Loyalty Discounts Becoming More Complicated Than Ever

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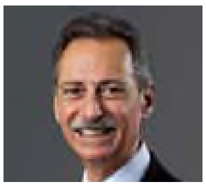

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According to a sharply divided opinion from the US Court of Appeals for the Third Circuit, discounts conditioned on customer loyalty can be anticompetitive even if the discounted price still exceeds the seller's cost. Further, a seller's insistence that dealers charge less for its brand than for rival brands can also spell trouble.

In its 2012 decision in *ZF Meritor, LLC v. Eaton Corp.*,[1] the Third Circuit confirmed that "loyalty discounts"—in which a seller provides price reductions or rebates to customers that buy at least a specified percentage of their purchases of a product from that seller—can violate the antitrust laws even if the discounted price is not below the seller's cost, and even if eligibility for the discount does not require 100 percent loyalty. How to tell whether a loyalty discount crosses the line depends on a variety of factors under the Third Circuit's approach, and the opinion illustrates some things that sellers may want to avoid. Also folded into the opinion is an important reminder of the risk associated with agreements with dealers that restrict the prices those dealers may charge for ***competing*** brands.

Discounts. The case involved loyalty discounts offered by Eaton Corporation, the leading maker of heavy-duty truck transmissions with a market share in excess of 80 percent. There were only four customers in the industry—the four manufacturers of heavy-duty trucks—and Eaton offered all of them contracts providing rebates conditioned on their purchasing 70 to 97.5 percent of their requirements from Eaton for a term of at least five years. The contracts provided that if a manufacturer did not meet its target, Eaton could require repayment of the rebates and also could pull the plug on the entire contract. Eaton's only competitor was ZF Meritor, which introduced an innovative new transmission in 2001, but did not offer as full a line as Eaton. ZF Meritor disappeared from the business in 2007, but not before initiating this lawsuit.

Preferred Pricing. In addition to incorporating loyalty discounts, Eaton's contracts required the truck manufacturers to charge truck buyers a "preferential price" for Eaton transmissions so that Eaton transmissions were always priced lower than those of its competitors. One truck manufacturer was instructed to price ZF Meritor transmissions at a $200 premium over

Eaton transmissions, while other manufacturers agreed to impose what they termed a penalty on ZF Meritor transmissions. In addition, at Eaton's urging, the truck manufacturers imposed additional price penalties on customers that selected ZF Meritor products.

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the district court's order against Eaton, upholding a jury verdict. The court rejected Eaton's argument that a loyalty discount cannot violate the antitrust laws unless it results in sales at below cost. The court held that although, without more, loyalty discounts involving a single product (not a bundle of products) are not anticompetitive unless the resulting price is below cost, other factors in this case resulted in "*de facto* partial exclusive dealing."

Principally, because of Eaton's large market share and entrenched customer demand, Eaton's products amounted to "necessary products" and so "losing Eaton as a supplier was not an option." Truck manufacturers therefore were not really "free to walk away" from their long-term contracts if a competitor offered a better price, even though the terms of the contracts provided that they could. No truck manufacturer "could satisfy customer demand without at least some Eaton products, and therefore no [manufacturer] could afford to lose Eaton as a supplier." Perhaps a better question would have been whether any truck manufacturer could afford to lose the Eaton discount. In any event, the court observed that "exclusive dealing arrangements can exclude equally efficient (or potentially equally efficient) rivals, and thereby harm competition, irrespective of below-cost pricing."

Implicit in this approach, but never articulated, is the fact that if some portion of the transmissions that each manufacturer bought from Eaton really amounted to "necessary" or "must have" products—because truck buyers would accept no substitute—then the "discount attribution rule" developed by other courts would require the entire discount provided to that manufacturer to be attributed only to the portion for which ZF Meritor realistically could still compete. If, with this recalculated discount, Eaton's sales were still above cost for that portion, there could be no liability because an equally efficient competitor could meet the adjusted price for that portion alone. The court never required or undertook this analysis, relying instead on its more amorphous theory of what constitutes *de facto* exclusivity coupled with the large share of the market thereby foreclosed.

The court also was not persuaded by the fact that Eaton's discounts did not require complete exclusivity and allowed truck manufacturers to purchase some transmissions from competitors without losing the discount on Eaton products. Although the court cited with approval cases that upheld programs requiring customers to purchase 60-80 percent of their needs in order to qualify for a discount, it noted that three of the truck manufacturers here were required to purchase 90 percent from Eaton, and the fourth was required to purchase 70 percent only because it made some of its transmissions itself. The court held that this resulted in the same foreclosure that would result from "complete exclusive dealing arrangements with 90 percent of the customer base" and therefore did not preclude a *de facto* exclusive dealing claim.

As for the preferential pricing requirement, the court held that it was reasonable for the jury to find this anticompetitive. The evidence showed that while some of the discounts on Eaton products were passed along by truck manufacturers to truck buyers, there also was evidence that the truck manufacturers achieved preferential prices for Eaton transmissions by "artificially increasing" the prices for ZF Meritor transmissions. This is not the first decision to challenge limitations on the gap a dealer must maintain between the prices of competing products. Although it may seem pro-competitive for a supplier to require that "My brand must be sold for less than other brands," if the customer sets the resale prices for all brands, this is no different from requiring that "Other brands must be sold for more than my brand." Depending on the dealer's cost for each brand, such a restriction might result in higher prices for all brands.

Judge Greenberg filed a long and impassioned dissent. To Judge Greenberg, the foundation of Eaton's program was the availability of a discount that did not result in sales below cost and this should have been the end of the analysis. He concluded by writing: "I do not know how corporate counsel presented with a firm's business plan…if it is a dominant supplier that seeks to expand sales through a discount program…will be able to advise the management," other than "to take a chance in the courtroom casino" some time in the future.

This case is important because it holds, over strong resistance, that discounts inducing exclusive dealing and quasi-exclusive dealing can result in unlawful foreclosure of competitors even if there is no bundling of different types of products and even if there is no selling below cost. This may not be the last chapter in this saga, however, because eventually this issue is likely to attract the attention of the Supreme Court, which has not taken a close look at exclusive dealing in almost 30 years. ◆

Endnote

1 *ZF Meritor, LLC v. Eaton Corp.*, 696 F.3d 254 (3d Cir. 2012).