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## Predatory Pricing - Collusion Between Insurers and Drug Companies

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# LEAD ARTICLE

## Predatory pricing

### *Collusion between insurers and drug companies*

Insurance companies and drug manufacturers can give consumers a headache when they join together. They may also be violating the law.

*By Caryn Beth Gordon*

The recently-proposed federal health care plans spark fear and apprehension in most areas of the health care industry. Many physicians, hospitals, and corporations are scrambling to predict the path of legislation and protect themselves from the industry turmoil. The application of the Sherman Antitrust Act to the health care field has also created controversy and anxiety. Implementing the Sherman Act within the health care field is a relatively new concept, compared to administering the Act in other areas of commerce. Until recently, most economists and health care industry analysts considered the Sherman Act incongruent with the medical care field.<sup>1</sup> The health care industry differs substantially from most other industries to which the Sherman Act generally applies.<sup>2</sup> In concert with these attitudes, the health care industry only recently began to conform with the Sherman Act's requirements.<sup>3</sup> Members of the health care field must not only accept the impending changes in legislation, but also apply these changes within the contours of the Sherman Antitrust Act. Thus, the health care field is ripe with controversy regarding the role of the Sherman Act and its various exceptions pertaining to the health care industry.

This article describes and discusses a hypothetical situation exploring the application of the Sherman Act to the health care industry. Specifically, this hypothetical involves an exclusionary agreement be-

tween a health insurance company and a pharmaceutical company.<sup>4</sup> The agreement precludes the pharmaceutical company from supplying other insurance companies' insureds with prescription drugs. In return for the promise of exclusive dealing, the insurance company agrees to provide exclusive customers for the pharmaceutical company. The pharmaceutical company will receive a guarantee of customers, and will thus enjoy a captive supply of purchasers.<sup>5</sup> On the surface, this agreement appears to benefit both parties; however, the effects on the market may foreclose these initial benefits.

This article analyzes the behavior of the two parties and determines whether the collusive activity violates sections 1 or 2 of the Sherman Antitrust Act.<sup>6</sup> The details of the agreement provide a simplistic look at a collusive arrangement; however, this accord provides a good tool to analyze the ramifications of a vertical alliance<sup>7</sup> in two particular markets.

#### **Vertical alliance: raising rivals' costs**

The insurance company in the hypothetical situation achieves predatory pricing through a vertical alliance with

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a single pharmaceutical company. To accomplish this, the two companies form an exclusionary dealing contract. The insurance company agrees to purchase (through its insureds) a certain volume of prescription drugs from the pharmaceutical company at a negotiated price. In order for the agreement to benefit both parties, the pharmaceutical company must refrain entirely from supplying other insurance companies with prescription drugs.

Such an alliance could potentially elevate the costs of other insurance companies by decreasing the supply of prescription drugs in the market, and thus forcing the costs of the remaining drugs to rise.<sup>8</sup> The collusive agreement between the insurance company and the pharmaceutical company would force the other insurance companies to depend on the remaining pharmaceutical companies and a smaller supply of prescription drugs. According to most economists, the decreasing supply in the pharmaceutical market would increase the price of the prescription drugs. To compensate for the increase in costs, this exclusive dealing contract forces the other insurance companies to raise their premiums.

Since the original contracting insurance company has an agreement that guarantees prescription drug prices, it would not have to raise its premiums with the other insurance companies. In fact, this insurance company could even lower its premiums to entice new customers, enduring a loss for the short run.

These are the building blocks of a predatory pricing scheme. The long-run gain outweighs this short-run loss if the insurance company maintains its reduced prices long enough to drive the other insurers out of the market. The company that instigated the vertical alliance eventually achieves a monopoly if it can maintain the contract prices or even lower them to a more competitive level.

If a monopoly is achieved, it affects consumers by creating prices that are above the competitive market price. The monopolizing insurance company controls the whole price structure of the insurance premium market. Without competition, consumers cannot choose their insurance suppliers. This limits their ability to bargain efficiently as purchasers of goods or services. They must rely on one insurance company to supply all of their health insurance.

This contract appears simple. However, the ramifications of such an accord would affect several markets. Obviously, the agreement would directly affect the health insurance industry. As the raising rivals' costs theory<sup>9</sup> proposes, limiting access to certain products or services

would raise the overall costs of the insurance company's rivals.<sup>10</sup> The increase in their costs would force the rival insurance companies to react in two different ways. First, the excluded insurance companies could raise their premiums, thus passing the costs onto the consumers. Second, they could leave the market entirely, giving the contracting insurance company a monopoly. The insurance company that formed the collusive agreement could increase its insurance market share dramatically and secure a monopoly in an extremely profitable market.

The agreement would also affect the pharmaceutical industry. With a reduction in market access, the non-contracting insurance companies would become more dependant on the non-contracting pharmaceutical companies. This might initially increase the non-contracting pharmaceutical companies' profit margins; however, the anti-competitive effects of the agreement could hurt them.<sup>11</sup> For example, if the agreement creates a monopoly, the non-contracting pharmaceutical companies would lose their bargaining power in the market, becoming dependent on the remaining insurance company. The pharmaceutical companies could no longer exert substantial control over the prices of their prescription drugs. With the insurance company obtaining a monopoly, the remaining non-contracting pharmaceutical companies would suffer an economic disadvantage.

## Predatory pricing

**Background.** Predatory pricing,<sup>12</sup> or pricing below marginal cost, occurs in many different markets. This paper focuses on the effects that predatory pricing has on the health care insurance industry. Many economists and health care analysts have investigated the phenomenon of predatory pricing in various markets, but the possibility of predatory pricing schemes within insurance companies has only surfaced recently. Predatory pricing is not per se illegal under the Sherman Act,<sup>13</sup> and because of many factors that this paper will explore, predatory pricing rarely occurs. In *Matsushita Electric Industrial Corp. v. Zenith Radio Corp.*,<sup>14</sup> the Supreme Court explained that:

A predatory pricing conspiracy is by nature speculation. Any agreement to price below the competitive level requires the conspirators to forgo profits that free competition would offer them. The forgone profits may be considered an investment in

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the future. For the investment to be rational the conspirators must have a reasonable expectation of recovering, in the form of later monopoly profits more than the losses suffered. . . the long-run gain depends in successfully neutralizing the competition.<sup>15</sup>

When a predation scheme leads to a monopoly, the predatory actor must continue with its activity to maintain the monopoly. The party cannot create a monopoly and assume that the market will stagnate. Thus, “[t]he success of any predatory scheme depends on *maintaining* monopoly power long enough both to recoup the predator’s losses and to harvest some additional gain.”<sup>16</sup> The monopolist must discourage future entry into the market. The insurance company in the hypothetical could achieve this by reducing its premiums more than once.<sup>17</sup>

This article analyzes predatory behavior in the proposed hypothetical situation and considers many factors including marginal and other costs.

*What constitutes predatory pricing?* Predatory pricing occurs when an actor in a particular industry lowers its prices specifically to drive competitors from the market. The actor can achieve this price reduction in many different ways.<sup>18</sup> This article focuses on reducing prices through an exclusive dealing agreement between a supplier of prescription drugs and an insurance company. There are benefits to both companies,<sup>19</sup> but for the insurance company, the best effect is enabling the insurance company to lower its prices enough to affect non-contracting insurance companies.

Once the actor has lowered its prices enough to affect other competitors adversely, this actor could acquire a monopoly and eventually gain back lost profits by raising the prices of its products or services. This requires an ability to sustain business with a profit loss long enough to force other companies either to lower their prices or lose their market shares. This behavior often drives competitors out of the market, granting the original actor a monopoly. The company that can endure lower prices in the short-run can achieve a long run gain by establishing a monopoly.

In their article in the *Harvard Law Review*, Professors Phillip Areeda and Donald F. Turner explain the requirements of predatory behavior. They illustrate that “predation in any meaningful sense cannot exist unless there is a temporary sacrifice of net revenues in the expectation of future gain.”<sup>20</sup> They further comment that:

Predatory pricing would make little economic sense to a potential predator unless he had (1) greater financial staying power than his rivals, and (2) a very substantial prospect that the losses he incurs in the predatory campaign would be exceeded by the profits to be earned after his rivals have been destroyed.<sup>21</sup>

Their article summarizes many economic principles in this area of analysis.<sup>22</sup> For the purposes of the hypothetical, it is not necessary to conduct such an extensive analysis. This paper examines, more specifically, the *effects* of predation on the health insurance industry and its interaction with pharmaceutical companies, rather than proving the *existence* of a predatory pricing scheme.

*Establishment of a predatory pricing scheme.* In order to prove an illegal predatory pricing scheme exists, a plaintiff<sup>23</sup> must prove a variety of factors. Thomas Campell explores the necessities for establishing predatory pricing activity in his *Columbia Law Review* article.<sup>24</sup> He explains that “to establish predation against a newly arrived competitor, a firm must first have monopoly power so that its behavior can affect the new entrant in a significant way. . . its conduct must be designed to impose harm upon the entrant that will force it out of the market.”<sup>25</sup> In addition, the courts have devised specific tests that plaintiffs must meet to establish predation. In general, courts have held that:

If a firm prices its goods below some measure of its cost—marginal cost, average total cost, or average variable cost—this is *strong evidence* that it is foregoing short-run profits in pursuit of a predatory pricing strategy that will eliminate competition and yield monopoly profits in the long run.<sup>26</sup>

The company’s intent usually plays a role in determining whether a predatory pricing scheme exists; however, the intent is only one factor in the analysis.<sup>27</sup> This conduct usually affects consumers negatively by either limiting their choices or increasing prices of the goods that remain on the market.<sup>28</sup> The parties involved in a possible predatory pricing scheme may attempt to rationalize their actions with a reasonable business justification. As Frances Miller explains in her article about vertical restraints, “[c]ourts should examine the business justification for challenged practices closely, to determine whether those

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practices merely constitute cover for an attempt to eliminate competitors.”<sup>29</sup>

In the proposed hypothetical, to determine the existence of a predatory pricing scheme, the courts might address the motives of the contracting parties. Perhaps if the insurance company and pharmaceutical company could properly explain their actions under a business justification analysis, then the courts might treat this agreement more leniently. Without such a justification, the courts might suppose that the parties entered into the contract to force other insurance companies and pharmaceutical companies from their respective markets.

**Raising rivals' costs.** *Exploration of raising rivals' costs theory.* The two basic premises of the “raising rivals' costs” theory are: (1) vertical exclusionary restraints that create market-wide price increases are anti-competitive; and (2) raising rivals' costs is a credible predatory strategy. This paper emphasizes the first premise. It does not determine whether it is prudent to raise rivals' costs without antitrust exemption. Thus, the second premise requires further scrutiny

before one can determine whether raising rivals' costs actually qualifies as credible or legal predatory behavior.

One can raise rivals' costs through many different strategies. Herbert Hovenkamp, in his influential article on exclusionary rights, discusses several methods, which differ in important ways, to achieve the same objective. He explains that “[s]ome strategies require concerted behavior by firms collectively controlling a significant market share. Others require not market dominance but rather success in convincing a legislative or administrative body to impose cost-raising regulations. Still others can be effected by single, perhaps even nondominant, firms.”<sup>30</sup> This paper concentrates on the first method involving concerted behavior by two companies.

In the proposed hypothetical, an insurance company contracts with a pharmaceutical company to engage in exclusive dealing. This entails supplying the insurance company's insureds with necessary prescription drugs while the insurance company provides customers for the pharmaceutical company. Since the other insurance com-

panies have less access to low cost prescription drugs, this agreement creates an anticompetitive environment.<sup>31</sup> Thus, the behavior of the contracting insurance company and pharmaceutical company can actually raise the costs of the insurance company's competitors.

**Potential antitrust violations.** Congress intended the Sherman Act to protect consumers from the unbridled power of large corporate entities by ensuring competitive conditions.<sup>32</sup> Thus, in concert with this assumption, allegations of exclusionary conduct should fail if the “injured party” or plaintiff is unable to demonstrate that the conduct actually injures competition and thus, consumers. In determining consumer injury, one must follow a two-step analysis.<sup>33</sup>

First, analysts determine if competitors in the market are injured by asking whether “the excluding firm (or firms) [are] able to raise rivals' costs materially by its purchase of exclusionary rights for inputs?”<sup>34</sup>

The authors illustrate this first step by discussing *United States v. Aluminum Co. of America (“Alcoa”)*.<sup>35</sup> Here, Alcoa, the aluminum company entered into contracts with several

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## Alcoa did not contract to purchase electric power, but paid utilities *not* to provide electricity to its rivals.

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electric utilities. It did not contract to purchase electric power from those utilities, but paid them *not* to provide electricity to its rivals. This contract forced the rivals to purchase power from other sources. If this caused the rivals' costs to rise, it provided Alcoa with substantial market power. If the rivals' costs rose, then they would increase their prices to cover their losses. Alcoa could charge a higher price for its aluminum—matching its competitors—but its increase was pure profit, not increased costs. This would injure the competitors; however, if the competing aluminum companies could purchase sufficient fuel or other resources elsewhere without a cost increase, their costs<sup>36</sup> would not be driven up and they would not have been injured.<sup>37</sup>

Since Alcoa's rivals were unable to obtain the electricity that Alcoa “controlled,” the control affected the demand for the remaining power. A basic supply and demand analysis demonstrates that when supply constricts a particular product, the price of that product will increase. The exclusionary agreement and the price increase would

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adversely affect the competitors. Hence, the competitors in *Alcoa* experience economic injury — satisfying the first prong of the antitrust violation test.

The contract in the hypothetical raises the insurance company's rivals' costs<sup>38</sup> by restricting the supply of prescription drugs. Thus, the insurance company must pass these costs along to its customers through higher premiums. This premium price increase will likely cause the competing insurance companies to lose customers to the contracting insurance company. If this loss is a significant reduction in their profits, the non-contracting insurance companies would not survive.

The non-contracting pharmaceutical companies, however, may benefit from the situation. With the limitation of pharmaceuticals on the market, the other insurance companies would depend on the remaining pharmaceutical companies to supply their insureds. Thus, the remaining pharmaceutical companies could raise their prices and compete between themselves. However, if the insurance companies could not survive in this market, and only one insurance company remained, the pharmaceutical companies would no longer have control. This monopoly would cause both the suppliers (pharmaceutical companies) and the purchaser of insurance (consumers) to rely on the one remaining insurance company.

The second question in the raising rivals' costs analysis is whether the actions of the predatory entity injure competition, and hence, consumers. According to Krattenmaker and Salop, *Alcoa's* behavior would not hurt consumers if adequate competition remained from non-excluded aluminum companies.

In the proposed hypothetical situation, the insureds (consumers) would have access to other pharmaceutical companies and insurance companies. The problem remains, however, that the reduction of particular products on the market eventually raises the prices of the remaining pharmaceuticals and thus, insurance premiums. These price increases could cause a monopoly for the originally-contracting insurance company. The existence of a monopoly illustrates the negative effects that this agreement has on competition. Thus, under Krattenmaker and Salop's second test, the agreement would violate the Sherman Antitrust Act.

*Benefits of a collusive agreement that raises rivals' costs.* Both the insurance company and the pharmaceutical company that formed the collusive agreement experience many incentives to form such an alliance. The col-

lusive agreement directly affects the pharmaceutical industry. Specifically, the pharmaceutical company that contracts with the insurance company experiences guaranteed high volumes of demand and thus, production. With the guarantee of high volume sales to the contracting insurance company, the pharmaceutical company can determine that unit costs will decline. This will enable the pharmaceutical company to redirect funds to research and development or other areas of its corporation.

Another direct effect of this agreement concerns both the relationship of the insurance company and pharmaceutical company to each other and their respective markets. As Krattenmaker and Salop state in their article on raising rivals' costs theory, "[t]he purchasing firm may associate its product with that of the supplier, thereby easily identifying the joint product in consumers' minds or facilitating joint promotional campaigns."<sup>39</sup> Thus, with joint promotion and association, this exclusivity reduces the manufacturer's costs of protecting the prescription drug's reputation once its title passes to the purchaser.<sup>40</sup> This type of partnership could actually encourage a joint venture. The courts have addressed antitrust issues with multiple hospitals engaging in joint ventures to purchase expensive medical equipment.<sup>41</sup> This type of collusive agreement between an insurance company and a pharmaceutical company perhaps requires the same type of analysis as joint venture cases.

One can apply these general ideas more specifically to the proposed hypothetical situation. An insurance company could form an exclusive agreement with a large brand name manufacturer of a particular type of drug. The two large corporations could pool their resources and promote both the product and the health insurance that one needs to obtain this product. For example, at the present time, public attention is focused on the drug Prozac. The multinational corporation, Eli Lilly & Co., manufactures Prozac for the treatment of depression, obsessive compulsive disorder, and other ailments. While there are other drugs on the market which may treat similar conditions, no single drug has received as much recognition as Prozac. If an insurance company could form an exclusive agreement with Eli Lilly & Co., the advertising potential would be tremendous. The joint promotional campaign could tout the success of Prozac, as well as the necessity of X insurance company's health insurance to obtain this drug.

Obviously, this example illustrates an extreme case. Most consumers and physicians seldom characterize an

existing drug on the market as a “wonder drug.” In fact, many physicians prescribe the generic forms of the more expensive name brand drugs. In Massachusetts, a pharmacy must substitute the generic form of a drug unless the physician has marked otherwise. However, many drugs do not have generic versions, thus creating more power for the contracting pharmaceutical company with such a drug. This Eli Lilly & Co. example illustrates the advertising, marketing, and investment potential that such an exclusive agreement entails.

In addition to the reduction of unit costs, the excluded pharmaceutical companies may fear a possible monopolistic situation. Under raising-rivals’-costs theory analysis, the excluded insurance companies may not survive the predatory behavior of the contracting insurance company. The insurance company’s behavior could force the other insurance companies from the market, causing the other pharmaceutical companies to become more or exclusively dependent on the contracting insurance company. Since the non-contracting pharmaceutical companies do not have a specific agreement that may protect them and the price of their products, the exclusionary agreement would affect the excluded pharmaceutical companies’ profits dramatically.

### **Predatory pricing affects consumers**

Courts analyze the effect that a collusive agreement has on consumers. If a collusive agreement does not actually harm the market, courts may not find a violation of the Sherman Antitrust Act.

**Creation of an insurance company monopoly.** In this hypothetical, the ramifications of the agreement would most likely affect insurance premiums.<sup>42</sup> If an insurance company successfully maintained an agreement with a pharmaceutical company for exclusivity and lower prices for the company’s insureds, thus lowering premiums, this would encourage insureds from other insurance companies to attempt to obtain equivalent low premiums. Thus, this agreement might force the other insurance companies to *lower* their insurance premiums.

An insurance company with a large market share could, perhaps, endure a lowered premium rate for an extended period of time. Since the collusive agreement would limit the supply of certain pharmaceuticals to the other insurance companies’ insureds, this would force these rivals to

depend more heavily on a smaller amount of pharmaceutical companies. With a limited supply of prescription drugs, basic economics dictates that the prices of these remaining drugs would increase. The collusive agreement would raise the costs of the insurance company’s rivals, and force them to either raise their premiums or operate with less profit. With the added force of the raised costs, the rival insurance companies might buckle under the economic pressure. This would establish a monopoly for the contracting insurance company.

If the contracting insurance company could withstand a loss of profits in the short-run, then it could stand to gain substantially in the long run by establishing a monopoly. With a limited choice between insurance companies, the collusive agreement could actually prove detrimental to consumers in the long run. Instead of extensive choices among health insurance companies, the effects of predatory pricing might force consumers to choose between only a few or one insurance company. Under the rule of reason analysis, this collusive agreement might not survive court scrutiny if the results do, indeed, limit consumer choice in the long run.

**Critics of recent court opinions.** Even though many argue that the predatory behavior harms the public in the long run, some economists do not subscribe to this point of view. Recent court opinions have many questions along these lines. For instance:

How...can an exclusive dealing or tying contract be labeled exclusionary when all firms may compete to obtain or offer such an agreement? Why would one firm refuse to deal with another unless it is inefficient to deal? Can a merger or purchaser and supplier harm competition any more severely than habitual, unilateral decisions by that purchaser and supplier to look principally to one another for purchasers and sales?<sup>43</sup>

Further, “[t]hese critics argue that what the courts have called anticompetitive exclusionary conduct is in fact efficient behavior that, if successful in increasing market shares, should be replicated rather than prevented by the courts.”<sup>44</sup>

The predatory behavior provides an efficiency challenge to companies involved in a particular market. The agreement between the insurance company and the pharmaceutical company forces other companies in these

markets to reduce waste and excess costs in their businesses. To compete against the contracting parties, the other insurance companies and pharmaceutical companies cannot engage in price increases, except where driven by excessive costs, because the markets would not sustain the non-contracting insurance companies extensive price increases while the contracting insurance company reduces its premiums. Thus, as the critics express, the exclusionary contract may provide efficiencies in the market that otherwise may not have existed. Simply stated, the contract creates strong incentives for non-contracting insurance company's and pharmaceutical companies to monitor their prices and behave more efficiently.

## The McCarran-Ferguson Act

*Introduction to the McCarran-Ferguson Act.*<sup>45</sup> The McCarran-Ferguson Act explicitly repeals sections of the Sherman Antitrust Act. It creates an express immunity from the Sherman Antitrust Act for entities involved in the "business of insurance."<sup>46</sup> This means that entities involved in the business of insurance are not subject to antitrust scrutiny unless the insurers are involved in a "boycott, coercion, or intimidation"<sup>47</sup>

scheme. It is often "perceived as a nearly impenetrable wall of antitrust immunity for the insurance industry."<sup>48</sup>

Obviously this approach requires determining whether the parties concerned are involved in the "business of insurance." Since the hypothetical might arguably involve some price-fixing, this would preclude either party in the hypothetical from claiming immunity under the McCarran-Ferguson Act even if it could claim that it was acting within the scope of the "business of insurance" exception. The notes after the text specifically address price-fixing and McCarran-Ferguson immunity. They state that:

Provision of subsec. (b) of this section dealing with regulation of insurance [states] that nothing in this chapter shall render the Sherman Antitrust Act, section 1-7, of this title, inapplicable to any agreement

to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation does not give insurance companies federal antitrust immunity from price-fixing conspiracies effectuated by boycott, coercion, or intimidation.<sup>49</sup>

**Royal Drug and Pireno: Defining the "business of insurance" exception under McCarran-Ferguson.** In *Group Life and Health Ins. Co. v. Royal Drug Co.*,<sup>50</sup> the main issue was whether the defendant insurance company could claim an exemption to the Sherman Act under the "business of insurance" exception of the McCarran-Ferguson Act. The plaintiffs asserted that an agreement entailing a prepaid prescription drug program between Blue Shield of Texas ("Blue Shield") and three other pharmacies was per se illegal under the Sherman Antitrust Act.<sup>51</sup> Defendant responded that it was exempt from the Sherman Antitrust Act and thus, it need not defend itself from a per se attack.

The controversial agreement between Blue Shield and three other pharmacies developed after Blue Shield offered to enter into a pharmacy agreement with each licensed pharmacy in Texas. The participating pharmacies would provide prescription drugs to Blue Shield's insureds for two

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McCarran-Ferguson provides a nearly impenetrable wall of antitrust immunity for the insurance industry.

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dollars and Blue Shield would provide the pharmacies with the costs of the drugs. The Supreme Court did not address whether the pharmacy agreements constituted per se violations of the Sherman Antitrust Act. The Court only resolved the issue of whether Blue Shield could claim exemption to the Sherman Act under McCarran-Ferguson.

The Court emphasized that the "exemption [under McCarran-Ferguson] is for the 'business of insurance,' not the 'business of insurers.'"<sup>52</sup> The Court cited *Securities and Exchange Comm. v. National Securities, Inc.* in its decision to help explain the legislative intent of the McCarran-Ferguson Act:

The statute did not purport to make the States supreme in regulating all the activities of insurance companies; its language refers not to the persons or companies who are subject to state regulation, but



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to law “regulating the business of insurance.” Insurance companies may do many things which are subject to paramount federal regulation; only when they are engaged in the “business of insurance” does the statute apply.<sup>53</sup>

The Court then acknowledged the lack of common law or statutory law that defines the “business of insurance.” In order to determine whether these agreements constitute the “business of insurance,” the Court analyzed “whether the Pharmacy Agreements f[e]ll within the ordinary understanding of that phrase, illuminated by any light to be found in the structure of the Act and its legislative history.”<sup>54</sup>

The Court stated that the “primary elements of an insurance contract are the spreading and underwriting of a policyholder’s risk.”<sup>55</sup> The defendant did not dispute this; instead, it argued that the Pharmacy Agreements did involve the underwriting of risks.<sup>56</sup> The problem with this analysis concerns the confusion between:

[O]bligations of Blue Shield under its insurance policies, which insure against the risk that policyholders will be unable to pay for prescription drugs during the period of coverage, and the agreements between Blue Shield and the participating pharmacies, which serve only to minimize the costs Blue Shield incurs in fulfilling its underwriting obligations.... The Pharmacy Agreements thus do not involve any underwriting or spreading of risk, but are merely arrangements for the purchase of goods and services by Blue Shield. By agreeing with pharmacies on the maximum prices it will pay for drugs, Blue Shield effectively reduces the total amount it must pay to its policyholders. The Agreements thus enable Blue Shield to minimize costs and maximize profits. Such cost savings arrangements may well be *sound business practice* and may well inure ultimately to the benefit of policyholders in the form of lower premiums, *but they are not the “business of insurance.”*<sup>57</sup>

The Court’s analysis in *Royal Drug* directly applies to the proposed hypothetical. It supports the opinion that the insurance company in the hypothetical could not claim exemption from the Sherman Act under McCarran–Ferguson. The agreement in the hypothetical does not entail the “business of insurance.” This agreement in-

volves neither the underwriting nor the spreading of risk of loss. The agreement, as the one in *Royal Drug*, would promote good business; however, it would not spread the risk of an insurance loss. In fact, the Court in *Royal Drug* alluded to this type of agreement and determined that this would not constitute the business of insurance.<sup>58</sup>

The facts in *Royal Drug* support a situation that closely resembles an insurance relationship. As previously stated, it involves an insurance company that, by definition, is in the “business of insurance” and pharmacies that directly supply prescription drugs to the insureds. The Supreme Court did not hold that this relationship was exempt from the Sherman Act under the McCarran–Ferguson exception. Thus, in considering the proposed hypothetical involving a pharmaceutical company, a corporation even further from the “business of insurance,” a court would most likely not deviate from the *Royal Drug* decision. Consequently, the hypothetical would not obtain exemption from the Sherman Act.

The Supreme Court, in a later decision, established a three part test to determine whether an agreement or activity constituted the “business of insurance.” In *Union Labor Life Ins. Co. v. Pireno*,<sup>59</sup> the Court explained that one must determine:

[F]irst, whether the practice has the effect of transferring or spreading a policyholder’s risk; second whether the practice is an integral part of the policy relationship between the insurer and the insured; and third, whether the practice is limited to entities within the insurance industry. None of these criteria is necessarily determinative in itself....<sup>60</sup>

To meet the *Pireno* test, the agreement must meet all three of the criteria. The hypothetical fails the first test. As addressed above, the agreement between the insurance company and the pharmaceutical company does not constitute the “transferring or spreading of...risk.” The risk that the agreement involves concerns an investment risk between the two parties, not the “policyholder’s risk.” In contrast, the accord may satisfy the second test. The contract to supply the insured exclusively with prescription medication is an “integral part of the policy relationship.” In the long run, the premium reduction benefits the insureds as well as the insurance company. Finally, the hypothetical situation fails the third test. The contract between the insurance company and pharmaceutical com-

pany is not "limited to entities within the insurance industry."<sup>61</sup> The pharmaceutical company does not fit within the definition of an insurance company or as a corporation in the insurance business.

Even though the hypothetical might satisfy the second criterion, it is necessary to qualify under all three criteria to meet the *Pireno* test. Thus, the pharmaceutical company and the insurance company in the hypothetical cannot claim exemption to the Sherman Act under the McCarran-Ferguson business of insurance exception.

**Per se illegal vertical price-fixing.** In *Fabe v. United States*,<sup>62</sup> the Court of Appeals for the Sixth Circuit used the Supreme Court's analysis in *Royal Drug* to decide the issues in a similar fact pattern regarding illegal price fixing. The court in *Fabe* explained that in *Royal Drug* the Supreme Court noted that "central to the definition of the 'business of insurance' are 'the spreading and underwriting of a policyholder's risk...[and] the contract between the insurer and the insured.'"<sup>63</sup> The provider agreements in *Fabe*, as the agreement in the proposed hypothetical between the insurance company and pharmaceutical company, serve neither goal described in *Royal Drug*.

The United States Court of Appeals for the Fifth Circuit had explained in its ruling in *Royal Drug* that:

The plaintiffs cite no case, however, to suggest that an insurance company, by engaging in pro-competitive conduct in the insurance business, can become a price-fixer in the retail drug business because its method of competition seeks to bring its customers the maximum insurance reimbursement. To support a claim of conspiracy to maintain resale prices, there must be evidence that tends to exclude the possibility that Blue Shield and the pharmacies were acting independently. *See Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752 (1984). The opposing effects of Blue Shield's intermediate interest in minimizing drug-sale reimbursements and of the pharmacies' ultimate interest in earning top dollar tend to indicate that these respective parties were acting independently and without a "conscious commitment to a common scheme designed to achieve an unlawful objective." *Id.*, quoting *Edward J. Sweeny & Sons, Inc. v. Texaco Inc.*, 637 F.2d 105, 111 (3d Cir. 1980).<sup>64</sup>

One can both compare and distinguish *Royal Drug* from the proposed hypothetical. Both cases concern a possible arrangement made between an insurance company and a company involved in pharmaceuticals. The plaintiffs in the first case approached the issue differently than those in the hypothetical. In *Royal Drug*, the plaintiffs tried the case as a per se violation of the Sherman Antitrust Act. In the hypothetical, though, a plaintiff could approach the situation from a "rule of reason" analysis.

The analysis in *Sausalito Pharmacy, Inc. v. Blue Shield of California*<sup>65</sup> supports the idea that a court should analyze the case from a "rule of reason" perspective rather than a per se argument. In *Sausalito*, the plaintiffs, independent retail pharmacies, challenged the legality of prepaid prescription drug plans administered or underwritten by the defendant insurance and plan administrator companies. In these plans, the insureds would pay a certain deductible for the cost of prescription drugs and the insurer would pay the remaining amount. The insured had to purchase her prescription drugs from a pharmacy that participated in the prepaid plan with the insurer.<sup>66</sup>

Thus, the defendants in *Sausalito* could not assert the McCarran-Ferguson exemption as a defense since both parties, which had allegedly colluded, were not in the "business of insurance."<sup>67</sup> Similar to *Sausalito*, the pharmaceutical company that allegedly colludes with the insurance company in the hypothetical would not fit within the "business of insurance" test. As the Supreme Court in *Royal Drug* stated, "an exempt entity forfeits antitrust exemption by acting in concert with nonexempt parties."<sup>68</sup>

The provider agreements did not constitute illegal price fixing since they did not "control any sale other than the one between the insurance company and the pharmacy."<sup>69</sup> Further, the court stated that the "price fixing within the scope of the per se prohibition of section 1 is an agreement to fix prices to be charged in transactions with third parties, not between the contracting parties themselves."<sup>70</sup> As in *Royal Drug*, the district court in *Sausalito* held that "contracts between a purchaser [insurance company] and seller [pharmacy] are not the sort of price fixing agreements which are per se illegal under the Sherman Act."<sup>71</sup> Thus, the court explained that since the contract did not set prices charged to third parties, "the issue to be decided is whether these agreements are unreasonable vertical restraints of trade,"<sup>72</sup> and that it should scrutinize these agreements under a rule of reason analysis. The court applied the rule of reason analysis and determined that

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“the agreements [between insurance companies and pharmaceutical companies] were not intended to fix prices of prescription drugs for all consumers.”<sup>73</sup>

The court in *Sausalito* also discussed predatory pricing and its antitrust implications. It stated that “a genuine antitrust concern would exist if it could be established that the participating pharmacies are using the pharmacy agreements to engage in predatory pricing.”<sup>74</sup> The analysis also emphasized the effects that the parties’ intent to engage in predatory pricing might have on the legality of the agreement. Since the plaintiffs attempt a per se argument, the court does not address the intent issue. The court summarized the case and quipped, “[w]e are convinced that plaintiffs have no more than a prayer, much less a wing, to support the allegations in the complaint.”<sup>75</sup>

This case provides guidance to the proper analysis a court might follow in response to the proposed hypothetical. One of the similarities between the hypothetical and the facts in *Sausalito* concerns the elusive predatory pricing issue. The court in *Sausalito* was not convinced that such a scheme existed.<sup>76</sup> The analysis of the hypothetical could follow similar reasoning. If the insurance company makes an exclusionary agreement with the pharmaceutical company, one could argue that this is simply an agreement between a buyer and seller, and thus should not face a per se rule. In contrast, since this type of agreement could actually affect the “price formation other than the terms of the contract itself,”<sup>77</sup> the court might actually apply the harsher per se rule.

Thus, in a situation involving either a lack of two parties both involved in the business of insurance or price-fixing in the business of insurance, the facts of the hypothetical prevent applying the McCarran–Ferguson exception to the Sherman Antitrust Act. The courts would analyze the hypothetical under a rule of reason analysis, without this statutory exemption.

### Using a rule-of-reason analysis

The courts generally have held that the rule of reason analysis is proper for a vertical pricing arrangement Sherman Act challenge.<sup>78</sup> The rule of reason analysis entails a balancing test between the costs to consumers for the questioned conduct versus the benefits to the market and the involved parties. Justice Brandeis in *Chicago Board of Trade*<sup>79</sup> described the rule of reason test:

The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts.<sup>80</sup>

To adhere to Justice Brandeis’ analysis, the courts must examine several factors including market share increases, and the anticompetitive and procompetitive effects of the agreement. If the courts determine that the procompetitive effects outweigh the anticompetitive ones, then they will, most likely, uphold the vertical alliance. However, if the reverse is true, the courts could strike down the agreement as detrimental to competition and as a violation of the Sherman Act.

**Market share analysis.** *The importance of determining market share.* The rule of reason analysis requires determining whether the anticompetitive effects of the vertical restriction outweigh the procompetitive ones:

As a general rule, only restrictions that foreclose a large share of a market will permit the two inferences necessary for concluding that a vertical restriction is anticompetitive; namely, that 1) the restrictions do indeed raise the costs of rivals; and 2) as a result, the strategizing firm is able to raise its own prices and earn monopoly returns. Thus, determination of market structure and of the strategizing firm’s relative position in the market becomes essential.<sup>81</sup>

The vertical restrictions of a nondominant<sup>82</sup> firm would generally prove harmless; however, one can find exceptions to this rule.<sup>83</sup> Usually, when a defendant’s market share is not significant enough to threaten competition, courts grant summary judgment, holding that a particular plaintiff has not established the prima facie case of unreasonableness as necessary under the Sherman Act.

*Market shares of the insurance and pharmaceutical companies.* When analyzing the hypothetical agreement

under the rule of reason doctrine, one must first establish the geographic and product markets affected by the agreement. The example assumes that the insurance company has the power and market share of Blue Cross and Blue Shield. Also, the hypothetical presupposes that the pharmaceutical company controls a market share comparable to Eli Lilly & Co. Thus, the market share, in most states, would be significant enough to potentially cause serious damage to competition and thus injury to consumers.

**Anticompetitive effects of the exclusive dealing agreement.** Another step in the rule of reason analysis concerns determining the anticompetitive effects of the exclusive dealing arrangement. The plaintiff must prove market domination or establish the overwhelming anticompetitive effect of the agreement by proving that the anticompetitive effects outweigh any positive results on either market or for either contracting party.

Measuring the exact anticompetitive effect is difficult since "the number of economic variables and difficulties in proving causation, direct proof of lowered output or higher prices will rarely be available."<sup>84</sup> Thus, the plaintiff must assess evidence *probative* of harm to competition, not merely adverse effects upon her own practice.<sup>85</sup>

In the hypothetical, the effects of the predatory pricing could establish a monopoly for one insurance company. This company would then have the market share and power to raise its prices beyond the previously competitive rate. The lack of consumer control or "normal" supply and demand curve would prove detrimental to consumer welfare.

The effects on the pharmaceutical company market could also prove detrimental to consumers. Initially, the agreement would increase the non-contracting pharmaceutical companies' power.<sup>86</sup> However, if the agreement creates a monopoly for the contracting insurance company, then the non-contracting pharmaceutical companies would lose their control over the pharmaceutical market. These pharmaceutical companies could no longer control their prices because they could only rely on one insurance company to supply them with customers. Instead of raising their prices in reaction to a diminished supply of prescription medication on the market, these pharmaceutical companies may have to lower their prices. Thus, the monopoly creates anticompetitive effects in both the insurance and pharmaceutical markets.

**Procompetitive effects of the agreement.** In the rule of reason analysis, one must also consider the procompetitive effects<sup>87</sup> of the action. The effects of the contract could impact many areas of the health care industry. The agreement between the insurance company and pharmaceutical company affects not only the economic status of the companies involved, but also the insurance and pharmaceutical markets.

The agreement promotes the welfare of two major corporations. The insurance company can establish a monopoly in the insurance market that provides it with the opportunity to raise premiums without competition. Thus, the profits in the long run outweigh the short run profit loss from predatory pricing.<sup>88</sup> The pharmaceutical company would benefit from the accord since the non-contracting pharmaceutical companies might lose their customers when the insurance company achieves a monopoly.<sup>89</sup> Since the insurance company guarantees the pharmaceutical company with a steady supply of customers, the contracting pharmaceutical company need not worry about the changes in the market after the implementation of the accord.

In addition to the contracting parties' benefits, the agreement can improve the quality of both markets, since it intensifies competition among insurance companies, the less stable ones might not survive in the new competitive market. The "weeding out" of less competitive insurance companies could improve the quality of the services which remain in the market. Thus, the reduction of inefficient insurance companies would provide consumers with more effective and competent insurance companies.

The agreement provides the pharmaceutical market with pro-competitive effects as well. The hypothetical initially creates more power for the non-contracting pharmaceutical companies. Since the agreement limits the supply of prescription medication, the non-contracting insurance companies become more dependent on fewer pharmaceutical companies. These pharmaceutical companies can take advantage of this reliance, raising their prices accordingly. However, as stated above, these companies would eventually lose their power when the contracting insurance company solidifies its monopoly.<sup>90</sup>

**Rule-of-reason balancing test.** These procompetitive results do not outweigh the negative effects on competition. The potential injury to consumers surpasses the positive influence that such an agreement could have on the

insurance or pharmaceutical markets. Even though the agreement benefits both contracting parties, the conceivable consumer injury would outweigh the possible benefits.

## Conclusion

The contracting parties could not use the "business of insurance" exception to escape application of the Sherman Antitrust Act. Using the rule of reason analysis, a court

should hold that the agreement between the insurance company and pharmaceutical company is a violation of the Sherman Act because the anticompetitive effects of the exclusionary accord outweigh the procompetitive benefits to both the corporations involved and to the two markets. Perhaps two corporations could form a similar agreement that would pass the stringent Sherman Act requirements. The proposed hypothetical situation, however, does not surpass the "unreasonable restraint" test of the Sherman Antitrust Act.

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# E N D N O T E S

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<sup>1</sup>E.g., Francis H. Miller, *Vertical Restraints and Powerful Health Insurers: Exclusionary Conduct Masquerading as Managed Care?*, 51 LAW & CONTEMP. PROBS. 195, 195 n. 1 (1988).

<sup>2</sup>See generally Philip A. Proger, *Application of the Sherman Act to Health Care: New Developments and New Directions*, 59 ANTITRUST L. J. 173 (1990) (differentiating health care from other industries and discussing the effects of regulation from application of the Sherman Act). The author explains that:

[t]he health care industry differs from many other industries in that its commercial relationships and impacts are generally local.... This local aspect makes state antitrust enforcement more likely.... The health care industry also differs from most industries in that it is already the largest industry in the United States and its rate of growth has been exceeding inflation. Thus, in terms of both sheer size in absolute dollars and percent of gross national product, as well as rate of growth in absolute dollars and percent of gross national product, the industry commands a significant position.

*Id.* at 174.

<sup>3</sup>See generally Proger, *supra* note 2.

<sup>4</sup>An exclusive dealing agreement exists when "a seller agrees to sell only to one purchaser or a purchaser agrees to buy only from one seller." JOHN J. MILES, HEALTH CARE AND ANTITRUST LAW: PRINCIPLES AND PRACTICE §4.07 (1994).

<sup>5</sup>See *infra* pp. 66-67 and accompanying notes for discussion and analysis of the benefits of the agreement.

<sup>6</sup>15 U.S.C. §1 (1994).

<sup>7</sup>Antitrust analysts commonly use the terminology "vertical and horizontal alliances." The article refers to this relationship as "vertical" because of the relationship concerns a buyer and a seller of goods, rather than competitors in the same market. The parties do not compete for market share. In his treatise on health care and antitrust law, John Miles illustrates the differences between the horizontal and vertical alliances. He explains that "[w]hile horizontal agreements are agreements among competitors or potential competitors, vertical agreements are between different parties at different levels in the chain of production or distribution, such as manufacturer and its supplier, a manufacturer and its wholesaler, a wholesaler and its retailer, or a retailer and its customer." MILES, *supra* note 4, at §4.01. This article will confine the majority of its analysis to the vertical relationship between the pharmaceutical and insurance company.

<sup>8</sup>The effects of the vertical alliance vary depending on the market share of both the insurance and the pharmaceutical company. This hypothetical assumes that the insurance company has the market share of Blue Cross and Blue Shield. This means that in most states the insurance company has a significant market share. The hypothetical also supposes that the pharmaceutical company has the market share of Eli Lilly & Co. or Warner-Lambert. This article analyzes the possible

procompetitive and anticompetitive effects of the vertical alliance. It does not focus on determining why the insurance company and pharmaceutical company control the market shares which they do.

<sup>9</sup>Thomas G. Krattenmaker et al., *Monopoly Power and Market Power in Antitrust Law*, 76 GEO. L.J. 241 (1987) (distinguishing restraint of own output theory from raising rivals' cost theory).

In this article, Krattenmaker, Salop and Lande describe two forms of obtaining monopoly power. The first theory entails a single firm "reducing its output and raising its price, and therefore the market price to the monopoly level." *Id.* at 250. At this point, the marginal revenue would equal marginal cost. The authors explain that in this instance, "[c]onsumer welfare and allocative efficiency are sacrificed because the firm forgoes sales to those consumers who would be willing to buy [the product] at a price above the cost of production but who are unwilling to buy at the price set by the firm." *Id.*

The second theory involves "altering the market structure in the previous example." *Id.* The authors refer to the raising rivals' cost theory as "Bainian market power." *Id.* They use a hypothetical involving widgets to explain the cause and effect of Bainian market power:

Suppose that 100 firms with identical, rising supply curves make widgets and that each produce an equal amount. Suppose further that gadgets, a second product, are a good substitute for widgets and

vice versa. Given this market structure, consider the effect of a strategy by the widget manufacturers that significantly raises the costs of manufacturing gadgets, thereby effectively removing all gadgets from the market.... As the increased cost of gadgets leads to gadget producers to shrink their output, the price of widgets will rise. Widget makers will benefit as their outputs and market share increase. Their total profits rise, while consumers lose the ability to buy gadgets at all and to buy widgets at the lower competitive price.

*Id.*

<sup>10</sup> See also Thomas G. Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power over Price*, 96 YALE L.J. 209 (1986) (explaining market ramifications of collusive agreements).

<sup>11</sup> See *infra* pp. 23–29.

<sup>12</sup> This can entail an “agreement to price below the competitive level [requiring] conspirators to forgo profits that free competition would offer them.” *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 588 (1986).

<sup>13</sup> 15 U.S.C. §1 (1994).

<sup>14</sup> *Matsushita*, 475 U.S. 574.

<sup>15</sup> *Id.* at 588.

<sup>16</sup> *Id.*

<sup>17</sup> In their article on predatory pricing, authors Phillip Areeda and Donald Turner explore the future entry of companies into a monopolistic market. They explain that:

Where entry is easy and relatively costless, the monopolist would have to maintain the lower price to forestall renewed entry. But where a new entrant must make a large investment in facilities, personnel training, distribution development, or product promotion, he will not enter without the prospect of survival for a period sufficiently long to recover those initial costs. The potential entrant who cannot survive at a price covering the monopolist's costs will not, therefore, enter when he thinks it probable that the monopolist will adopt that lower price in response to entry. [Thus,] [i]f the monopolist reduces his

price once or twice, he will discourage future entry.

Philip Areeda & Donald Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 689, 706 (1975).

<sup>18</sup> One of the best ways to achieve this reduction of prices is to increase efficiencies in the company. If the company can naturally drive down its own prices, then it does not need to sustain a substantial loss during the short run. The company can also artificially lower its prices and simply sustain the loss in the hopes of achieving the long run gain. In a predatory pricing situation, which involves a large insurance company such as Blue Cross and Blue Shield, this type of behavior might provide “a tempting target for antitrust scrutiny. . . [if Blue Cross attempts] to use [its] economic leverage [a] traditional insurer[] to exclude competitors in [its] market.” Miller, *supra* note 1, at 207.

<sup>19</sup> See *infra* pp. 67–67 and accompanying notes.

<sup>20</sup> Areeda & Turner, *supra* note 17, at 698.

<sup>21</sup> *Id.*

<sup>22</sup> The authors reached conclusions that have been the cornerstone of predatory pricing analysis. They reached their conclusions based on a monopolist's general (nondiscriminatory) pricing in the market in which she has monopoly power. They conclude generally that:

(a) A short-run profit-maximizing (or loss-minimizing) price is nonpredatory even through below average cost.

(b) A price at or above average cost should be deemed nonpredatory even though not profit-maximizing in the short run.

(c) A price at or above reasonably anticipated short-run marginal and average variable costs should be deemed non-predatory even though not loss-minimizing in the short run.

(d) Unless at or above average cost, a price below reasonably anticipated

(1) short-run marginal costs or

(2) average variable costs should be deemed predatory, and the monopolist may not defend on the grounds that his price was “promotional” or

merely met an equally low price of a competitor.

*Id.* at 732–733. In addition, since marginal cost data are typically unavailable:

(a) A price at or above reasonably anticipated average variable cost should be conclusively presumed lawful. [and]

(b) A price below reasonably anticipated average variable cost should be conclusively presumed unlawful.

*Id.* As to “predatory devices other than general price reductions [the authors] conclude that:

[1] The above conclusions apply to different returns on different products and as to price discrimination, whether between different geographic markets or in the same market, except that a monopolist should have the benefit of any defenses—such as a “promotional” pricing or “meeting competition”—available to other sellers in any market in which he lacks monopoly power.

[2] There should be no prohibition of investment whether in a new product line or in the monopoly product line.

[3] Promotional spending should be deemed predatory when timed to coincide with entry or promotion buy a rival, and when average variable cost, including the promotional expenditure, exceeds price.

[4] There should be no prohibition of nonpredatory spending or of product variation.

*Id.* at 733.

<sup>23</sup> Sections 4 and 5 of the Clayton Act, 15 U.S.C. §§ 12 – 36, grant private parties standing to enforce the Sherman Act in actions for either injunctive relief or treble damages. See generally THOMAS GRAENEY, *ANTITRUST IN THE HEALTH CARE SECTOR* 17 (1993).

<sup>24</sup> Thomas J. Campell, *Predation and Competition in Antitrust: The Case of Nonfungible Goods*, 87 COLUM. L. REV. 1625 (1987).

<sup>25</sup> *Id.* at 1626.

<sup>26</sup> *Id.* (emphasis added).

<sup>27</sup> See generally *Utah Pie Co. v. Continental Baking Co.*, 386 U.S. 685, 702–703 (1967) (stating that the predatory in-

tent has a bearing on the likelihood of injury to competition).

<sup>28</sup>See Krattenmaker & Salop, *supra* note 10. In their article on raising rivals' costs, Krattenmaker and Salop explore the effects that this predatory behavior has on consumer welfare. The authors describe a major policy dilemma concerning the congressional intent in the passage of the Sherman Antitrust Act.

If the Sherman Act gives consumers and firms an entitlement to enter transactions that they would have made but for restraints of trade that confer monopoly power on certain other firms, then an exclusionary agreement that confers monopoly power on its purchaser by raising its rivals' costs should *not* be saved by efficiency claims unless these savings are so substantial that price will fall in spite of the increase in monopoly power.... On the other hand, if the Sherman Act places little value on the division of wealth between consumers and stockholders and instead seeks to promote a new value of efficient transactions and low production costs, and if one doubts the ability of firms to erect entry barriers or their propensity to engage in rent-seeking behavior, then the likelihood and magnitude of any cost reduction should be part of the calculus employed in judging exclusion claims.

*Id.* at 280–281. (emphasis added).

<sup>29</sup>Miller, *supra* note 1, at 196–197.

<sup>30</sup>Herbert Hovenkamp, *Antitrust Policy, Restricted Distribution, and the Market for Exclusionary Rights*, 71 MINN. L. REV. 1293, 1294 (1987) (citations omitted).

<sup>31</sup>In their authoritative article on raising rivals' costs theory, Krattenmaker and Salop characterize this process as the "bottleneck" theory. Krattenmaker, *supra* note 10, at 234.

<sup>32</sup>See generally Judy Whalley, *Priorities and Practices — The Antitrust Division's Criminal Enforcement Program*, 57 ANTITRUST L.J. 569 (1988); See also *supra* note 23.

<sup>33</sup>Thomas G. Krattenmaker & Steven C. Salop, *Economic Concepts and Antitrust Analysis: A Critical Reexamination Analyzing*

*Anticompetitive Exclusion*, 56 ANTITRUST L.J. 71, 74 (1987).

<sup>34</sup>*Id.* at 74.

<sup>35</sup>The parties in *Alcoa* are not similar to insurance and pharmaceutical companies. The issue concerning raising rivals' costs in a competitive market is, however, quite similar. The facts of *Alcoa* concern a contract between an aluminum producing company (Alcoa) and electric utility companies. In 1914, Alcoa contracted with some electric utility companies *not* to provide electricity to rival aluminum purchasers. This contractual agreement is quite similar to the proposed hypothetical. Alcoa did not buy electric power from the utilities with whom it contracted; instead, the utilities were only selling Alcoa market power. Since this forced the rivals' costs to increase, Alcoa could charge a higher price for its product. See *United States v. Aluminum Co. of America*, 148 F.2d 416 (5th Cir. 1945) (emphasis added).

<sup>36</sup>In fact, many could say that Alcoa lost the bet because they wasted money on an exclusionary contract that gave them no monetary benefit. However, since the competitors could not obtain the electricity elsewhere for comparable prices, Alcoa did benefit from the agreement.

<sup>37</sup>Krattenmaker & Salop, *supra* note 33, at 74.

<sup>38</sup>See *supra* notes 8–11 and accompanying text.

<sup>39</sup>Krattenmaker & Salop, *supra* note 10, at 229.

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

<sup>41</sup>See generally *Key Enterprises of Delaware, Inc. v. Venice Hospital*, 919 F.2d 1550 (11th Cir. 1990) (explaining that hospital and private corporation implementing joint venture to promote product recommendations and their intent in forming this joint venture unreasonably restricted competition by excluding competing vendors and channeling patient choice and also that the evidence supported specific intent to monopolize durable medical equipment market).

<sup>42</sup>See *supra* notes 8–11 and accompanying text.

<sup>43</sup>Krattenmaker & Salop, *supra* note 10, at 219.

<sup>44</sup>*Id.*

<sup>45</sup>15 U.S.C. §§ 1011–1015 (1994).

<sup>46</sup>15 U.S.C. § 1012(a) (1994).

<sup>47</sup>15 U.S.C. § 1013(b) (1994).

<sup>48</sup>William A. Montgomery, *Changing Insurance Policies: Coping With the New Antitrust Environment*, 61 ANTITRUST L.J. 313, 314–315 (1993).

<sup>49</sup>15 U.S.C. § 1013(b) (1994). See also *California League of Independent Ins. Producers v. Aetna Cas. & Sur. Co.*, 179 F. Supp. 65, 66 (N.D. Cal. 1959).

<sup>50</sup>440 U.S. 205 (1979).

<sup>51</sup>"The complaint alleged that the petitioners had violated §1 of the Sherman Act, 15 U.S.C. §1, by entering agreements to fix the retail prices of drugs and pharmaceuticals, and that the activities of the petitioners had caused Blue Shield's policyholders not to deal with certain of the respondents, thereby constituting an unlawful group boycott." *Royal Drug*, 440 U.S. at 207.

<sup>52</sup>*Royal Drug*, 440 U.S. at 210.

<sup>53</sup>*Id.* at 211, quoting *SEC v. National Securities, Inc.*, 393 U.S. 453, 459–460. (emphasis in original).

<sup>54</sup>*Royal Drug*, 440 U.S. at 211.

<sup>55</sup>*Id.*

<sup>56</sup>Petitioners state the following in their brief. "In *Securities and Exchange Commission v. Variable Annuity Life Insurance Co.*, 359 U.S. 65, 73 (1959), the 'earmark' of insurance was described as the 'underwriting of risks' in exchange for a premium. Here the risk insured against is the possibility that, during the term of the policy, the insured might suffer financial loss arising from the purchase of prescription drugs, or that he may be financially unable to purchase such drugs. In consideration of the premium, Blue Shield assumes the risk by agreeing with its insureds to contract with Participating Pharmacies to furnish the needed drugs and to reimburse the Pharmacies for each prescription filled for the insured. In short, each of the fundamental elements of insurance is present here: the payment of a premium in exchange for a promise to indemnify the insured against losses upon the happening of a specified contingency." *Royal Drug*, 440 U.S. at 213.

<sup>57</sup>*Royal Drug*, 440 U.S. at 213–214 (emphasis added).

<sup>58</sup>The Court did not describe a contract between an insurance company and a

pharmaceutical company, but described one between an insurance company and a large retail drug store chain. In this case, "policyholders could obtain drugs under their policies only from stores operated by this chain. The justification for such an agreement would be administrative and bulk-purchase savings resulting from obtaining all the company's drug needs from a single dealer. Even though these cosy savings might ultimately be reflected in lower premiums to policyholders, would such a contract be the 'business of insurance?'" *Id.* at 215.

<sup>59</sup>458 U.S. 119 (1982).

<sup>60</sup>*Id.* at 129.

<sup>61</sup>*Id.* at 129.

<sup>62</sup>939 F.2d 341 (6th Cir. 1991).

<sup>63</sup>*Id.* at 345, quoting *Royal Drug*, 440 U.S. at 211, 215.

<sup>64</sup>*Royal Drug Co. v. Group Life and Health Insurance Co.*, 737 F. 2d 1433, 1438 (5th Cir.1984).

<sup>65</sup>544 F. Supp. 230 (N.D. Cal. 1981).

<sup>66</sup>*Id.* at 232.

<sup>67</sup>*See generally* *Royal Drug*, 440 U.S. 205 (1979).

<sup>68</sup>*See id.* at 231.

<sup>69</sup>*See* *Sausalito*, 544 F. Supp. at 234.

<sup>70</sup>*Id.*, quoting *Sitkin Smelting & Refining Co. v. F.M.C.*, 575 F.2d 440, 446 (3d Cir. 1978) (emphasis added).

<sup>71</sup>*Sausalito*, 544 F. Supp. at 233.

<sup>72</sup>*Id.* at 234.

<sup>73</sup>*Id.* at 237.

<sup>74</sup>*Id.*

<sup>75</sup>*Id.* at 242.

<sup>76</sup>*Id.* at 237.

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

<sup>78</sup>*See generally*, *Miles*, *supra* note 4.

<sup>79</sup>*Chicago Bd. of Trade v. United States*, 246 U.S. 231 (1918).

<sup>80</sup>*Id.* at 238.

<sup>81</sup>*Hovenkamp supra* note 30, at 1302.

<sup>82</sup>Antitrust analysts typically use this word to signify a firm that does not possess a significant amount of market share. The application would vary in different market. *See generally* *Hovenkamp*, *supra* note 30; *Krattenmaker*, *supra* note 10.

<sup>83</sup>*See, e.g.*, *Campell v. City of Chicago*, 639 F. Supp. 1501, 1504 (N.D. Ill. 1986).

<sup>84</sup>*Hovenkamp*, *supra* note 30, at 65.

<sup>85</sup>*Id.*

<sup>86</sup>*See supra* note 11 and accompanying text.

<sup>87</sup>*See supra* pp. 66-67.

<sup>88</sup>The insurance company would not have to lower its premiums to benefit from the agreement. The insurance company could maintain its premiums while the non-contracting insurance companies' costs increase. *See supra* pp. 63-65 and note 31.

<sup>89</sup>*Id.*

<sup>90</sup>*Id.*

## ANNOUNCEMENTS

### *New air smoking ban*

The U.S. Department of Transportation announced a smoking ban on all flights between the United States, Canada and Australia beginning March 1, 1995. Flights traveling over countries that have not signed the agreement are exempt. Each country already forbids smoking on domestic flights.

The first limited ban on smoking in the United States took effect in 1988. In 1990, Congress outlawed smoking on all scheduled flights in the 48 contiguous states, the U.S. Virgin Islands, and Puerto Rico. Congress also banned smoking on flights within Hawaii and Alaska, and for flights between these two states if less than six hours in duration.

Negotiations between the countries began a year ago in Montreal, headquarters of the United Nations affiliate that monitors international air standards, the International Civil Aviation Organization (ICAO). Furthermore, the ICAO has set a July 1996 deadline for the end of smoking on all commercial flights.

No new U.S. legislation is required to honor the agreement. Presently, the U.S. Department of Transpor-

tation has the authority to add such a provision to the existing ban, according to a spokesman.

Even before the agreement took effect, several airlines eliminated smoking on certain international flights. For example, on January 1, 1995, Delta Air Lines banned smoking on all 250 of its trans-Atlantic flights after passenger surveys revealed an overwhelming preference for non-smoking flights.

### *Pricing practice upheld*

The Arkansas Supreme Court recently ruled that Wal-Mart Stores Inc. did not engage in illegal predatory pricing by selling certain products below cost. The state's high court, overturning a lower-court decision, applied a broad standard in defining what constitutes predatory pricing.

Three local pharmacies filed suit against Wal-Mart when its Conway, Arkansas pharmacy priced certain products below cost. In an October 1993 ruling, the state chancery court awarded the plaintiffs \$289,407 in damages and maintained that Wal-Mart intended to The

*Please see "Pricing Practice" on page 82*