Third Circuit's holding in *LePage's Inc. v. 3M,* was improper because it did not require McKenzie to show that PeaceHealth's bundled discounts constituted below-cost pricing.

Relying on recent U.S. Supreme Court authority suggesting that "above-cost pricing will not be considered exclusionary conduct for antitrust purposes," the court agreed and rejected the Third Circuit's more open-ended standard for finding bundled discounts anticompetitive. The Ninth Circuit instead held "that the exclusionary conduct element of a claim arising under § 2 of the Sherman Act cannot be satisfied by reference to bundled discounts ***unless the discounts result in prices that are below an appropriate measure of the defendant's costs."***

The court next addressed (1) what the "appropriate measure of defendant's costs" is for anticompetitive bundling claims, and (2) how bundled discounts should be accounted for in determining whether the defendant effectively set the price for the product or service in which it competes with the plaintiff below its "cost." The court concluded that "a plaintiff must establish that, ***after allocating the discount given by the defendant on the entire bundle of products to the competitive product or products,*** the defendant sold the competitive product or products ***below its average variable cost of producing them.***"

At least in the Ninth Circuit, this standard, in theory, allows firms offering bundled discounts the ability to determine whether their discount policy is lawful. As long as the price of the competitive product less the total discount is greater than the average variable cost, the discounting is not anti-competitive.

Because these issues of below-cost pricing were not addressed by the trial court, the Court of Appeals reversed the jury verdict and remanded the case for further proceedings.

McKenzie's Tying Claim Resurrected

McKenzie also asserted a tying claim against PeaceHealth. McKenzie alleged that that PeaceHealth illegally tied primary and secondary hospital service to its provision of tertiary service — a service that only PeaceHealth provided in the geographic market. Dismissing this claim before trial, the district court concluded as a matter of law that McKenzie could not establish coercion — an essential element of a tying claim.

The Court of Appeals reversed, reasoning that there was a genuine dispute of fact as to whether payors were coerced into accepting PeaceHealth's primary and secondary services as a condition for getting access to its tertiary services. The court again remanded the case to the district court for a finding on "whether PeaceHealth forced insurers either as an implied condition of dealing or as a matter of economic imperative through its bundled discounting, to take primary and secondary services if the insurers wanted tertiary services." The court left open whether McKenzie would have to make the same below-cost showing required of the bundling claim if its only evidence of coercion was based on a theory that PeaceHealth's bundled discounts were implicitly coercive.

Lessons to Be Learned From *PeaceHealth*

The *PeaceHealth* decision provides fairly clear guidance for hospital systems that want to offer bundled discounts without running afoul of the antitrust laws. The threshold question, and one that was

indisputably present and thus not discussed in *PeaceHealth,* is whether the hospital has monopoly power or is sufficiently dominant in its market to support a finding that there is a dangerous probability of it achieving monopoly power. This generally requires a fairly high market share, usually something in excess of 50 percent. Absent such market power in a relevant product or service market, there can be no viable Section 2 claim.

If a hospital system is sufficiently dominant to invoke Section 2 of the Sherman Act, it should only offer bundled discounts after conducting a careful analysis of the relationship between the discounts and its cost of providing the services at issue. In the Ninth Circuit, it would be prudent to take advantage of the "safe harbor" created by the *PeaceHealth* court and to ensure that the bundled discounts do not result in below-cost pricing. It remains to be seen whether other circuits also will adopt the safe harbor.

Finally, discounting hospitals should keep in mind the prospect of a tying claim, even if they are not subject to a viable Section 2 claim. A tying claim still requires market power in one service market, such that the seller can coerce the buyer to purchase the tied product as a condition of getting access to the tying product. But the threshold for a finding of market power sufficient to support a tying claim may be lower than what is required for monopoly power under Section 2. Any plaintiff challenging a bundled discount as a tie also will have to show that there are two separate products or services and that the buyer is coerced into buying one to get the other.

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