

Predatory Pricing & Unfair Trade Practices

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Overview

- Core Concept & Statutory Basis
- *Brooke Group*
- Varying Approaches to the Cost Test
- *American Airlines & Spirit Airlines*
- Are There Limits To *Brooke Group*?
 - Predatory Bidding & *Weyerhaeuser*
 - Multi-Product Packaging & Bundling
 - Price-Squeezes

Predatory Pricing

Facing Economics

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"US Jobless Claims Hit 19-Year High" — *Financial Times*, May 30, 2002

"US Productivity Rate Best in 19 Years" — *AP*, May 31, 2002

YOU'LL HAVE TO GO

Productivity and Unemployment Both Going Up, So...

Washington, D.C. (SatireWire.com) — With the latest reports showing U.S. business productivity growing at its strongest pace in 19 years, while the number of Americans filing for unemployment has also surged to its highest level in 19 years, economists today concluded that everyone should be fired.

"The numbers clearly show businesses have been getting more and more out of fewer and fewer employees," said Harvard economist Neil Fischer. "So it doesn't take a genius to determine that employees are a drag on productivity, and that were the economy to reach total unemployment, it would therefore reach total productivity."

Critics immediately assailed the theory, pointing out that a similar tactic by AT&T failed when the company [cut 120 percent of its workforce](#) to save more money than it earns, and subsequently ceased to exist. However, Stanford economist Rachel Horwith said the productivity postulate was different, and has already been proven in the market.

"Just look at Enron," she said. "Some of their best-producing units, at least on paper, had no one in them working in them at all."

Virginia-based efficiency consultant Harvey Watts, however, accused economists of twisting the facts.



When discussing economics with children, it's best to strap them in tightly so they can't get away.

Predatory Pricing

Facing Economics

"It's absurd to say that no employees would create more, because there would be no one left to create anything," said Watts. "No, the truth is, we want to *decrease* productivity. The more people we have producing less, the more people we'll need to produce what we need. So as soon as production stops, boom, you have full employment."

Watts conceded he frequently consults for the French government.

Meanwhile, Federal Reserve Board Chairman Alan Greenspan argued both interpretations could lead to disaster. "If people don't have jobs, they can't buy what's produced, and vice versa," he said. "So the bottom line is, if no one really wants what

you're producing, then there's no point in making it."

In response, ABC cancelled its entire fall lineup.

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Predatory Pricing

The Basic Concept

- Reducing prices to below the predator's costs for the purpose of driving a competitor out of business and then recouping losses suffered due to the price cuts by charging supra-competitive prices after the competitor has left.
- In concentrated markets, it can also mean cutting prices below cost to discipline a competitor, convincing the competitor to join you in oligopolistic supra-competitive pricing.

Predatory Pricing

The Danger of Penalizing Competitive Conduct

- “[C]utting prices in order to increase business often is the very essence of competition.”

Matsushita Electric Industrial Co. v. Zenith Radio Corp., 475 U.S. 574, 594 (1986).

- “Low prices benefit consumers regardless of how those prices are set.”

Atlantic Richfield Co. v. USA Petroleum Co., 495 U.S. 328, 340 (1990).

- “A legal precedent or rule of law that prevents a firm from unilaterally cutting its prices risks interference with one the Sherman Act’s most basic objectives: the low price levels that one would find in well-functioning markets.”

Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 230 (1st Cir. 1983).

Predatory Pricing

The Danger of Penalizing Competitive Conduct

- “[T]he mechanism by which a firm engages in predatory pricing -- lowering prices -- is the same mechanism by which a firm stimulates competition . . . [M]istaken inferences [in the identification of predatory pricing] . . . are especially costly, because they chill the very conduct the antitrust laws are designed to protect.”

Cargill, Inc. v. Monfort of Colorado, Inc., 479 U.S. 104, 122 n.17 (1986).

- “[P]redatory pricing schemes are rarely tried, and even more rarely successful.”

Matsushita, 475 U.S. at 589

Predatory Pricing Litigation

- Predatory pricing claims tend to be difficult to win under federal antitrust law. Nevertheless, private civil predatory pricing claims are filed and litigated.
- The airline cases:
 - *United States v. AMR Corporation, et al.*, 140 F. Supp. 2d 1141 (D. Kan. 2001), *aff'd*, 335 F.3d 1109 (10th Cir. 2003).
 - *Spirit Airlines, Inc. v. Northwest Airlines, Inc.*, 431 F.3d 917 (6th Cir. 2005), *cert. denied*, 166 L. Ed. 12 (U.S. 2006).
- *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., Inc.*, 127 S. Ct. 1069 (2007) (predatory bidding).

Predatory Pricing

Statutory Bases

- Sherman Act §2
- Robinson-Patman Act (Clayton Act §2) – Primary Line Injury

Predatory Pricing

Sherman Act §2 Offense

Elements of a Monopolization Claim:

- (1) the possession of **monopoly power** in a relevant market, and
- (2) the willful acquisition or maintenance of that power through **exclusionary conduct/improper means** (as distinguished from growth or development as a consequence of superior product, business acumen, or historical accident).

Eastman Kodak Co. v. Image Technical Services, Inc., 504 U.S. 451, 481 (1992).

Predatory Pricing

Sherman Act §2 Offense

Elements of an Attempt to Monopolize Claim:

1. The defendant has engaged in anticompetitive or exclusionary conduct;
2. With a specific intent to monopolize a relevant market; and
3. A dangerous probability of success.

Spectrum Sports, Inc. v. McQuillan, 506 U.S. 447, 450 (1993).

Predatory Pricing

Clayton Act §2(a) Offense

- Section 2(a) of the Clayton Act:

“It shall be unlawful for any person engaged in commerce . . . to **discriminate in price** between **different purchasers** of **commodities** of **like grade and quality** . . . where the effect of such discrimination may be substantially to lessen competition or **tend to create a monopoly** in any line of commerce”

- As interpreted by the Supreme Court, the Clayton Act §2(a) “**primary line injury**” standard differs from that of a Sherman Act §2 attempt-to-monopolize claim in that Clayton Act §2(a) only requires the plaintiff to show a “**reasonable likelihood**” of recoupment (as contrasted with the “**dangerous probability of success**” standard under the Sherman Act).

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Predatory Pricing

The Brooke Group Decision

- *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).
- “[P]rimary-line competitive injury under the RPA is of the same general character as the injury inflicted by predatory pricing schemes actionable under §2 of the Sherman Act.”
- §2 requires showing a dangerous probability of actual monopolization; RPA requires only a reasonable possibility of substantial injury to competition.
- Essence of claims are the same: pricing products in an unfair manner with an objective to eliminate or retard competition and thereafter exercise control over price in the relevant market.

Predatory Pricing

The Brooke Group Decision

The Court imposed two requirements for predatory pricing claims:

1. Must prove that the **prices are below an appropriate measure of the alleged predator's costs.**
2. Must demonstrate that the defendant had a **reasonable prospect/dangerous probability of recouping** its investment in below-cost prices.

Predatory Pricing

The Brooke Group Decision

1. Below an appropriate measure of the defendant's costs

- Objective is to protect an equally efficient competitor.
- Administrability and risk of chilling legitimate price cutting.

Predatory Pricing

The Brooke Group Decision

2. Reasonable prospect/dangerous probability of recoupment.

- “That below-cost pricing may impose painful losses on its target is of no moment to the antitrust laws **if competition is not injured** Even an act of pure malice by one business competitor against another does not, without more, state a claim under the federal antitrust laws.”
- Summary disposition of a case may be appropriate if the nature of the market is such that recoupment would be implausible.

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Predatory Pricing

Measuring Whether Price Is Below Cost

- Brooke Group does not say what is an appropriate measure of costs.
- What are the options?
 - Fixed and Variable Costs.
 - Marginal Cost
 - Total Costs of Production

Predatory Pricing

Measuring Whether Price Is Below Cost

- Little dispute that marginal cost is the optimal measure – if you could figure out what that is.
- Why?
 - If above marginal cost: (a) the firm will not exclude equally efficient competitors, and (b) the firm can sustain the price, as well as contribute to covering its fixed costs.
 - If below marginal cost: (a) firm cannot rationally plan to maintain the low price, and (b) if it does not expect eventually to raise its price, it would do better to stop production (since it is losing money).

Predatory Pricing

Current Approaches to the Price-Cost Test

1. The Areeda-Turner Average Variable Cost Test

- Prices above short-term average variable cost are presumptively lawful as a matter of law and prices below average variable cost are presumptively predatory.
- AVC as a proxy for marginal cost.
- P. Areeda & D. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 Harv. L. Rev. 697, 732-33 (1975).

Predatory Pricing

Current Approaches to the Price-Cost Test

2. Prices above average total cost are lawful, but prices between average variable cost and average total cost may be unlawful.
 - Burdens on plaintiff v. defendant vary when price is above AVC and below ATC.
3. Undetermined

Predatory Pricing

Current Approaches to the Price-Cost Test

4. Average Avoidable Costs

5. Industry-specific considerations

- High research & development costs but low production costs

Predatory Pricing

Current Approaches to the Price-Cost Test

So is everything clear?

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Predatory Pricing

American Airlines

- The DOJ alleged that American Airlines (“American”) monopolized or attempted to monopolize airline passenger service to and from the Dallas-Fort Worth airport (“DFW”), an AA hub, by matching the fares offered by "low-cost carriers" and adding capacity in certain DFW routes.
- Directly predated in seven "core" DFW routes and, through a reputation for predation derived from that conduct, monopolized or dangerously threatened to monopolize some 40 other "reputation" routes.
- True core routes: DFW-Wichita, DFW-Kansas City, DFW-Long Beach, DFW-Colorado Springs

Predatory Pricing

American Airlines

- The DOJ offered **four tests** to measure predation in this case.
- DOJ tests employed various of American's internal decision accounting profitability measures (or adjusted measures) to attempt to approximate whether American covered its "incremental" or marginal costs when it added matched fares and added capacity on the routes at issue.
 - VAUDNC & FAUDNC Tests
 - FAUDNC included **allocated** overhead expenses, the costs of aircraft ownership, and return on equity, and comprised at least 97 percent of American's costs incurred in running the airline.
- The Court rejected the DOJ's tests because, among other infirmities, the tests either effectively imposed a **short-run profit maximization** requirement or used American's "**fully allocated**" costs.

Predatory Pricing

American Airlines

- The District Court used **average variable cost**, explaining that "[a]verage variable cost, as a measure of predatory pricing, enjoys not only weight of authority, it is also most congruent with the goal of the Sherman Act: prohibiting unfair competitive practices while simultaneously encouraging open, indeed vigorous price competition."
- Because the "uncontroverted facts" established that American did not price below its average variable costs (as measured by American's internal profitability measures that are based on costs categorized as variable in American's internal decision accounting system) on the core routes at issue, summary judgment was appropriate.

Predatory Pricing

American Airlines

- On appeal, the 10th Circuit affirmed, but declined to adopt AVC for all cases.
 - Ideal measure would be marginal or incremental cost.
 - “Because there may be times when courts need the **flexibility** to examine both AVC as well as other proxies for marginal cost in order to evaluate an alleged predatory pricing scheme, we again decline to dictate a definitive cost measure for all cases.”

Predatory Pricing

American Airlines

- The 10th Circuit agreed with the District Court that the government's four tests were flawed.
 - Variable cost-based tests improperly required short-run profit maximization or included allocated costs related to its overall operations at the DFW hub (i.e., ticket agents, security).
 - FAUDNC tests were fully allocated measures of costs because they included 97-99% of American's total costs.

Predatory Pricing

American Airlines

- Flights v. Routes
- Inclusion of Opportunity Costs
- Cost Categorization & Critical Importance of Detailed Expert Analysis
- Importance of Time Period

Predatory Pricing

American Airlines

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Predatory Pricing

American Airlines

- Meeting Competition Defense
- Monopolization by Reputation

Predatory Pricing

Spirit Airlines v. Northwest Airlines

- Plaintiff low-cost carrier alleged that Northwest responded to Spirit's entry on the Boston and Philadelphia routes to and from Northwest's Detroit hub with a predatory combination of lowered prices and expanded capacity.
- Spirit defined the relevant market as limited to price-sensitive passengers who would be drawn to the bargain prices offered by Spirit.
- Spirit's Claim: Northwest's revenues from tickets sold to leisure/price-sensitive passengers on the Detroit-Boston and Detroit-Philadelphia routes during the alleged predation periods were below Northwest's average variable costs for the incremental capacity represented by its low-fare seats.

Predatory Pricing

Spirit Airlines v. Northwest Airlines

Market Definition

- The Sixth Circuit agreed that, even though everyone on a given flight in the same class of service (*i.e.*, coach) presumably purchased the same "service" or "product" (*i.e.*, a flight from Detroit to Boston), it might be reasonable to apply the price-cost test to sales involving only a subset of those passengers.
- For summary judgment purposes, the Court declined to reject the plaintiff's proposed "product market."

Predatory Pricing

Spirit Airlines v. Northwest Airlines

Price-Cost Test

- Spirit's proposed price cost test attempted to compare:
 - (a) incremental revenues Northwest received from its additional low-fare seats offered in response to Spirit; and
 - (b) the average variable costs associated with carrying those additional low-fare passengers.
- Used internal managerial accounting measures even though the "variable costs" included in Northwest's "Flight Profit System" did not break out the incremental costs of servicing leisure/price-sensitive – as opposed to all – passengers on a flight.

Predatory Pricing

Spirit Airlines v. Northwest Airlines

The Court concluded that "a reasonable trier of fact *could* find that the testimony of Spirit's experts is reasonable based upon the record and relevant economic principles," and declined to resolve an "intellectual disagreement" among experts for Northwest and Spirit.

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Predatory Bidding

- Predatory bidding cases involve claims that buyers price at *higher* than competitive levels in order to take buying opportunities away from competitors, drive those competitors from the market, and thereafter potentially recoup through lower prices made possible by the predatory buyer's "monopsony" power.
- Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co., Inc., 127 S. Ct. 1069 (2007).

Predatory Bidding

Weyerhaeuser

- The Ninth Circuit:
 - “We conclude that Brooke Group does not apply in this predatory bidding case because benefit to consumers and stimulation of competition are less likely to result here than in predatory pricing cases.”
 - In a relatively inelastic market, the plaintiff “need not show that the defendant operated at a loss and that a dangerous probability of the defendant’s recoupment of those losses existed to succeed on its claim.”
 - Weyerhaeuser “paid a higher price for logs than necessary, in order to prevent [Plaintiff] from obtaining the logs [it] needed at a fair price.” (Emphasis added.)

Predatory Bidding

Weyerhaeuser

■ The United States:

- The Ninth Circuit's decision should be reversed because the *Brooke Group* standards that govern predatory pricing claims should have been applied to Ross-Simmons' predatory bidding claim. **The Ninth Circuit standard “turns on a subjective determination of whether the price paid for the relevant input was ‘higher . . . than necessary’ or not ‘fair.’”**
- The Ninth Circuit's analysis improperly ignored whether Weyerhaeuser acquired monopoly power (*i.e.*, the ability to charge higher prices) in the *downstream output* market through its predatory bidding in the *upstream input* market. The record suggested that Weyerhaeuser could not have recouped its losses from its bidding practices in the input market because, even after Ross-Simmons' exit, Weyerhaeuser lacked monopoly power in the output market.

Predatory Bidding

Weyerhaeuser

- The Supreme Court:
 - The *Brooke Group* two-prong test for predatory pricing also applies to predatory bidding claims.
 - There are a variety of "legitimate" reasons that a buyer might bid up input prices, noting that "this sort of high bidding is essential to competition and innovation on the buy side of the market."
 - Application:
 - Prong #1: "A plaintiff must prove that the alleged predatory bidding led to below-cost pricing of the predator's outputs."
 - Prong #2: "Defendant has a dangerous probability of recouping the losses incurred in bidding up input prices through the exercise of monopsony power."

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Multi-Product Discounting

- Some decisions suggest that multi-product (or “package”) discounts by a monopolist may violate the antitrust laws, even where the discounted prices exceed incremental costs.
 - *See LePage’s Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003) (en banc), *cert. denied*, 124 S. Ct. 2932 (2004); *Ortho Diagnostic Systems, Inc. v. Abbott Labs., Inc.*, 920 F. Supp. 455 (S.D.N.Y.), *reargument denied*, 926 F. Supp. 371 (S.D.N.Y. 1996).
- Does *Brooke Group*, which involved a single product, apply to claims involving bundles or package pricing/discounting?

Multi-Product Discounting

The Ortho Hypothetical

<u>Firm A</u>	<u>Firm B</u>
Conditioner stand-alone price = \$5.00	
Conditioner AVC = \$2.50	
Shampoo stand-alone price = \$5.00	
Shampoo AVC = \$1.50	Shampoo AVC = \$1.25
Bundle (Shampoo + Conditioner) price = \$5.25	
Bundle AVC = \$4.00	

Multi-Product Discounting

The Ortho Hypothetical

- Understanding the hypothetical:
 - Assume there is a monopolist (Firm A) that sells a monopoly product, conditioner, bundled with a competitive product, shampoo.
 - Under the price and cost assumptions laid out in the table, Firm B may be excluded from the otherwise competitive market for shampoo because of Firm A's bundled discount, even though Firm A is pricing its bundle above its average variable cost (AVC) and even though Firm B produces the competitive product, shampoo, more efficiently than Firm A.
 - Doing the math: If you assume that customers need both conditioner and shampoo, to persuade customers to buy shampoo from Firm B in the face of Firm A's bundled price, Firm B would have to sell its shampoo for only 25 cents so that customers could buy the conditioner separately from Firm A at \$5 and not end up spending more than the \$5.25 price of the bundle.
 - Firm B cannot price in that manner and remain profitable.

Multi-Product Discounting

Varying Approaches

- Courts have take varied approaches:
 - *Ortho Diagnostic Systems, Inc. v. Abbott Labs., Inc.*, 920 F. Supp. 455 (S.D.N.Y.), *reargument denied*, 926 F. Supp. 371 (S.D.N.Y. 1996).
 - *See LePage's Inc. v. 3M*, 324 F.3d 141 (3d Cir. 2003) (en banc), *cert. denied*, 124 S. Ct. 2932 (2004).
 - ***Cascade Health Solutions v. PeaceHealth*, No. 05-35627, 2007 U.S. App. LEXIS 21075 (9th Cir. Sep. 4, 2007).**

Multi-Product Discounting

Varying Approaches

- **Antitrust Modernization Commission** recommended a three-part test for predation claims targeting bundled discounts.
 - Antitrust Modernization Comm'n, *Report and Recommendations* 94-100 (2007), available at http://www.amc.gov/report_recommendation/toc.htm.
- **AMC Test:**
 - (1) after allocating all discounts and rebates attributable to the entire bundle of products to the competitive product, the defendant sold the competitive product below its incremental cost for the competitive product;
 - (2) the defendant is likely to recoup these short-term losses; and
 - (3) the bundled discount or rebate program has had or is likely to have an adverse effect on competition.

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Price-Squeezes

- Basic Hypothetical:

- Firm that operates at two levels of an industry (e.g., manufacturing and retail)
- Firm's customers at wholesale level are its competitors at retail level
- Firm's wholesale price charged to retail competitors is high
- Firm's customers who buy at the wholesale level complain that they are unable to compete with the defendant at the retail level because of the higher price charged at wholesale.

Price-Squeezes

The Traditional Approach

- Judge Hand's Test in *Alcoa*:
 1. Wholesale price must be “higher than a fair price”
 2. Retail price must be so low that competitors cannot match the price and still make a “living profit”
- Other courts have recognized price-squeeze claims under frameworks similar to Judge Hand's
- Criticism of the Hand test:
 - Administrability
 - What is “fair price”? Sufficient “Living Profit?”
 - Outdated concern for competitor welfare
 - Creates potential liability for above-cost pricing, which conflicts with *Brooke Group*

Price-Squeezes

An illustration from Town of Concord

Level 1: Aluminum Ingot

Alcoa:
monopoly power
in production of
ingot

Wholesale Price:
\$ 100

Actual cost of ingot
production: \$95

Level 2: Production of Aluminum Sheet

Competitors:

\$ 50 sheet production
+ \$ 100 ingot

\$ 150 costs

Competitors'
retail price:
\$150

v.

Alcoa:

\$ 50 sheet production
+ \$ 95 ingot

\$ 145 costs

Alcoa's
retail price:
\$145

Price-Squeezes

Can they harm competition?

- Potential anti-competitive consequence: Firm extends its monopoly to a second-level
 - Only one maximum monopoly profit for any given end-product
 - But increased entry barriers and decreased nonprice competition
- Potential pro-competitive benefits:
 - Elimination of less-efficient competitors at the retail level
 - Removal of a retail-level monopolist
- Areeda & Hovenkamp: “Most” price squeezes are not “invidious”
 - 3A Phillip E. Areeda & Herbert Hovenkamp, Antitrust Law ¶ 767c at 126 (2d ed. 2002)
- Then-Judge Breyer in *Town of Concord*: competitive considerations are “closely balanced”
 - *Town of Concord v. Boston Edison Co.*, 915 F.2d 17, 25 (1st Cir. 1990)

Price-Squeezes

- The Supreme Court will address the issue in *Pacific Bell Telephone Co. v. linkLine Communications, Inc.*, No. 07-512 (U.S. 2008)
 - Question Presented: “Whether a plaintiff states a claim under Section 2 of the Sherman Act, 15 U.S.C. 2, by alleging that the defendant – a vertically integrated retail competitor with an alleged monopoly at the wholesale level – engaged in a 'price squeeze' by leaving insufficient margin between wholesale and retail prices to allow the plaintiff to compete, when the defendant has no antitrust duty to provide the wholesale input to the plaintiff.”
- Oral argument occurred in December 2008

Price-squeezes

The Background of linkLine

- Allegation: Plaintiff linkLine Communications alleged that Defendant attempted to monopolize the retail DSL market through a price squeeze
- Ninth Circuit:
 - Held that it is possible for Plaintiff to make out a price squeeze claim by showing that Defendant has set its wholesale price "so high that its customers cannot compete with it" in the retail DSL market
 - Did not require the Plaintiff to show that the retail price was below any measure of Defendant's costs

linkLine Commc'ns, Inc. v. SBC California, Inc., 503 F.3d 876, 880, 885 (9th Cir. 2007)

Price-Squeezes

The linkLine dissent

- Judge Gould's dissent: "the notion of a 'price squeeze' is itself in a squeeze between two recent Supreme Court precedents."
 - After ***Trinko***, courts cannot examine the setting of the **wholesale** price, because if Defendant has no duty to deal at all, Defendant likewise has no duty to deal at reasonable prices
 - After **Brooke Group**, the **retail** price cannot form the basis of an antitrust claim unless it is below-cost
- United States as Amicus Curiae in *linkLine*:
 - Brief argued that Court should not recognize price-squeeze theory based solely on inadequate margin between wholesale and retail prices
 - Price-squeeze claim should meet *Brooke Group* requirements

Slides available at www.gibsondunn.lawyers/jarp

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