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Distributing Products Under the Nonprofit Institutions Act: Price Discrimination, Arbitrage, and Fraud in the Pharmaceutical Industry

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The author participated in two cases that addressed issues discussed in this article. In *United States v. Ferro*, No. 99-00180-0104-CR-W-SOW, 2000 WL 33394614, at *1 (W.D. Mo. May 8, 2000) (order dismissing indictment), *rev'd*, 252 F.3d 964 (8th Cir. 2001), *reh'g denied*, No. 00-2467, 2001 U.S. App. LEXIS 18150 (Aug. 2, 2001), the author prepared an opinion letter and testified at an evidentiary hearing before a United States magistrate judge on behalf of the defendants. In *United States v. Almanza*, No. 98-CR55S (D. Colo. Feb. 12, 1998), the author, as a court-appointed expert, prepared an opinion letter on behalf of the defendants. The author was neither solicited nor compensated to prepare this article, and counsel in neither case just cited have reviewed or commented upon a draft of this article prior to publication.

After this article had been accepted for publication, but before publication, the Eighth Circuit Court of Appeals reversed the district court's opinion in *United States v. Ferro*, 252 F.3d 964 (8th Cir. 2001), and the Supreme Court denied defendants' petition for certiorari, 2002 US LEXIS 279 (U.S. Jan. 7, 2002). The Eighth Circuit's opinion in *Ferro* is critiqued, *infra*, notes 275–81.

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I. INTRODUCTION

In 1936, the Robinson-Patman Act[1] was enacted as an amendment to section 2 of the Clayton Act.[2] Subject to technical requirements and defined defenses, these enactments prohibit primary-[3] and secondary-line price discrimination[4] practices by which a seller charges different prices to different buyers for the same commodity.[5]

1. Robinson-Patman Antidiscrimination Act, 15 U.S.C. §§ 13–13b (1994). For brief discussions of the legislative history surrounding the Robinson-Patman Act, see 1 ABA SECTION OF ANTITRUST LAW, MONOGRAPH 4, THE ROBINSON-PATMAN ACT: POLICY AND LAW 8–19 (1980) [hereinafter ABA ANTITRUST SECTION MONOGRAPH]; FREDERICK M. ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT 3–23 (1962). For an extended discussion of the legislative history that critiques the underlying economic and policy assumptions as well as the ability of the Robinson-Patman Act to achieve its goals, see UNITED STATES DEPARTMENT OF JUSTICE, REPORT ON THE ROBINSON-PATMAN ACT 101–250 (1977).

2. Clayton Act, ch. 323, § 2, 38 Stat. 730 (1914) (current version at 15 U.S.C. § 13 (1994)). For a brief discussion of the legislative history surrounding the price discrimination provision of the Clayton Act, see ABA ANTITRUST SECTION MONOGRAPH, *supra* note 1, at 5–8.

3. In primary-line discrimination, the competitive injury occurs or is threatened to competitors of the price discriminating seller. For example, a seller charges a high price in a noncompetitive area to generate revenues so that it can drive out (or unfairly compete against) competition by subsidizing a low price in a competitive area. *See* Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 220 (1993) ("This type of injury, which harms direct competitors of the discriminating seller, is known as primary-line injury."); UNITED STATES DEPARTMENT OF JUSTICE, *supra* note 1, at 5 ("Where the price discrimination allegedly injures the competitors of the seller granting it, there is said to be 'primary line injury.'").

4. In secondary-line discrimination, the competitive injury occurs or is threatened to price-disfavored purchasers of the price discriminating seller. For example, a buyer who pays a lower price is thereby able to drive out (or unfairly compete against) competition from buyers who pay a higher price. Texaco Inc. v. Hasbrouck, 496 U.S. 543, 558 n.15 (1990) ("[T]he probable impact . . . on the favored and disfavored buyers [is] (second-line injury)"); UNITED STATES DEPARTMENT OF JUSTICE, *supra* note 1, at 5 ("Where the effect of the price discrimination is alleged to injure the competitors of the buyer receiving the preferential discriminatory price, there is said to be 'secondary line injury.'"). If the competitive injury occurs or is threatened to customers of a price-disfavored purchaser of the price discriminating seller, it is called third-line or tertiary-line discrimination. *Hasbrouck*, 496 U.S. at 558 n.15. ("The probable impact [is] . . . on the customers of [the secondary-line purchaser] (third-line injury)."). Falls City Indus. v. Vanco Beverage Inc., 460 U.S. 428, 436 (1983) ("[The] injury component of a Robinson-Patman Act violation is not limited to the injury to competition between the favored and the disfavored purchaser; it also encompasses the injury to competition between their customers."); Perkins v. Standard Oil Co., 395 U.S. 642, 647 (1969) (noting that the Court of Appeals found a "fourth level" injury due to "impaired competition with a customer . . . of a customer . . . of the favored purchaser" of the price discriminating seller).

5. Defined instances of price discrimination, whether at the primary, secondary, or tertiary level, are prohibited by the Robinson-Patman Act, which contains the following basic

The Robinson-Patman Act, which added the prohibition of secondary-line price discrimination to protect price-disfavored purchasers of a discriminating seller,[6] was meant to counter the perceived market power of large retail chains that enabled those chains to extract price favors from suppliers.[7] Those without market power, the small retailers, were at a disadvantage because they paid higher prices for the commodities that they resold in competition with the larger chains.[8] These concerns resonated well with the then-prevailing antitrust policy, which had a populist bias aimed at preserving "small

provisions. Section 2(a) of the Act, which is the most frequently used, prohibits a seller from discriminating in price between different buyers when the discrimination adversely affects competition. Section 2(a) also establishes the cost justification defense and the changing conditions defense. Section 2(b) establishes the affirmative defense of meeting competition. Section 2(c) prohibits a seller from achieving price discrimination by way of commissions or brokerage fees that are paid to favored buyers, except for services actually provided. Section 2(d) and 2(e) prohibit a seller from achieving price discrimination by way of providing promotion or advertising services to favored buyers, unless equivalent benefits are provided to all competing buyers. Section 2(f) makes it unlawful for a buyer "knowingly to induce or receive" a discriminatory price prohibited by the Robinson-Patman Act. Section 3 (codified at 15 U.S.C. § 13a (1994)) provides criminal sanctions for unreasonably low pricing. Section 4 (codified at 15 U.S.C. § 13b (1994)) exempts a cooperative association's returns of its net earnings to its members but not the receipt of discriminatory prices or the activities that generate those earnings. Additionally, the Nonprofit Institutions Act (codified at 15 U.S.C. § 13c 1994)), enacted in 1938, provides an exemption for defined institutions who operate not-for-profit and purchase supplies for their own use. In this article, the focus is upon price discrimination that may be unlawful under section 2(a) and the exemption provided by the Nonprofit Institutions Act.

6. UNITED STATES DEPARTMENT OF JUSTICE, *supra* note 1, at 5 ("The chief objective of the Robinson-Patman Act, however, was not to prohibit primary line injury; that situation was already covered by the Clayton and Sherman Acts. Rather, the Act's main purpose was to prohibit price differentials which affected competition at the secondary line.").

7. "The major legislative purpose behind the Robinson-Patman Act was to provide some measure of protection to small independent retailers and their independent suppliers from what was thought to be unfair competition from vertically integrated, multi-location chain stores." *In re* Boise Cascade Corp., 107 F.T.C. 76, 210 (1986), *rev'd on other grounds*, Boise Cascade Corp. v. Fed. Trade Comm'n, 837 F.2d 1127 (D.C. Cir. 1988), *subsequent proceeding*, Boise Cascade Corp., 113 F.T.C. 956 (1990); *see also* Aimee M.W. Pollak, Note, *Should the Exemption from the Robinson-Patman Act Apply to Pharmaceutical Purchases by Nonprofit HMOs?*, 73 N.Y.U. L. REV. 965, 968–71 (1998) (Robinson-Patman Act meant to protect independent merchants from large chain stores by preventing suppliers from favoring chain stores). F.M. Scherer, *How US Antitrust Can Go Astray: The Brand Name Prescription Drug Litigation*, 4 INT'L J. ECON. BUS. 239, 244 (1997) [hereinafter Scherer, *Prescription Drug Litigation*] ("Passage of the Robinson-Patman Act was led by 'mom and pop' grocers, but the National Association of Retail Druggists (NARD), unlike most other business interests, also supported its enactment.").

8. Perhaps surprisingly, a 1934 Federal Trade Commission Report "indicated that only between 15 and 20 percent of the difference in retail prices was attributable to the chains' advantages in buying prices." ABA ANTITRUST SECTION MONOGRAPH, *supra* note 1, at 10.

dealers and worthy men"[9] as well as the deconcentrated industries in which they can survive.[10]

Today, antitrust commentators question the prohibition of price discrimination,[11] largely because antitrust policy has shifted toward the goal of consumer welfare and the concomitant goal of encouraging suppliers to maximize output.[12] Economic theory teaches that

9. United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290, 323 (1897). The quote in the text is taken from one of the earliest Sherman Act cases, and this language has led to numerous statements to the effect that antitrust serves populist goals. *See, e.g.*, Brown Shoe Co. v. United States, 370 U.S. 294, 344 (1962) (interpreting Congressional intent as "desire to promote competition through the protection of viable, small, locally owned businesses . . . [even though] occasional higher costs and prices might result"); United States v. Aluminum Co. of Am., 148 F.2d 416, 429 (2d Cir. 1945) (indicating that the antitrust purpose is "to perpetuate and preserve, for its own sake and in spite of possible cost, an organization of industry in small units"). For those who champion a different view of antitrust policy, the original phrase, taken from *Trans-Missouri*, was, at best, unfortunate dictum. *See* ROBERT H. BORK, THE ANTITRUST PARADOX 25 (2d ed. 1993) ("We shall hear more of these 'small dealers and worthy men' that Peckham loosed upon us, for they are the widows and orphans of antitrust debate, and they may yet sweep the field.").

10. Requiring large retailers to pay the same price for commodities as small retailers does not necessarily assure that retail markets will remain deconcentrated. If large retailers are more efficient than small retailers, the retail market will tend toward concentration, not because of lower prices paid by large retailers for supplies, but because large retailers perform distribution services at a lower cost. *Compare* Scherer, *Prescription Drug Litigation*, *supra* note 7, at 246 (suggesting that, since fair trade was abolished in 1975, retail pharmacies have been slow to innovate), *with* Roy Weinstein & John Culbertson, *How U.S. Antitrust Can Be on Target: The Brand Name Prescription Drug Litigation*, 4 INT'L J. ECON. BUS. 257, 263 (1997) (pointing out that without discounts, retail pharmacies have no incentive to invest in new retailing methods).

11. In fact, the questioning has been legion and almost uniformly scathing: "The fact is that no other antitrust statute has been subjected to so steady a barrage of hostile commentary as the Robinson-Patman Act. Indeed, the scholarly and professional literature on the statute resembles a cascade of vituperation." BORK, *supra* note 9, at 385. For representative bibliographies, see ABA ANTITRUST DIVISION MONOGRAPH, *supra* note 1, at 21 n.86; ROWE, *supra* note 1, at 551–56 & nn.69, 80. For a book-length criticism, see UNITED STATES DEPARTMENT OF JUSTICE, *supra* note 1.

12. Perhaps the most comprehensive statement of this view of antitrust policy is ROBERT H. BORK, THE ANTITRUST PARADOX (2d ed. 1993), the first edition of which was published in 1978. *See also* RICHARD A. POSNER, ANTITRUST LAW (1976) (book length economic analysis of antitrust law). For a Supreme Court opinion that adopts this view, see *Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 58–59 (1977) ("[D]eparture from the rule-of-reason standard must be based upon demonstrable economic effect."). After the publication of the just-cited works and Supreme Court opinion, the debate about the appropriate goals of antitrust law has continued. *See, e.g.*, Robert H. Lande, *Wealth Transfers as the Original and Primary Concern of Antitrust: The Efficiency Interpretation Challenged*, 34 HASTINGS L.J. 65 (1982) (antitrust law meant to prevent wealth transfer from consumers to monopolists); Robert Pitofsky, *The Political Content of Antitrust*, 127 U. PA. L. REV. 1051 (1979) (suggesting that where economic analysis is indeterminate, political concerns can and should

where a supplier can successfully price discriminate by charging different prices to groups of consumers with different demand characteristics, the supplier can expand beyond the profit-maximizing output associated with a single price.[13] Indeed, in the modern context of utility regulation, economic analysis, supported by a history of successful results, has shown that, by charging different prices to groups of purchasers with different demand characteristics, suppliers can provide more services to more consumers.[14] Nonetheless, an important and historically consistent theme of the antitrust laws, of which

should be taken into account); Louis B. Schwartz, *"Justice" and Other Non-Economic Goals of Antitrust*, 127 U. PA. L. REV. 1076 (1979) (contending that non-economic goals of antitrust should predominate); Eleanor M. Fox, *The Modernization of Antitrust: A New Equilibrium*, 66 CORNELL L. REV. 1140 (1981) (explaining that socio-political values coincide with efficiency goals and should continue to guide antitrust); Herbert Hovenkamp, *Antitrust Policy After Chicago*, 84 MICH. L. REV. 213 (1985) (Chicago School model of efficiency will be replaced by new economic model). For symposia on the goals of antitrust, see Symposium, *The Antitrust Alternative*, 62 N.Y.U. L. REV. 931 (1987) and Symposium, *Symposium on Antitrust Law and Economics*, 127 U. PA. L. REV. 918 (1979).

13. *See generally* WARD S. BOWMAN, JR., PATENT AND ANTITRUST LAW 100–05 (1973) (explaining how a patentee can expand output through price discrimination); Scherer, *Prescription Drug Litigation*, *supra* note 7, at 250–54 (1997) (discussing welfare and profit effects of price discrimination in the pharmaceutical industry).

As these sources indicate, economic or market power is necessary for a price discriminating seller to charge a higher price to price-disfavored customers. Drug manufacturers seem to have the requisite power. *See* F.M. Scherer, *Pricing, Profits, and Technological Progress in the Pharmaceutical Industry*, 7 J. ECON. PERSP. 97, 99 (1993) [hereinafter Scherer, *Pharmaceutical Industry*] ("The combination of physician decision-making, imperfect information, and third-party payment makes drug demand stronger and less price-elastic than it might otherwise be, conferring considerable monopoly power upon the sellers of well-accepted drugs."); F.M. SCHERER, INDUSTRY STRUCTURE, STRATEGY, AND PUBLIC POLICY 389–90 (1996) [hereinafter SCHERER, INDUSTRY STRUCTURE] ("Pharmaceutical producers enjoy substantial monopoly power in setting the prices of significant new products, in part because of patent and regulatory barriers to competitive entry and partly, after patents expire, because habit and the fear that generic copies will be less effective lead physicians to prescribe first-moving brands."); Weinstein & Culbertson, *supra* note 10, at 259–60 ("The relevant product market for most brand-name drugs is highly concentrated, generally with only a small number of competitors in each therapeutic class. . . . As a result of promotional practice of drug companies discussed above and characteristics of demand for drugs, demand faced by brand-name drug manufacturers is relatively inelastic, even at prices substantially in excess of incremental cost.")

14. *See generally* RICHARD J. PIERCE, JR., ECONOMIC REGULATION: CASES AND MATERIALS 133–42 (1994) (discussing Ramsey pricing in context of utility regulation); RICHARD J. PIERCE, JR., & ERNEST GELLHORN, REGULATED INDUSTRIES IN A NUTSHELL (4th ed. 1999) (same). Moreover, there are fact situations where, because the technical requirements of a Robinson-Patman Act violation are not met, suppliers may freely increase profits and maximize output by engaging in price discrimination. For example, the price discrimination practiced by the airline industry does not come within the purview of the Robinson-Patman Act because the airlines sell a service and not a commodity. *See infra* note 87.

the Robinson-Patman Act is a part, is to curb the abuse of market power. In the context of utility regulation, price regulation prevents the abuse of market power by suppliers.

What is perhaps less appreciated is that, when the Robinson-Patman Act was enacted, there were concerns that the prohibition of price discrimination might reach too far.[15] At that time, the government was able to secure price favors from suppliers who actively sought potentially large and lucrative government contracts.[16] As it continues to do today, the government provided goods and services, such as education and health care, to consumers who otherwise might not be able to obtain those goods and services from private industry.[17] Suppliers who granted price favors to the government but charged higher prices to private industry might be seen as putting private industry at a disadvantage when selling goods and services also provided by the government.[18] Consequently, some feared that the Robinson-Patman Act would force the government to pay higher prices to its suppliers, all to the detriment of the public policy goals that government pursues.[19]

A second concern, voiced on behalf of eleemosynary institutions,

15. Pollak, *supra* note 7, at 972 ("broad sweep of the Robinson-Patman Act had engendered confusion about its application").

16. More recently, not every industry has sought government contracts through lower prices. A preface to a recent study of pricing in the pharmaceutical industry, implying that the pharmaceutical industry now seeks to charge high prices to the government, noted the following change to the pricing environment: "The federal government further complicated the working environment by granting itself access to the best prices the pharmaceutical companies made available, effectively penalizing drug firms and their customers." E.M. KOLASSA, ELEMENTS OF PHARMACEUTICAL PRICING *xi* (1997).

17. *See* 14 HERBERT HOVENKAMP, ANTITRUST LAW § 2354d, at 200 (1999) [hereinafter HOVENKAMP, ANTITRUST] ("[A] school may be owned by a school district, which is a governmental subdivision; the same might be said of a public college, university, library, or hospital.").

18. *But see id.* at 200–01 ("While the statute itself is silent about sales to federal and state governments, at least some of the drafters believed that general principles of sovereign immunity or statutory construction effectively created an exemption for governmental purchases.").

19. This concern was addressed just after the Robinson-Patman Act was enacted in a 1936 opinion letter issued by United States Attorney General Homer Cummings. 38 Op. Att'y Gen. 539 (1936). That opinion letter, and case law following it, are discussed, *infra* at notes 244–51. For more extended discussions of the so-called governmental entity exemption, see HOVENKAMP, ANTITRUST, *supra* note 17; EARL W. KINTNER, FEDERAL ANTITRUST LAW § 25.10 (1983). In its pharmaceutical price discrimination statute, Maine explicitly provides an exception for "the State and any political subdivision of the State." ME. REV. STAT. ANN. tit. 32, § 13804(1) (West 1999).

was that the Robinson-Patman Act would prevent suppliers from granting price favors to those institutions.[20] This concern mirrored the one directed at preserving price favors for the government. Eleemosynary institutions provide goods and services, such as education and health care, to consumers who otherwise might not be able to obtain those goods and services from private industry. Suppliers who granted price favors to eleemosynary institutions but charged higher prices to private industry might be seen as putting private industry at a disadvantage when selling goods and services also provided by eleemosynary institutions. Here as well, some feared that the Robinson-Patman Act would force eleemosynary institutions to pay higher prices to their suppliers, all to the detriment of the charitable or other worthy goals that eleemosynary institutions pursue.[21]

This article focuses upon the second concern and, in particular, the Nonprofit Institutions Act which was enacted in 1938 to create a Robinson-Patman Act exemption for suppliers who grant price favors to eleemosynary institutions.[22] The legislative history is remarkably brief, but it indicates that Congress was concerned with preserving the ability of eleemosynary institutions to pursue their charitable or other worthy goals.[23] The committee report in the House first noted that the Robinson-Patman Act prohibited price discrimination where

20. *See* Abbott Labs. v. Portland Retail Druggists Ass'n, 425 U.S. 1, 12 (1976) ("[T]he legislative history of the Nonprofit Institutions Act [of 1938] indicates clearly that that Act was concerned with the suspicion that Robinson-Patman, at the time just recently enacted, actually might operate to outlaw price favors that sellers would wish to grant to eleemosynary institutions"); KINTNER, *supra* note 19, § 25.9, at 464–65 ("Shortly after the passage of the Robinson-Patman Act in 1936, some concern was expressed that the new statute might prevent the offering of price concessions to educational and other non-profit institutions.").

21. *See* Pollak, *supra* note 7, at 972 ("The exemption was meant to restore discounts that suppliers apparently had offered to the named institutions in furtherance of their charitable work, but which were withdrawn after enactment of the Robinson-Patman Act. . . . [T]he loss of discounts severely impacted their ability to function and survive.").

22. Nonprofit Institutions Act of 1938, ch. 283, 52 Stat. 446 (codified at 15 U.S.C. § 13c (1994)). This antitrust exemption has received scant attention in the literature. Two leading treatises do provide extended discussions, but both discuss limited case law and indicate that many issues remain unsettled. *See* HOVENKAMP, ANTITRUST, *supra* note 17, § 2354c, at 200 (noting "rather imprecise statutory language"); KINTNER, *supra* note 19, § 25.9, at 465 ("This proviso [the Nonprofit Institutions Act] has given rise to several questions of interpretation.").

23. KINTNER, *supra* note 19, § 25.9, at 469 ("[It is] clear that this statute is designed to perform an important affirmative role: to allow charitable institutions to operate flexibly and inexpensively, so that they may receive the benefit of lower prices, and pass them on to the persons they serve.").

"the effect . . . may be substantially to lessen competition"[24] and then stated that the Nonprofit Institutions Act would not interfere with this purpose by "mak[ing] certain that favors in price which are occasionally extended to eleemosynary institutions, because of the character of the institution, do not fall under the ban of the [Robinson-Patman] Act."[25] Similarly, the committee report in the Senate noted, perhaps more directly, that "[t]he purpose of the Robinson-Patman Act . . . does not seem to apply as to eleemosynary institutions as they are not operated for profit."[26] As evidence that an exemption was needed, both reports attached the same letter from an association of approximately two thousand and seven hundred voluntary nonprofit hospitals who "care [for] the needy sick."[27] The letter stated that, because of the Robinson-Patman Act, "hospital supply bills are increasing about 20 percent," and "many hospitals may have to close their doors[, placing] an almost impossible burden on Federal, State, and municipal institutions."[28]

With these concerns as background, in 1938 Congress enacted the Nonprofit Institutions Act, which provides in full:

> Nothing in the Act approved June 19, 1936, known as the Robinson-Patman Antidiscrimination Act, shall apply to purchases of their supplies for their own use by schools, colleges, universities, public libraries, churches, hospitals, and charitable institutions not operated for profit.[29]

24. H.R. REP. NO. 75-2161, at 1 (1938) (accompanying H.R. 8148).

25. *Id.*

26. S. REP. NO. 75-1769, at 1 (1938) (accompanying H.R. 8148).

27. H.R. REP. NO. 75-2161, at 2 (1938) (accompanying H.R. 8148; quoting letter from John H. Hayes, President, Hospital Bureau of Standards and Supplies (Dec. 18, 1937)); S. REP. NO. 75-1769, at 1–2 (1938) (same).

28. *See supra* note 27. This concern has resurfaced in the past few years, albeit for different reasons. At least one commentator believes that the recent and increased competition in health care will discourage for-profit hospitals from providing charity care, all to the detriment of public hospitals that do. *See* Henry W. Zaretsky, *Comment on: F.M. Scherer, "How U.S. Antitrust Can Go Astray: The Brand Name Prescription Drug Litigation*," 4 INT'L J. ECON. BUS. 271, 273 (1997).

29. 15 U.S.C. § 13c (1994). In its pharmaceutical industry price discrimination statute, Minnesota has a substantively identical provision: "Nothing in this subdivision shall apply to purchases for their own use by schools, colleges, universities, public libraries, churches, hospitals or charitable institutions not operated for profit." MINN. STAT. ANN. § 151.061(i) (West 1998). By contrast, Maine limits its analogous exception to charitable organizations that are "exempt from federal income taxation because [they] meet[] the requirements of the United States Internal Revenue Code, Section 501(c)(3) . . . ." ME. REV. STAT. ANN. tit. 32, §

Recently, the stakes have been raised when the Nonprofit Institutions Act exemption to illegal price discrimination is at issue. Some drug manufacturers, seeking to design price-favored distribution channels, have required price-favored purchasers to sign "own use" clauses by which the purchasers impliedly agree not to resell pharmaceutical products to buyers in price-disfavored channels of distribution, a practice known as "diversion." Some price-favored purchasers who have disregarded these contractual restrictions have been charged with criminal violations of federal mail and wire fraud statutes.[30] The legality of the "own use" contractual restrictions, and the propriety of enforcing those restrictions in civil or criminal actions, depend upon a correct understanding of the exemption provided by the Nonprofit Institutions Act.

The discussion continues, in Part II, by briefly describing the practice of price discrimination used by some drug companies when they sell pharmaceutical products.[31] While suppliers in other indus-

13804(4) (West 1999).

30. *See* United States v. Costanzo, 4 F.3d 658, 660 (8th Cir. 1993) ("Central to the charges was the claim that defendants defrauded drug manufacturers by obtaining pharmaceuticals at highly discounted prices by falsely representing that the pharmaceuticals would be used solely by nursing home patients, although defendants intended all the while to divert the drugs to wholesalers in violation of the own-use restrictions."); United States v. Stewart, 872 F.2d 957, 958 (10th Cir. 1989) ("According to the superseding indictment, the defendant devised a scheme to obtain pharmaceuticals from drug manufacturers at reduced prices by representing that the drugs were being purchased for use in hospitals, when in fact the defendant intended to sell the drugs to various wholesalers."); United States v. Ferro, No. 99-00180-0104-CR-W-SOW, 2000 WL 33394614, at *4 (W.D. Mo. May 8, 2000) (order dismissing indictment) [hereinafter *Ferro I*] ("The charges against the defendants in this case stem from an underlying premise that defendants defrauded pharmaceutical manufacturers by signing contracts containing 'own use' clauses in which they represented that the discounted pharmaceutical products would be dispensed only for nursing home patients and then selling those products to commercial wholesalers."), *rev'd*, 252 F.3d 964 (8th Cir. 2001) [hereinafter *Ferro II*], *cert. denied*, 2002 US LEXIS 279 (U.S. Jan. 7, 2002); United States v. Almanza, No. 98-CR-55S, ¶ 10, at 4–5 (D. Colo. Feb. 12, 1998) (alleging that defendants purchased pharmaceutical products at "greatly reduced prices by falsely representing that . . . the purchasing pharmacies serviced institutions such as nursing homes" but then sold those products "to pharmaceutical wholesalers for profit"); *see also* United States v. Weinstein, 762 F.2d 1522 (1985) (involving RICO and mail fraud allegations where pharmaceutical products were diverted from the export market into the domestic market).

31. Because this article uses examples from the pharmaceutical industry, the article has implications for the ongoing public policy debate surrounding prescription drugs. The article is not intended to spawn implications that go beyond price discrimination issues that arise under the Robinson-Patman Act and the Nonprofit Institutions Act. For example, the article is not concerned with issues that may arise under regulations of the wholesale distribution of drugs authorized by the Prescription Drug Marketing Act of 1987, 21 U.S.C. § 353(e) (1994). *See*

tries have engaged in price discrimination and sought the benefits of the Nonprofit Institutions Act exemption,[32] the pharmaceutical industry provides a useful background for the discussion of the exemption's statutory requirements in Part III.[33] Part IV addresses two additional concerns not anticipated by the language of the Nonprofit Institutions Act. The article concludes in Part V by discussing implications, not only for those who design distribution systems under the Nonprofit Institutions Act, but also for those who ask the courts to enforce those distribution systems.

generally Melody Petersen, *When Good Drugs Go Gray: Booming Underground Market Raises Safety Concerns*, N.Y. TIMES, Dec. 14, 2000, at C1. This article is not concerned with the issues relating to whether the overall profit margins of pharmaceutical companies are sufficient both to pay for the fixed costs of research and development and to provide adequate incentives for further research and development. *See* KOLASSA, *supra* note 16, at 21–22 (noting that public policy debates surrounding pharmaceutical prices most often focus upon industry's claim of "need to generate research funding"); Scherer, *Pharmaceutical Industry*, *supra* note 13, at 97 (discussing issues in pricing, profit margins, and research and development). This article is not concerned with the extent to which patent protection permits discriminatory pricing by the patentee. *See* Peter Zweifel, *Comment on: F.M. Scherer, "How US Antitrust Can Go Astray: The Brand Name Prescription Drug Litigation"*, 4 INT'L J. ECON. BUS. 277 (1997) (suggesting benefits of price discrimination by patentee drug manufacturer and that organizational innovations should be treated the same). Nor is this article concerned with special price discrimination laws or other price regulations that are directed solely to the pharmaceutical industry. *See* ABA ANTITRUST SECTION, ROBINSON-PATMAN ACT COMMITTEE, DRUG PRICE DISCRIMINATION LAWS AND THE ROBINSON-PATMAN ACT 17–26 (1996) (federal proposals and state enactments) [hereinafter ABA ANTITRUST SECTION COMMITTEE REPORT]. For an economic study of a range of issues in the pharmaceutical industry, see SCHERER, INDUSTRY STRUCTURE, *supra* note 13, at 336–90.

32. *See* Logan Lanes, Inc. v. Brunswick Corp., 378 F.2d 212 (9th Cir. 1967) (bowling alley equipment); Students Book Co. v. Wash. Law Book Co., 232 F.2d 49 (D.C. Cir. 1955) (academic books); Bridges v. MacLean-Stevens Studios, Inc., 35 F. Supp. 2d 20 (D. Me. 1998) (school portrait photography); Lago & Sons Dairy, Inc. v. H.P. Hood, Inc., No. 92-200-SD, 1994 U.S. Dist. LEXIS 12909 (D.N.H. Sept. 6, 1994) (milk); Computronics, Inc., v. Apple Computer, Inc., 600 F. Supp. 809 (W.D. Wis. 1985) (personal computers).

33. The pharmaceutical industry provides a unique background to the extent that, in addition to antitrust policy, there are other federal and state policies that come into play when examining pricing issues in the pharmaceutical industry, especially issues pertaining to prescription drugs. *See generally* ROY LEVY, FEDERAL TRADE COMMISSION, THE PHARMACEUTICAL INDUSTRY: A DISCUSSION OF COMPETITIVE AND ANTITRUST ISSUES IN AN ENVIRONMENT OF CHANGE 9–24 (1999) (reviewing other federal and state policies); ABA ANTITRUST SECTION COMMITTEE REPORT, *supra* note 31 (review of other federal and state efforts to regulate price discrimination in the pharmaceutical industry); SCHERER, INDUSTRY STRUCTURE, *supra* note 13, at 82–83 (discussing state and federal laws affecting substitution of generic for branded drugs).

II. PRICE DISCRIMINATION IN THE PHARMACEUTICAL INDUSTRY

In the pharmaceutical industry, two basic types of distribution channels have developed in the domestic market for pharmaceutical products.[34] One channel is for drugs sold to health care institutions for use solely by patients in that institution. This channel oftentimes is called a "closed door" distribution channel perhaps because, once the drugs are inside the institution, the institution's doors are closed, and the drugs may not be sold in competition with retail outlets or

34. The distinction in the text segregates channels of distribution into two groups depending upon price differences. Within each group, however, there may be a variety of ways to structure a channel of distribution. For an overview of the various entities that may participate in a channel of distribution, see ABA ANTITRUST SECTION COMMITTEE REPORT, *supra* note 31, at 5–7. Another and distinct channel of distribution is for pharmaceutical products destined for export. Here, drug manufacturers may engage in price discrimination because the Robinson-Patman Act, by its own terms, does not apply to commodities destined for export. *See* 15 U.S.C. § 13(a) (1994) (limiting coverage to sales in which "such commodities are sold for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States"); *see also* United States v. Weinstein, 762 F.2d 1522, 1527 (11th Cir. 1985) ("By its terms, the [Robinson-Patman] Act does not cover sales of goods for export."). Thus, the Robinson-Patman Act is not offended if a United States drug manufacturer charges a lower price for pharmaceutical products that will be exported. For example, in a case where a seller located in the United States sold at a lower price to a buyer also located in the United States, the court held "that if all the sales by Barmatic to Fimex were for resale abroad, the Robinson-Patman Act does not apply regardless of the location of the plaintiff or the defendant." Fimex Corp. v. Barmatic Prods. Co., 429 F. Supp. 978, 980 (E.D.N.Y. 1977), *aff'd*, 573 F.2d 1289 (2d Cir. 1977).

Reports in the popular press indicate that drug manufacturers grant significant price favors on pharmaceutical products destined for export. *See generally* Lynette S. Pisone, Comment, *The Political Debate Concerning Discriminating Pricing Practices Within Health Care Reform*, 4 J. PHARM. & L. 63, 73–74 (1994) (noting that although "[d]rug manufacturers often come under fire concerning the differentials between the prescription drugs prices of the United States and those lower prices offered in other countries," evidence suggests that any price differences turn upon the particular drug and whether the country is industrialized or developing); Scherer, *Pharmaceutical Industry*, *supra* note 13, at 111–12 & 111 n.18 (arguing that while lower prices in less developed countries may be due to weaker patent protection, "there are hints that demand is more income-elastic in less developed nations and less elastic in the more prosperous nations"); SCHERER, INDUSTRY STRUCTURE, *supra* note 13, at 385 ("comparisons showing that identical branded drugs cost much more in the United States than in many foreign nations"). When this happens, a price-favored purchaser who obtains pharmaceutical products for export might also engage in diversion and sell to domestic buyers who otherwise would pay a higher price. At least one group of price-favored purchasers who obtained pharmaceutical products for export but diverted those products have also been convicted of criminal violations of federal mail and wire fraud statutes. *Weinstein*, 762 F.2d at 1527.

For a brief overview of the history of retailing in the pharmaceutical industry, see Scherer, *Prescription Drug Litigation*, *supra* note 7, at 240–46.

to customers who are not patients of the institution.[35] The other channel of distribution is for drugs that are sold to retail outlets without any restriction on resale. This channel oftentimes is called an "open door" distribution channel perhaps because, once the drugs are sold to the retail outlet, the outlet's doors are open, and the drugs may be resold in competition with retail outlets and without regard to where customers might be patients.[36]

A. Two-Tiered Pricing

Drug manufacturers typically charge different prices for the same pharmaceutical product depending upon the channel of distribution.[37] The "closed door" channel is the price-favored channel be-

35. *Ferro I*, 2000 WL 33394614, at *2 ("One channel of distribution is called a 'closed door' channel because once the purchaser receives the pharmaceutical products, its doors are closed to any sale in competition with the manufacturer. . . . An example of a 'closed door' channel would be a pharmacy in a not-for-profit hospital where the pharmacy only dispenses drugs to people who are patients in the hospital and would not sell them to walk-in customers or others; their doors are closed to any customers who might come in from the outside.") (citations to record omitted).

36. *See id.* at *2 ("The other channel of distribution is the 'open door' channel. In this channel, once the purchaser receives the pharmaceutical products, its doors are open to any customer who may walk in. . . . An example of an 'open door' channel would be a retail pharmacy.") (citations to record omitted).

37. "A notable example of differential pricing is the so-called 'two-tiered pricing structure' under which pharmaceutical companies set lower prices to large buyers like hospitals, HMOs and PBMs, and charge higher prices to other buyers that include the uninsured and independent and chain retail pharmacies." LEVY, *supra* note 33, at 75 (footnotes omitted); *see also* Jeffrey L. Harrison, *The Brand Name Prescription Drug Litigation: Comments on Scherer*, 4 INT'L J. ECON. BUS. 265, 266 (1997) (stating that in a recent case, "testimony by individuals associated with the [drug] manufacturers [was] that a two-tiered pricing system was viewed by those in the industry as 'the appropriate practice'").

Two-tiered pricing in the pharmaceutical industry has persisted for some time. *See* ABA ANTITRUST SECTION COMMITTEE REPORT, *supra* note 31, at 17 n.47 (citing *Small Business Problems in the Drug Industry: Hearings before the Subcomm. on Regulatory Agencies*, 90th Cong. 197 (1967) and H.R. No. 1983, 90th Cong. 79 (1968) (concluding that price discrimination existed against retail druggists)). There are, of course, other ways to characterize the ways that the pharmaceutical industry discriminates in price: "[T]here are, in fact, several pharmaceutical markets, each with its own set of prices and pricing methods. There are retail, hospital, and managed care markets; branded and generic markets; and chronic and acute markets. Each is approached somewhat differently." KOLASSA, *supra* note 16, at 29–30; *see also Weinstein*, 762 F.2d at 1527 (price differences also distinguish the export from the domestic channels of distribution: "[P]harmaceutical manufacturers maintain a bifurcated pricing structure. . . . A much lower price is quoted for sales to exporters . . . ."). There are a variety of ways that drug manufacturers effectively charge different prices. For example, there are "prescription drug rebate programs for HMO and PBM organizations, and special prices for Medicaid recipients." LEVY, *supra* note 33, at 75.

cause drug manufacturers charge lower prices to purchasers in the "closed door" channel.[38] The "open door" channel is the price-disfavored channel because drug manufacturers charge higher prices to purchasers in the "open door" channel.[39]

At times, the different prices diverge to such a degree that the difference does not appear to be based upon different costs of production, distribution, or marketing.[40] For example, one case noted that purchasers in the "closed door" channel pay as little as twenty-five percent of the price charged to purchasers in the "open door" channel.[41] More recently, the popular press has increasingly reported

Another mechanism for drug companies to charge different prices is by way of forward vertical integration when acquiring pharmacy benefit management (PBM) services which administer prescription drug delivery for health insurance programs. *See* LEVY, *supra* note 33, at 3, 34–36 (March 1999) (discussing vertical integration into PBM market). This presents the possibility for a drug manufacturer to charge a lower, internal price to its wholly owned PBM than the drug manufacturer charges purchasers in the "open door" distribution channel. *See also id.* at 45 n.107 ("Mail order pharmacies, particularly the pharmacies under the control of PBMs, continue to expand in competition with chain and independent retail pharmacies.") PBMs and other health care organizations, however, have integrated information technology and, consequently, achieved efficiencies. *See id.* at 43–71. This mechanism might still raise price discrimination concerns because, under the Robinson-Patman Act, a sale by a controlled or owned subsidiary may be treated as a sale by the corporate parent. ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 441 & n.76 (4th ed. 1997) [hereinafter ANTITRUST LAW DEVELOPMENTS] ("[F]ailure to treat a parent and its subsidiary as the 'same seller' might enable firms to evade the Robinson-Patman Act by the simple device of selling to the disfavored customers through a subsidiary.") (citing Caribe BMW, Inc. v. BMW, 19 F.3d 745, 750 (1st Cir. 1994)).

38. *Ferro I*, 2000 WL 33394614, at *2 ("Manufacturers sell at a low price in the 'closed door' channel.").

39. *See id.* ("Manufacturers sell their pharmaceutical products at a higher price in the 'open door' channel."). In addition, within each of the two general types of distribution channels discussed in the text, there may be further price differences. *See* Pisone, *supra* note 34, at 78 ("Those opposed to the manufacturers' pricing techniques have taken their stance and they do not intend to stop until one manufacturer is no longer able to justify sending out the same product, on the same day, with eight to sixteen different prices under the guise of cost-savings, classification, or economies of sale.") (footnote omitted); Weinstein & Culbertson, *supra* note 10, at 258 (summarizing judicial findings regarding tiered pricing system in which retail pharmacies were price-disfavored).

40. *See also* KOLASSA, *supra* note 16, at 2–3 ("Legislation and litigation have forced [pharmaceutical] companies to reconsider the [market] segments they had previously identified, but few have done more than simply reclassify groups into new segments and establish arbitrary guidelines for discounting within each segment.").

41. United States v. Costanzo, 4 F.3d 658, 659 (8th Cir. 1993) ("[D]rug manufacturers sell pharmaceuticals to institutional ["closed door"] pharmacies at prices that may be as low as twenty-five percent of the prices at which the companies sell drugs to other ["open door"] customers.") Similarly, one study noted "[t]he common practice whereby the community retail pharmacy ["open door" channel] pays prices thirty to ninety percent higher than hospitals,

on the dramatic differences in the prices of pharmaceutical products sold by retail outlets in the United States and the same products from the same manufacturers sold in other contexts. In these contexts as well, the dramatic differences in price do not appear based upon different costs of production, distribution, or marketing.[42] As the Supreme Court noted some time ago in an analogous context, "The [House] Subcommittee found that the difference between drug prices for retailers and government customers 'is extremely substantial' and 'not always fully explainable by either cost justifiable quantity discounts, economies of scale, or other factors inherent in bulk distribution.'"[43]

There are several reasons why drug manufacturers might charge different prices to different purchasers.[44] Recent trends in the health care industry have created large, institutional purchasers.[45] Drug

clinics, HMO's, mail-order pharmacies and other large purchasers for the same quantity of the same product." Pisone, *supra* note 34, at 82 (footnote omitted). The same study, at another point, noted that, "Prucare, a buying group for hospital pharmacies, on average paid prices fifty-nine percent lower than wholesale prices made available to community retail pharmacies ["open door" channel] for the exact same product. 'One-fifth of the prescription drugs were priced at 82 percent or more below the average community retail wholesale price.'" *Id.* at 89 (quoting Press Release, Newswire Ass'n, Inc., Drug Makers Asked by Retail Pharmacy Coalition to Support Effort to End Discriminatory Prices (Aug. 11, 1993)).

42. One study, for example, spoke in terms of "the *excessive* discounts afforded to the HMO's, hospitals, etc." Pisone, *supra* note 34, at 73 (emphasis added).

43. Jefferson County Pharm. Ass'n v. Abbott Labs., 460 U.S. 150, 165 (1983) (quoting H.R. REP. NO. 90-1983, at 77 (1968)).

44. Regardless of the particular strategy that drives the reason for price differentials, the bottom line is that, by charging different prices to different customers, pharmaceutical manufacturers can increase profits. *See* Pisone, *supra* note 34, at 65 ("Discriminatory pricing practices, or cost shifting, has made drug manufacturing one of the most lucrative businesses in the marketplace.").

45. "The number of health maintenance organizations (HMOs) in the U.S. increased from 235 in 1980 to 749 in 1996, and enrollment in these cost-containment organizations expanded from 9,100,000 to 77,300,000 over the same period. Pharmacy benefit managers (PBMs), which administer prescription drug delivery under health insurance plans, managed the drug benefits of some 161 million people according to a 1998 report, up from 60 million in 1989. Both HMOs and PBMs utilize a variety of techniques made possible by the advances in information technology to contain the costs of prescription drugs, including drug formularies, generic substitution, and therapeutic interchange programs." LEVY, *supra* note 33, at 3–4 (footnotes omitted); *see also id.* at 25–27 (discussing growth of managed care organizations and their cost containment initiatives); Scherer, *Pharmaceutical Industry*, *supra* note 13, at 98–99 ("Third-party reimbursement plans operated by the government and private insurers have expanded to cover an estimated 44 percent of prescription drug outlays in 1987, up from 28 percent in 1977.") (citation omitted); Harrison, *supra* note 37, at 266 ("Structural changes on the buying side of the market occurred throughout the 1970s and 1980s. These changes meant that manufacturers were faced with buyers possessing significant buying or monopsony

manufacturers may provide price discounts to large, institutional purchasers simply because of the bargaining power of large, institutional purchasers.[46] Or, drug manufacturers may provide price favors

power.")

By way of comparison, a reason cited as to why prescription drug prices in some foreign countries are lower than those sold by competitive retail outlets in the United States is that some foreign governments act as institutional purchasers for their nationalized health care systems. Scherer, *Pharmaceutical Industry*, *supra* note 13, at 108–09 ("Many nations with extensive governmental health care programs bring their substantial purchasing power to bear on the prices . . . effect[ively] forcing the drug-makers to price-discriminate across geographic markets."). Seeking to gain a like advantage for its citizens who live just across the border from Canada, Maine recently announced that it was exploring the possibility of becoming an institutional buyer of prescription drugs. *Id.* at 110 (discussing price effects Canadian compulsory licensing of drug patents); SCHERER, INDUSTRY STRUCTURE, *supra* note 13, at 380–82 (1996) (discussing price effects of Canadian compulsory licensing and of requirements to substitute generic drugs). For a discussion of the economic forces that, in the 1980s, led large, institutional purchasers to control the rising costs of pharmaceuticals through restrictive formularies, drug utilization reviews, and service substitution, see KOLASSA, *supra* note 16, at 13–19.

46. As one noted economist has summarized: "[D]uring the 1980s new health care organizations in the United States began exercising countervailing power to wrest appreciable price discounts from the producers of patented and branded drug products. Lacking equivalent power and perhaps also, at least at first, the incentive to change their formulaic price-setting, retail pharmacists were unable to elicit matching discounts." Scherer, *Prescription Drug Litigation*, *supra* note 7, at 239; *see also* ABA ANTITRUST SECTION COMMITTEE REPORT, *supra* note 31, at 8–9 ("According to one estimate, the number of Americans covered by managed pharmacy benefit programs more than doubled from about 57 million in 1989 to 115 million in 1994. As of April 1993, more than 50% of prescription drug sales were influenced in some way by managed care programs.") (footnotes omitted); *id.* at 12 ("For example, health plans and PBMs [pharmaceutical benefit managers] motivated by cost-containment objectives have insisted that manufacturers reduce prices to compete for patients covered by these plans. Many manufacturers have offered health plans, PBMs, and hospitals rebates or discounts based on the volume of prescriptions written for that manufacturer's drugs or the volume of that manufacturer's drugs sold through the formulary. In other cases, rebates or discounts are conditioned on a certain product (or products) being included on a formulary, in some cases, as the exclusive drugs(s) in particular therapeutic classes.") (footnotes omitted); Weinstein & Culbertson, *supra* note 10, at 261 (managed care organizations demand discounts for drugs to be included in formulary).

One study has noted that the pharmaceutical companies object to price controls because, in a competitive environment of negotiations with individual institutions, "the industry will have to vie for prized business opportunities such as HMO's and hospitals." Pisone, *supra* note 34, at 72. The clear implication is that, through these individual negotiations for large accounts, drug manufacturers will grant price favors to obtain contracts with large, institutional purchasers.

The preface to a recent study notes that one of the "major changes" that "sent a shock" to the "pricing environment" of pharmaceuticals was "the emergence of managed care and hospital buying groups [that] gave rise to new concerns about price sensitivity." KOLASSA, *supra* note 16, at *xi*. One result, noted in the same study, is that, after lowering prices on new products, "[n]ational account groups then set to work discounting from these already lower

for marketing reasons.[47] One case suggested, for example, that drug manufacturers charged lower prices to institutional purchasers to obtain brand loyalty by introducing doctors and patients to a branded pharmaceutical product in a low-price, institutional setting with the hopes that the same doctors and patients will continue to prescribe and purchase the same brand in a high-price, non-institutional setting.[48] Both of these reasons might explain why drug manufacturers

prices." *Id.* The same study later critiques, from a profit-maximizing perspective, the practice of granting discounts to "managed care and other buyers perceived to be large and influential." *Id.* at 8; *see also* Pisone, *supra* note 34, at 67 ("[M]ail order houses and the like are purchasing pharmaceuticals at unbelievably low prices while the retail pharmacy pays increasingly higher prices. . . . [O]rganizations such as hospitals, nursing homes, HMO's and the mail order houses . . . have imperiled the prosperity of the retail pharmacy . . . . ") (footnotes omitted).

One result is that retail pharmacies have started to combine into purchasing groups in order to obtain the bargaining power of large institutions. *Id.* at 88–89. For additional indications that large, institutional buyers receive price favors, see *Costanzo*, 4 F.3d at 659 ("One reason that drug manufacturers offer institutional pharmacies low prices is that manufacturers recognize that the amount that insurance companies and the government, which pay for many of the patients in institutions, will reimburse for pharmaceuticals is relatively low."); Scherer, *Pharmaceutical Industry*, *supra* note 13, at 106–08 (discussing federal statutory and other efforts to obtain discounts and suppressed prices); *see also* SCHERER, INDUSTRY STRUCTURE, *supra* note 13, at 378–79 (1996) ("Erosion [of branded drugs' prices] was greater for drugs with particularly high sales to hospitals, which avidly embrace cost-saving opportunities through generic purchases, and for the subset of drugs taken by injection, whose use is preponderantly within hospitals."); *id.* at 385–86 (describing rebate and lost containment requirements for drug manufacturers to keep branded drugs eligible for federally supported cost reimbursements). Of course, price favors to the government are exempted from the Robinson-Patman Act by virtue of the so-called government entity exemption. *See supra* note 19.

47. A recent study identified many business rationales that might lead drug manufacturers to discriminate in price, including profit maximization by selling at different prices to customers with different elasticities of demand, FTC STUDY, *supra* note 33, at 74, 82–83; price discounts to encourage prescribing physicians to switch from one brand to another, *id.* at 80; price discounts to help introduce new drugs, *id.* at 84; price discounts to discourage health care providers to substitute different therapeutic alternatives, *id.* at 91–92; and price discounts to provide discounts as payment for services, *id.* at 90–91. The study also quotes from a judicial opinion which suggests that a pharmaceutical seller may have been offered price discounts to institutional purchasers so that the seller would not be foreclosed from physicians who can only prescribe prescription drugs purchased by the institution. *See id.* at 90 (quoting *In re* Brand Name Prescription Drugs Antitrust Litig., No. 94 C 897, MDL 997, 1996 U.S. Dist. LEXIS 4335 (N.D. Ill. Apr. 4, 1996)); *see also In re* Brand Name Prescription Drugs Antitrust Litig., 186 F.3d 781, 783 (7th Cir. 1999) ("A wholesaler is compensated for the warehousing and other functions that he performs in the distribution of his drugs through the difference between the price that he pays his supplier and the price at which he resells to retailers.").

48. *Costanzo*, 4 F.3d at 659 ("[D]rug manufacturers [who offer institutional pharmacies low prices] want doctors in institutions to be able to prescribe the manufacturer's drugs, since this increases the chances that the doctors will prescribe the same drugs to patients the doctor sees in other contexts. . . . [The] manufacturers [also] hope that patients who are

charge lower prices to institutional purchasers in the "closed door" channel while charging higher prices to purchasers in the "open door" channel.[49]

Another reason why drug manufacturers might charge different prices for prescription drugs is because of different demand characteristics associated with the purchasers typically found in each channel of distribution.[50] If this theory explains the practice, purchasers in the "closed door" channel have a relatively elastic demand for drugs, that is, they are relatively price sensitive.[51] These purchasers will not and, perhaps, cannot purchase drugs at higher prices. A typical purchaser in the "closed door" channel would be a not-for-profit insti-

treated with a certain drug in an institutional setting will continue to use that particular medication after they are released from the institution.") One study suggests that this marketing strategy is successful because "the physician is not always aware of the existence of the generic substitution" and, consequently, may write a prescription in a way that prohibits the pharmacist from providing anything other than the branded product. Pisone, *supra* note 34, at 87–88 (noting difference, in 1992, of $57.36 for branded Inderoll and $1.84 for generic equivalent); *see also* Scherer, *Pharmaceutical Industry*, *supra* note 13, at 98 ("The menu of drugs is so vast and complex that few physicians can inform themselves fully about the available alternatives."); SCHERER, INDUSTRY STRUCTURE, *supra* note 13, at 373 (after physician prescription and pharmacist substitution, "generic substitution occurred in at most 25 percent of the cases for which it is feasible"). For a critique, from a view favoring profit-maximizing for drug companies, of using price discounts to introduce a new pharmaceutical product, see KOLASSA, *supra* note 16, at 2–7.

Another point to make in this regard is that, where a brand-name prescription drug enjoys patent protection, after patent protection ends the drug manufacturer may enjoy a first-mover advantage in the form of a lingering brand preference over generic alternatives. *See* Scherer, *Pharmaceutical Industry*, *supra* note 13, at 100 (discussing "reputational advantage enjoyed by the original [patented] drug"). Of course, a first-mover or reputational advantage can be exploited in ways that do not require price discrimination. *See also* SCHERER, INDUSTRY STRUCTURE, *supra* note 13, at 371–72 (evidence that first-mover advantage allows pharmaceutical innovator to maintain high prices after low-price generics introduced).

49. Another case has suggested that "in many instances pharmaceutical manufacturers used nonprofit and export organizations as a 'dumping-ground' for pharmaceutical products nearing expiration." United States v. Weinstein, 762 F.2d 1522, 1527 (11th Cir. 1985). While this might identify an added benefit for an established, lower-priced channel of distribution, it does not provide a complete explanation for the original decision to establish a lower-priced channel of distribution.

50. *See* KOLASSA, *supra* note 16, at 2–3 (noting that, although different market segments have different degrees of price sensitivity, "too much attention has been paid to intermediaries in the distributive process that have wrongly been classified as market segments"); Scherer, *Pharmaceutical Industry*, *supra* note 13, at 101 ("[I]t is not too extreme an oversimplification to suppose that when generic substitutes exist, the world of drug buyers consists of two quite different groups—those who are price-sensitive and those who are not.").

51. *See* MARK SEIDENFELD, MICROECONOMIC PREDICATES TO LAW AND ECONOMICS 15 (1996) ("A good for which a small percentage change in price causes a large percentage change in quantity demanded is called 'elastic.'").

tution that cannot pass costs through to the consuming patient and, therefore, operates at the lowest cost possible.[52] By contrast, purchasers in the "closed door" channel have a relatively inelastic demand for drugs, that is, they are relatively price insensitive.[53] These purchasers can and will purchase drugs at higher prices provided, of course, that they can pass the increased costs through to their customers.[54] A typical purchaser in the "open door" channel would be a retail pharmacy that is a for-profit business that passes its costs through to the consuming patient and seeks to maximize profits subject, of course, to the constraints of competition.[55]

If different prices are based upon different demand characteristics, an important point is that the price discrimination strategy is actually based upon the demand characteristics of the ultimate consumers, the patients.[56] The initial purchasers are the pharmacies or

52. The fact that there are other kinds of institutional purchasers who routinely receive price favors from drug manufacturers suggests that this is not the theory followed by drug manufacturers when selecting purchasers who receive price discounts. *See* LEVY, *supra* note 33, at 74 ("Drug companies have also offered larger discounts to hospitals and other managed care providers."). Of course, not all hospitals and managed care providers are operated not for profit.

53. *See* SEIDENFELD, *supra* note 51, at 15 ("A good for which a large percentage change in price causes only a small percentage change in quantity demanded is called 'inelastic.'").

54. A recent study provided some reasons why some patients who purchase in the "open door" channel of distribution pay more for prescription drugs: "The economic literature suggests that physicians do not necessarily act in the best interest of consumers when making cost effective drug choices. Physicians face information processing limitations that impede their ability to choose efficiently among available treatment options. Further . . . third-party insurance without adequate cost controls makes consumers and others less likely to contain their prescription drug expenditures." LEVY, *supra* note 33, at 57 (footnote omitted).

55. Of course, there may be intermediaries such as wholesalers and distributors, but where these intermediaries are also for-profit organizations, they will not only pass their costs on to their purchasers, but also compete with each other with a view to garnering increased profits from retail druggists. For a description and chart which shows the potential complexity of the arrangements that may be used when prescription drugs are purchased at a retail outlet in conjunction with a benefits program, see LEVY, *supra* note 33, at 45–47.

56. One might argue that, because many health care purchasing decisions are made by health care institutions, the demand characteristics of patients are less important. *See* KOLASSA, *supra* note 16, at 23 ("Although the concept of willingness [of patients] to pay is compelling, we must admit that, because of the distortions in our health care system due to differences in payment sources for health care and the lack of direct decision-making authority for patients, such measures may not only be impracticable but also misleading.") Nonetheless, patients ultimately pay for health care and pharmaceuticals, whether through insurance premiums paid directly or through wage reductions so that employers purchase insurance on employees' behalf. Consequently, at some point, the demand characteristics of patients come into play. *See also id.* at 25 ("Differences in reimbursement status dramatically alter the levels of price sensi-

other institutions that, in turn, resell or provide pharmaceutical products to the ultimate purchasers, the consuming patients. The demand characteristics of the initial purchasers are derived from the demand characteristics of their consuming patients.[57] Initial purchasers in the "closed door" channel do not pay higher prices because they cannot pass along higher prices to patients who have a relatively elastic demand and are relatively price sensitive. By contrast, initial purchasers in the "open door" channel do pay higher prices because they can pass along higher prices to patients who have a relatively inelastic demand and are relatively price insensitive. If this is the theory, the price discrimination strategy is based, not so much upon assigning purchasing institutions to one distribution channel or another, but rather upon segregating purchasing institutions according to the different demand characteristics of the kinds of patients to whom those institutions resell or provide pharmaceutical products.[58]

If drug manufacturers charge different prices because of the different demand characteristics of different kinds of consuming patients, the manufacturers will increase profits and, at the same time, increase consumer welfare by expanding output.[59] Consumers with different demand characteristics who are asked to pay different prices will react differently in terms of the quantity of goods that they pur-

tivity and the economic effects of a [pharmaceutical] product.").

57. *See* 1 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 813 (1987) ("[D]emand for intermediate goods is *derived* from the demand for the final goods they help produce.").

58. This point may not be fully appreciated by the pharmaceutical industry. A recent study noted, from a perspective favoring profit-maximizing for drug companies, that, while market segments exhibit different degrees of price sensitivity, "intermediaries . . . have wrongly been classified as market segments." KOLASSA, *supra* note 16, at 2–3. Perhaps this shortcoming derives from perception that pharmaceutical consumers are less involved in purchasing decisions than typical consumers. *See id.* at 22 ("[M]ost pharmaceutical purchases are directed purchases and . . . few patients can correctly be considered well-informed consumers.").

59. *See generally* BORK, *supra* note 9, at 394–98. Interestingly, this point was made in the context of the pharmaceutical industry by noting the impact when the government legislated access to the best prices and thereby disrupted the price discrimination strategy of drug manufacturers by apparently leading those manufacturers to raise the price of their discounted products:

> The Omnibus Budget Reconciliation Act of 1990 (OBRA 90) effectively penalized companies for providing discounts. The government's attempt to share in those discounts had the effect of changing the economics of discounting, reducing the value of many customers when Medicaid rebates were calculated. The net result was the significant reduction of discounting activities in the pharmaceutical market, which reduced the revenue expected to be generated by the rebates.

KOLASSA, *supra* note 16, at 26 (footnote omitted).

chase. The twin antitrust goals of consumer welfare and output maximization are advanced where those who pay higher prices have a relatively inelastic demand and, consequently, are relatively price insensitive. By definition, consumers with a relatively inelastic demand and price insensitivity will not significantly change the quantity of goods that they purchase if they pay higher prices. They will purchase roughly the same amount even if price increases. Those who pay lower prices should have a relatively elastic demand and, consequently, greater price sensitivity. By definition, consumers with a relatively elastic demand and price sensitivity will significantly increase the quantity of goods that they purchase if they pay lower prices. They will purchase a significant amount more if price decreases. If drug manufacturers engage in a strategy of price discrimination based upon different demand characteristics, these manufacturers increase quantity and maximize profits by charging a higher price to inelastic and price insensitive purchasers in the "open door" channel while charging a lower price to elastic and price sensitive purchasers in the "closed door" channel. The price insensitive purchasers will continue to purchase roughly the same amount at a higher price, while the price sensitive purchasers will now purchase more at a lower price.[60]

By contrast, while the other proffered reasons for charging different prices may lead to increased profits, there is no assurance that those reasons for charging different prices will increase consumer welfare by expanding output. The fact that a large, institutional pur-

60. Robert Bork succinctly explains,

> The basic theory of price discrimination is quite simple. A monopolist faces a sloping demand curve. The market demand, however, is likely to be a composite of widely differing demands of individual customers. Such demands are said to be relatively elastic if price changes result in relatively large changes in the amount of the product demanded, and relatively inelastic if price changes produce smaller effects on amounts demanded. A monopolist who is moderately thoughtful about his self-interest will realize that he could increase net revenues if he could segregate his customers according to the elasticities of their demands. The reason is obvious. When the demand elasticities of customers are different, no single price can extract the maximum return from each. If they can be segregated so one class of customers cannot resell to the other, the monopolist can charge them different prices and so extract the maximum return from each class.

BORK, *supra* note 9, at 396–97; *see also* Kenneth G. Elzinga & David E. Mills, *The Distribution and Pricing of Prescription Drugs*, 4 INT'L J. ECON. BUS. 287, 292 (1997) (describing price discrimination in same terms and noting that welfare effects are "an 'extremely complex' matter" (quoting Scherer, *Prescription Drug Litigation*, *supra* note 7, at 253)).

chaser has bargaining power does not necessarily imply that the large, institutional purchaser sells to consumers who have relatively elastic demand characteristics and therefore are relatively price sensitive. In fact, where a large, institutional purchaser operates for profit and seeks to maximize profits by, inter alia, raising the price at which it resells pharmaceutical products, the implication would seem to be that, to generate those profits, consuming patients have relatively inelastic demand characteristics and are relatively price insensitive.[61] If different prices are used as a marketing device to gain brand loyalty that transfers from one context to another, any consumer welfare justification seems implausible. Consumers who initially pay a low price in an institutional context do not change their demand characteristics simply because those same consumers subsequently find themselves in a non-institutional setting and, for that reason, pay a higher price. Both proffered reasons fall short of assuring an increase in consumer welfare because a consumer welfare justification turns, not upon whether a lower price is charged to institutions, but rather upon whether a lower price is charged to those kinds of institutions that resell to consumers with relatively elastic demand characteristics.

B. Arbitrage and "Own Use" Clauses

Crucial to any system of price discrimination, whether aimed at increasing consumer welfare or not, is the need to prevent arbitrage, a practice also known as diversion. This is the practice by which a purchaser who buys at the lower price is able to resell or divert to those who are willing to pay a higher price.[62] The reseller who en-

61. This point was made in a recent commentary about price discrimination in the pharmaceutical industry:

> A drug manufacturer does not separate its consumers into groups with predispositions for high or low demand elasticities as is done in the textbook model of monopolistic third-degree price discrimination. Rather, it is hospitals, HMOs, and PBMs who actually separate customers. Moreover, the separation achieved between consumers who qualify for low prices and those that do not has nothing to do with the underlying demand elasticities of the consumers themselves. Qualifying for low prices only has to do with who controls a consumer's pharmacy benefits.

Elzinga & Mills, *supra* note 60, at 292.

62. In economic terms, the need to prevent arbitrage arises because the competitive solution does not naturally result in separating equilibria in which consumers pay different prices for different product configurations. Such a result happens where there is little, if any, cross elasticity between the different product configurations. *See* DOUGLAS G. BAIRD, ET. AL., GAME THEORY AND THE LAW 154 (1994) (indicating that high-risk insureds purchase higher priced insurance policies). Consider, for example, two consumers who are purchasing vehicles.

gages in arbitrage will be successful whenever the reseller can cover costs and earn a profit while charging less than the supplier charges price-disfavored purchasers.[63] Those purchasers who were willing to pay a higher price to the supplier now pay, instead, a lower price to the reseller. If the supplier subsequently responds by competing with the reseller, price competition will cause a downward pressure on price until every purchaser, in both channels of distribution, pays the same, lower price. Thus, a supplier who pursues a price discrimination strategy must prevent arbitrage for the strategy to be successful in the marketplace.[64]

Consequently, suppliers who pursue a price discrimination strategy must design distribution systems that prevent arbitrage, or diversion, from the low-price distribution channel into the high-price distribution channel.[65] Contract provisions that prevent such arbitrage are integral to the success of the price discrimination strategy. For example, drug manufacturers may try to prevent arbitrage by inserting clauses into their contracts with purchasers that prevent purchasers from diverting, that is, selling outside of the lower priced, "closed door" channel and into the higher priced, "open door" channel.[66] A

One owns a horse ranch and needs a vehicle that can carry hay bales and other feed. This consumer purchases a pickup truck, a relatively lower priced vehicle. The other consumer enjoys driving on winding roads and also wants to make a fashion statement. This consumer purchases a foreign sports car, a relatively higher priced vehicle. Here, there is no need to prevent arbitrage, or diversion, because a purchaser of a pickup truck would not be able to resell that vehicle, even at a lower price, to the sports car enthusiast because the sports car enthusiast needs a different kind of vehicle. Because sports car consumers and pickup consumers prefer different kinds of vehicles, different prices can be charged without the concern of arbitrage.

63. One case has described this as "the so-called diversion market of the American pharmaceutical industry," United States v. Weinstein, 762 F.2d 1522, 1527 (11th Cir. 1985), albeit in a context that includes the diversion of lower-priced products destined for export into the higher-priced "open door" channel in the domestic market. *See id.* After noting that "[a] much lower price is quoted for sales to exporters and nonprofit organizations," the court explained, "[n]otably, resale under these circumstances is also at a significant advantage. Nonprofit and export organizations can, because of the low price at which they were able to obtain the products, undercut the domestic prices pharmaceutical manufacturers offer on their own goods. This is the diversion market. It is a significant source of supply for many discount pharmacies and hospitals throughout the nation." *Id.*

64. *See generally* BORK, *supra* note 9, at 394–98; *see also Weinstein*, 762 F.2d at 1527 ("Understandably, diversion is unpopular with pharmaceutical manufacturers.").

65. *See* Arnold C. Celnicker, *An Economic and Antitrust Analysis of the Distribution of Medical Products*, 16 AM. J.L. & MED. 499, 519–20 (1990) ("It is common for major medical products manufacturers to monitor and control resales so as to prevent arbitrage from unraveling the price discriminations.").

66. Efforts to prevent arbitrage may take other forms: "[A]lthough well-known U.S.

direct or explicit way to prevent arbitrage would be a clause that specifically identifies price-disfavored purchasers in the "open door" channel as those to whom the price-favored purchaser may not resell.

The "own use" clause mentioned in the introduction is a clause that prevents arbitrage, although an "own use" clause is an indirect and awkward way to do so. Consider, for example, the following contractual language which was quoted in one of the criminal cases cited above: "I [the price-favored, "closed door" purchaser] further certify that pharmaceuticals will be sold or dispensed only to members of this facility and only for the facility's 'own use' within the meaning of 15 USC 13C [sic] (52 Stat. 446)."[67] This language indirectly prohibits arbitrage because, under an "own use" clause, the purchaser expressly represents that it is purchasing drugs only for its "own use" which, in turn, impliedly represents that the purchaser is not purchasing drugs for the alternate use of engaging in arbitrage by reselling into another channel of distribution. Another "own use" clause that indirectly prohibits arbitrage in a similar manner is set forth in the margin.[68]

pharmaceutical houses frequently supply 'branded generic' copies of *competitors'* products whose patents have expired, they rarely offer generic versions of their own original drugs. The reason emphasized by industry executives . . . was fear of extensive arbitrage against the price-insensitive market." Scherer, *Pharmaceutical Industry*, *supra* note 13, at 101–02. The same author later provided an expanded explanation of this price discrimination strategy:

> In principle, this two-price approach is a standard exercise in price discrimination. However, it is not easily pulled off. To discriminate in price, a firm must be able to segregate its customers. The price-sensitive class includes particularly well-informed retail consumers, patients of health maintenance organizations with policies favoring generics, and most hospital pharmacies. Using a "generic" label and charging lower prices is a plausible means of segregating consumers by demand elasticity. Many branded drug companies, we have seen, have chosen to produce generic versions of *rival* firms' drugs. But they have been reluctant to offer generic versions of their own drugs because of the price discriminator's scourge: arbitrage. If high-price consumers become aware that the original brand producer is selling a low-price copy of its own drug, they may defect in droves from the high-price market to the low-price market.

SCHERER, INDUSTRY STRUCTURE, *supra* note 13, at 378 (emphasis in original).

67. *Ferro I*, No. 99-00180-0104-CR-W-SOW, 2000 WL 33394614, at *3 (W.D. Mo. May 8, 2000).

68. Another example of an "own use" clause that indirectly prohibits arbitrage was quoted at length by the same court:

> I certify that the above-named Client [price-favored purchaser in the "closed door" channel] is not engaged in retail sales and that all items purchased through the GeriMed Program will be utilized consistent with the established guidelines based on [sic] United States Supreme Court decision in Abbott Laboratories, et al., vs. Portland Retail Druggists Association, et al. As used herein, any and all merchandise

C. "Own Use" and Antitrust Policy

There is something going on in the "own use" clauses besides preventing arbitrage indirectly: drug manufacturers employ "own use" clauses to seek representations of compliance with the Nonprofit Institutions Act. The words "own use" are taken from the statute itself and were interpreted by the Supreme Court in the leading case of *Abbott Laboratories v. Portland Retail Druggists Ass'n.*[69] The "own use" clause just quoted in the text explicitly cites to the Nonprofit Institutions Act, and the "own use" clause just quoted in the margin explicitly refers to *Abbott Laboratories.*[70] Thus, "own use" clauses that employ language taken from the statute and that refer to the statute or controlling case law seek a representation that the price-favored purchaser in the "closed door" channel will comply with "own use" as those words are understood in the context of the Nonprofit Institutions Act. As one district court found, drug manufacturers employ "own use" clauses to obtain representations that the price discrimination strategy comes within the Nonprofit Institutions Act exemption.[71]

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purchased under this program shall be for our own use. The phrase "own use" is limited to the following:

> 1. Dispensing of the product to inpatients or emergency patients for treatment at the facilities serviced by the client;
> 2. Dispensing of the product to former patients upon their discharge as take-home prescriptions or supplies necessary for a limited time and reasonable time as continuation of treatment;
> 3. Dispensing of the product to Client employees or employees of the facilities serviced by the Client for their own use or the use of their dependents (but not for the use of their non-dependent family members); or
> 4. Dispensing of the product to a staff member physician in a facility serviced by the Client for his or her personal use, or for the use of his or her dependents (but not other persons or for use in the physician's private practice).

I further represent and warrant that this Pharmacy [client] shall not buy, distribute, sell, transfer, or use contract bid priced products or cause the distribution of bid priced products in any manner contrary to the requirements of "own use" or any terms and conditions contained in this document.

Id. (first bracketed text added).

69. 425 U.S. 1 (1976).

70. Another example of an "own use" clause from the *Ferro I* case, quoted *infra* note 158, additionally cites to *De Modena v. Kaiser Foundation Health Plan, Inc.*, 743 F.2d 1388 (9th Cir. 1984), another case that interprets and applies the Nonprofit Institutions Act. *See also* Celnicker, *supra* note 65, at 520 (two examples of contractual prohibitions of arbitrage, one citing *Abbot Laboratories* and the other referring to "Robinson-Patman Act").

71. *Ferro I*, 2000 WL 33394614, at *4. In *Ferro I*, after an evidentiary hearing before a

United States Magistrate Judge, the District Court made the following finding:

> Although the government argues that the applicability of the Nonprofit Institutions Act is irrelevant in this case, the documents which form the basis for the fraud charges against defendants indicate otherwise. Several of the documents completed by the defendants make reference to the Nonprofit Institutions Act and the *Abbott Laboratories v. Portland Retail Druggists Association, Inc.* case. It appears that the pharmaceutical companies were attempting to bring the sales to Home Care Pharmacy within the exemption created by the Nonprofit Institutions Act. No other exemption has been identified which would allow the same manufacturer to sell a drug such as Accupril to Penn Plaza Pharmacy, a retail pharmacy, at one price and Home Care Pharmacy at a significantly lower price without running afoul of the Robinson-Patman Act.

Id.

On appeal, the Eighth Circuit disagreed with the District Court's finding, but the basis for the Eighth Circuit's disagreement is unclear and unsupported. For example, when selecting a standard of review, the Eighth Circuit stated, without qualification, "We review dismissal of an indictment for failure to state an offense de novo." *Ferro II*, 252 F.3d 964, 965–66 (8th Cir. 2001) (citation omitted). The Eighth Circuit did not restrict that standard of review to the ultimate decision of the District Court. Consequently, the Eighth Circuit selected the de novo standard of review for all issues on appeal, including the findings of fact that the District Court made to reach the finding quoted at the outset of this footnote.

In criminal cases, however, while the ultimate decision of a district court in a pre-trial matter may be reviewed under a de novo standard, any findings of fact are reviewed under the clearly erroneous or, as it is sometimes called, the clear error standard. *See generally* 2 STEVEN ALAN CHILDRESS & MARTHA S. DAVIS, FEDERAL STANDARDS OF REVIEW §§ 11.10–11.14 (3d ed. 1999) (standards of review for criminal pre-trial proceedings). As the Supreme Court stated in the context of its review of a pre-trial motion to suppress evidence,

> We therefore hold that as a general matter determinations of reasonable suspicion and probable cause should be reviewed de novo on appeal. Having said this, we hasten to point out that a reviewing court should take care both to review findings of historical fact only for clear error and to give due weight to inferences drawn from those facts by resident judges and local law enforcement officers.

Ornelas v. United States, 517 U.S. 690, 699 (7th Cir. 1996); *see also* United States v. United States Gypsum Co., 333 U.S. 364, 394–95 (1948) (applying clearly erroneous standard of FED. R. CIV. P. 52(a) to findings of fact made without jury in criminal case).

In *Ferro II*, the Eighth Circuit erred in adopting the de novo standard of review for all findings, including findings of fact, and the sloppiness of its selection of the de novo standard is revealed by its misplaced reliance on the sole authority that it cites in support of a de novo standard. In *United States v. Zangger*, 848 F.2d 923, 924 (8th Cir. 1988), the defendant challenged the sufficiency of the indictment by attacking the wording of the indictment. In *Zangger*, there was no evidentiary hearing with regard to the motion to dismiss the indictment, and there were no findings of fact. Consequently, the *Zangger* court's statement of the appropriate standard of review did not need to indicate how a district court's findings of fact, after an evidentiary hearing, should be reviewed on appeal. To the same effect is the lone case that the *Zangger* court cites in support of selecting the de novo standard, *United States v. Givens*, 767 F.2d 574 (9th Cir. 1985). In the *Givens* case as well, the defendant attacked the wording of the indictment, there was no evidentiary hearing with regard to the motion to dismiss the indictment, and there were no findings of fact. *Id.* at 584–85.

Moreover, in *Ferro II*, the Eighth Circuit's adoption of a de novo standard of review for all findings, including findings of fact, flies in the face of established practice in its own circuit.

Perhaps surprisingly, even though "own use" clauses seek a representation regarding compliance with an exemption to illegal price discrimination, not every case involving an "own use" clause has considered the antitrust implications of potential violations of the Robinson-Patman Act. For example, in one of the criminal cases cited above, *Costanzo*, the defendant-purchasers knowingly entered into contracts that contained "own use" clauses restricting resale to nursing homes, diverted pharmaceutical products to wholesalers in the "open door" channel, and falsified reports to the manufacturer-sellers of the quantities of pharmaceutical products sold in compliance with the "own use" clauses so as to hide the diversion.[72] Nowhere did the court discuss price discrimination under the Robinson-Patman Act much less the exemption under the Nonprofit Institutions Act. Nowhere did the court examine the "own use" clauses to determine whether those clauses were employed to prevent arbitrage in a price discrimination strategy that might be illegal under the Robinson-Patman Act or, if presumptively illegal, exempt under the Nonprofit Institutions Act. Instead, the court examined the failure to

Until *Ferro II*, Eighth Circuit opinions in criminal cases had consistently reviewed findings of fact in pre-trial proceedings seeking dismissal of indictments under the clearly erroneous or clear error standard. *E.g.*, United States v. Van Someren, 118 F.3d 1214, 1216 (8th Cir. 1997) (clear error standard to findings of fact in motion to dismiss indictment under Speedy Trial Act); United States v. Cardona-Rivera, 64 F.3d 361, 363 (8th Cir. 1995) (same); United States v. Gomez, 38 F.3d 1031, 1035 (8th Cir. 1994) (clear error standard applied to finding of fact in magistrate judge's report in motion to dismiss indictment under statute of limitations); United States v. Koory, 20 F.3d 844, 847 (8th Cir. 1994) (clear error standard applied and substantial deference given to findings of fact, upon report and recommendation of magistrate judge, in motion to dismiss indictment under Speedy Trial Act); United States v. Manthei, 979 F.2d 124, 126 (8th Cir. 1992) (clearly erroneous standard applied to findings of fact determining whether to apply FED. R. CRIM. P. 16 in motion to dismiss indictment).

The Eighth Circuit's error in selecting a standard of review is only compounded by its confusion in understanding why "own use" clauses are employed in a case like *Ferro*, where the "own use" clauses explicitly refer to the Nonprofit Institutions Act as well as case law interpreting the exemption. Indeed, the Eighth Circuit appears to have ignored the de novo standard of review that it erroneously selected. Rather than examine anew the "own use" clauses quoted by the district court, the Eighth Circuit ignored the record and looked to two cases and a study, none of which examined analogous clauses, the Robinson-Patman Act, or the Nonprofit Institutions Act. *See infra* note 106 (critiquing Eighth Circuit use of inapposite authority).

72. *See* United States v. Costanzo, 4 F.3d 658, 660 (8th Cir. 1993) (involving a "claim that defendants defrauded drug manufacturers by obtaining pharmaceuticals at highly discounted prices by falsely representing that the pharmaceuticals would be used solely by nursing home patients, although defendants intended all the while to divert the drugs to wholesalers in violation of the own-use restrictions"); *id.* at 661 ("fake drug utilization reports for nonexistent institutional patients").

comply with the "own use" clauses in isolation, did not consider whether antitrust policy was at issue, and upheld convictions of mail fraud.

A different result was reached by the District Court in an analogous case.[73] In *Ferro*, the defendant-purchasers also entered into contracts that contained "own use" clauses restricting resale to nursing homes, and the indictment alleged that the defendants diverted pharmaceutical products to wholesalers.[74] The *Ferro I* court, however, considered whether the drug manufacturers employed "own use" clauses to prevent arbitrage in a price discrimination strategy that might be illegal under the Robinson-Patman Act and, if so, whether the drug manufacturers also employed the "own use" clauses to obtain representations that sales to the defendants would bring the price discrimination strategy within the Nonprofit Institutions Act exemption.[75] After this analysis, the court dismissed the indictment and did not hold the defendants "criminally liable for failing to follow through with what appears to be a scheme by the pharmaceutical manufacturers to engage in illegal price discrimination in violation of the antitrust laws."[76] The *Ferro I* court thus examined the failure to comply with the "own use" clauses in a larger context of the antitrust exemption that was referenced by the contracts, considered antitrust policy that was at issue, and dismissed an indictment alleging mail fraud.

As the divergent results in these two cases indicate, the analysis of price discrimination issues, including the availability of the Nonprofit Institutions Act exemption, can have a significant impact when "own use" clauses are at issue. It is to that analysis that the discussion now turns. The principal focus of this article is the proper design of price discriminating distribution systems to comply with the Nonprofit Institutions Act exemption. As noted already, "own use" clauses that prevent arbitrage can be integral to those distribution systems. The enforcement of "own use" clauses, especially in crimi-

73. As noted above, the District Court was reversed on appeal. *See supra* notes 30, 71.

74. *Ferro I*, 2000 WL 33394614, at *4 ("The charges against the defendants in this case stem from an underlying premise that defendants defrauded pharmaceutical manufacturers by signing contracts containing 'own use' clauses in which they represented that the discounted pharmaceutical products would be dispensed only for nursing home patients and then selling those products to commercial wholesalers.").

75. *See id.*

76. *See id.* at *6.

nal actions, raises a myriad of issues that go beyond the policies and concerns of the antitrust laws in general and the Nonprofit Institutions Act in particular. Many of those issues will be highlighted and briefly discussed, but any comprehensive treatment of other than antitrust issues is beyond the scope of this article.

III. PRICE DISCRIMINATION AND THE NONPROFIT INSTITUTIONS ACT

Before turning to the requirements of the exemption created by the Nonprofit Institutions Act, a preliminary note is in order regarding the antitrust laws and statutory construction. The antitrust laws occupy a central role as our "Magna Carta of free enterprise."[77] To achieve the statutory purposes behind the antitrust laws, courts routinely favor enforcement by construing liability provisions liberally while, at the same time, construing exemptions narrowly.[78] This approach to statutory construction is no less applicable to the Nonprofit Institutions Act.[79] As the Supreme Court stated in *Abbott Laboratories*, "We therefore conclude that the exemption provision of the Nonprofit Institutions Act is a limited one . . . ."[80] Indeed, the Nonprofit Institutions Act exemption applies only to illegal price discrimination under the Robinson-Patman Act[81] but does not bar

77. This phrase probably appears first in the Supreme Court's opinion in *United States v. Topco Associates Inc.*, 405 U.S. 596, 610 (1972) ("Antitrust laws in general, and the Sherman Act in particular, are the Magna Carta of free enterprise."). The phrase has been oft repeated by the Supreme Court, even in later times when the goals of antitrust have shifted. *E.g.*, Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 651 (1985) (Stevens, J., dissenting) (quoting *Topco* in case deciding if Sherman Act claims are arbitrable under Federal Arbitration Act); Associated Gen. Contractors of Cal. v. Cal. State Council of Carpenters, 459 U.S. 519, 538 n.38 (1983) (quoting *Topco* in case under section 4 of the Clayton Act); Cmty. Communications v. City of Boulder, 455 U.S. 40, 56 n.19 (1982) (quoting *Topco* in case raising issue of state-action antitrust exemption).

78. *See* Burge v. Bryant Pub. Sch. Dist., 520 F. Supp. 328, 331 (E.D. Ark. 1980) (construing Nonprofit Institutions Act and discussing Supreme Court cases), *aff'd*, 658 F.2d 611 (8th Cir. 1981) (per curiam); *see also* White & White, Inc., v. Am. Hosp. Supply Corp., 540 F. Supp. 951, 977–79 (W.D. Mich. 1982) (no implied antitrust exemption under Medicare reasonable cost regulations for hospital purchasing groups or their vendors), *rev'd on other grounds*, 723 F.2d 495 (6th Cir. 1983).

79. For an analysis which urges that, because the Nonprofit Institutions Act is obsolete due to dramatic changes in the nonprofit sector, the exemption should be interpreted under the changed circumstances theory, see Pollak, *supra* note 7, at 985–97.

80. Abbott Labs. v. Portland Retail Druggist Ass'n, 425 U.S. 1, 14 (1976).

81. Because the exemption extends to any prohibition in the Robinson-Patman Act, 15 U.S.C. § 13c (1994) ("[n]othing in the Act . . . shall apply"), the exemption is not limited to

claims that the same business practice may transgress other antitrust provisions.[82]

A. Robinson-Patman Act Analysis

Where a supplier charges different prices for the same commodity, concerns immediately arise that the practice may violate the Robinson-Patman Act prohibition of price discrimination under Section 2(a).[83] The general structure of analysis under the Robinson-Patman Act is (1) first to establish a prima facie case of illegal price discrimination, (2) second to determine if any affirmative defenses exist, and (3) third to determine if an antitrust exemption applies.

The issue of whether an antitrust exemption applies only arises after a prima facie showing of illegal price discrimination to which there are no affirmative defenses. If there is no prima facie case of illegal price discrimination under the first step of the analysis, there is no liability and hence no need to examine whether there is an affirmative defense or an antitrust exemption under the second and third steps. If there is a prima facie case and also an affirmative defense under the first two steps of the analysis, there is no liability and hence no need to examine whether there is an antitrust exemption under the third step. But, if there is a prima facie case and no affirmative defense under the first two steps of the analysis, then there is potential liability and therefore a need to examine whether there is an antitrust exemption under the third step. In this last situation, liability turns upon the availability of an antitrust exemption.

The practice in the pharmaceutical industry described above cer-

price differences and buyer liability under sections 2(a) and 2(f) but extends to a seller's provision of brokerage fees, promotional allowances, or valuable services that otherwise would violate sections 2(c)–(e). *See* KINTNER, *supra* note 19, § 25.9, at 465 n.117.

82. *See* Am. Academic Suppliers, Inc. v. Beckley-Cardy, Inc., 699 F. Supp. 152, 155–56 (N.D. Ill. 1988) (Nonprofit Institutions Act exemption does not bar claims under other antitrust provisions), *aff'd*, 922 F.2d 1317 (7th Cir. 1991).

83. Price discrimination under the Robinson-Patman Act is different than economic price discrimination. Both compare sales by a single seller of the same product to two purchasers. Price discrimination under the Robinson-Patman Act is triggered when the two purchasers pay different prices for the same product. Economic price discrimination is triggered when the seller recovers different economic profits from the two sales. If, for example, a seller's transaction costs vary depending upon the purchaser to whom a sale is made, the seller will recover different economic profits even though the purchasers pay the same price for the same product. Thus, economic price discrimination can exist without triggering a violation of the Robinson-Patman Act. Moreover, under certain conditions, economic price discrimination does not raise competitive concerns in an unregulated market. *See* LEVY, *supra* note 33, at 75–76, 83–85.

tainly appears to satisfy the elements for a prima facie case of secondary-line price discrimination.[84] The elements of a prima facie case are (1) a price difference[85] (2) between sales to two buyers[86] (3) of commodities[87] (4) of like grade and quality[88] (5) that creates a reasonable possibility or probability of competitive injury.[89]

84. There are preliminary matters of a jurisdictional nature. Because the Robinson-Patman Act was enacted pursuant to Constitutional authority to regulate interstate commerce, at least one of the compared sales under Section 2(a) must cross interstate lines. ANTITRUST LAW DEVELOPMENTS, *supra* note 37, at 430–34. Different language is used in Sections 2(c), 2(d), 2(e), and 2(f) which has been interpreted to embrace the broader concept of affecting interstate commerce. *Id.* at 436. As noted already, Section 2(a) requires that the commodities must be "sold for use, consumption, or resale within the United States," and therefore does not apply to export or import sales. *See supra* note 34. Sales in the United States of already imported commodities are covered, however. ANTITRUST LAW DEVELOPMENTS, *supra* note 37, at 434–35.

85. The first element of illegal price discrimination is "merely a price difference." ANTITRUST LAW DEVELOPMENTS, *supra* note 37, at 436 (quotation omitted).

> Actual net prices—after all discounts, rebates, surcharges, and [so on]—are compared to determine [if] there was a price difference. Differences in credit terms may [also] constitute a price difference. [D]elivered pricing [systems] where the price includes the costs of delivery [do not constitute a price difference if] available to all customers on a nondiscriminatory basis.

Id. at 436–37. To find a price difference, only prices of reasonably contemporaneous sales may be compared. *Id.* at 438.

86. "Generally, at least two completed sales are required. Thus, a sale and an offer to sell [or] a sale and a refusal to sell . . . do not come within [this element.] . . . [A]n enforceable contract may substitute for [a completed sale]." *Id.* at 438–39 (footnotes omitted). Other transactions, such as leases, consignment arrangements, licenses, and loans, do not satisfy this element. *See id.* at 439–40. "While both sales must be made by the same seller," *id.* at 440 (footnote omitted), a sale through an intermediary may be included if the seller exercises sufficient control over the intermediary such that the intermediary's pricing behavior can be attributed to the seller. *See id.* So, too, "sales by a subsidiary may be attributed to the corporate parent [if] . . . the parent exercises control over the subsidiary's customer and pricing decisions." *Id.* at 441. The sale by a wholly owned subsidiary has been attributed to the corporate parent without showing control. *See id.* at 438–41.

87. Section 2(a) applies only to "commodities," a term which has been interpreted to mean tangible products. *See id.* Services and intangible items are not included. *See id.* at 442. In a transaction that mixes commodities and services, courts look to the dominant nature of the transaction. *See id.* at 441–43.

88. *See id.* at 436. Commodities sold to the favored and disfavored buyers must be of like grade and quality. Thus, gloves made of cheaper material by less skilled workers and subject to less rigid inspection do not meet this element. *Id.* Brand names, labels, packaging, and warranties are not relevant to determine if the commodities are of like grade and quality. *See id.* at 443–44. Bona fide differences that affect consumer use or marketability are relevant. *Id.* at 444–45.

89. Although often called the "competitive injury" requirement, an actual injury to competition is not required as courts have held that the Act only requires a "reasonable possibility" or "probability" of injury. *Id.* at 446. In practice, this requirement has resulted in differ-

Drug manufacturers who follow the practice of selling at different prices to an "open door" channel and a "closed door" channel facially meet each of the five elements of a prima facie case of illegal secondary-line price discrimination.[90] Because drug manufacturers charge different prices to buyers depending upon the channel of distribution, there is a price difference between sales to at least two buyers. Because pharmaceutical products are goods and not services, the requirement of "commodities" is met. Because the same pharmaceutical products are sold to both channels, the "like grade and

ent standards, depending upon whether the injury is at the primary or secondary line. *See id.*

The analysis of competitive injury in primary-line cases was addressed by the Supreme Court in *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993). In *Brooke Group*, the Supreme Court recognized that the theory of competitive injury in cases of primary-line discrimination under the Robinson-Patman Act mirrored the theory of competitive injury in predatory pricing cases under section 2 of the Sherman Act. *See id.* at 221; *see also* ANTITRUST LAW DEVELOPMENTS, *supra* note 37, at 448. *Brooke Group* is an important case because, for the first time, the Supreme Court indicated that the same factual analysis required in section 2 cases involving predatory pricing should apply to cases involving primary-line discrimination. *See id.* at 447–48. After *Brooke Group*, a plaintiff in a primary-line case must plead and prove a relevant market and analyze the likely competitive impact within that market, including the plausibility that the defendant will recoup any losses from below cost pricing. *See id.* at 448. Consequently, after *Brooke Group*, competitive injury at the primary line is found either directly by market analysis or indirectly by predatory intent. *See id.* at 447–49. Predatory intent, in turn, can be inferred from below cost sales known as predatory pricing (but there is no requirement of a reasonable likelihood of recouping losses as there is in Sherman 2 cases). *See id.* at 446–49.

Competitive injury at the secondary line requires that the favored buyers and the disfavored buyer must be in competition. *Id.* at 449. For example, both buyers must operate in the same geographic area. *See id.* at 450. Direct evidence of lost sales or profits shows competitive injury. *Id.* Indirect evidence typically involves not insubstantial price differences over an extended period of time between buyers with low margins. *Id.* Evidence that no sales or profits were lost can rebut indirect evidence. *See id.* at 451. The same considerations are brought to bear upon competitive injury at the tertiary line. *Id.* at 452.

The distinction between primary and secondary (or tertiary) line discrimination is significant because, after *Brooke Group*, a different and more stringent market analysis is required to show competitive injury in cases of primary-line discrimination. A failure to appreciate the difference demonstrates a misunderstanding of the requirements of the Robinson-Patman Act. For example, even though *Ferro II* clearly involved secondary-line discrimination, the Eighth Circuit cited *Brooke Group* for the proposition that the element of competitive injury, "requires careful analysis of difficult, often-litigated issues such as whether the discount may substantially lessen competition at any level of competition." 252 F.3d 964, 967 (8th Cir. 200. Courts have not, however, applied the holding in *Brooke Group*, to cases like *Ferro* that involve secondary (or tertiary) line discrimination. No doubt, the Eighth Circuit's misunderstanding of the Robinson-Patman Act contributed to its misunderstanding of both the record and the price discrimination analysis proffered by the defendants in *Ferro*.

90. *See also* Celnicker, *supra* note 65, at 512–15 (basic scenario of differential pricing of medical products likely satisfies prima facie case).

quality" requirement is met.[91] Finally, because a buyer in the "closed door" channel has a decisive cost advantage vis-à-vis a buyer in the "open door" channel, there is a reasonable possibility of competitive injury to the buyer in the "open door" channel whenever both buyers are in the same area and would sell to the same customers but for the difference in price.[92]

91. Sometimes, drug companies sell the same product at different prices depending upon whether the product is branded or sold as a generic. KOLASSA, *supra* note 16, at 29–30 (noting different "prices and pricing methods" for "branded and generic markets"). As noted above, however, the use of brand names is not relevant to the determination of the requirement of "like grade and quality." *See supra* note 88. Indeed, there is evidence that, after the patend expired on a branded drug, at least two drug manufacturers sold the generic equivalent through a subsidiary and at a dramatically reduced price. SCHERER, INDUSTRY STRUCTURE, *supra* note 13, at 378. In so doing, these drug manufacturers appear to be pursuing the first-mover advantage on the branded drug while trying to capture sales of the generic version to relatively price sensitive consumers who have a relatively elastic demand for drugs.

92. Along with the dramatic changes in the provision of health care services over the past several years, so too has there been a dramatic change in the analysis of secondary (or tertiary) line discrimination in the pharmaceutical industry. At one time the possibility of competitive injury between purchasers in different channels of distribution was presumptively dismissed. The belief was that drug purchasers were in different "classes," that is, a purchaser in one "class" or channel of distribution did not sell to and compete for the customers of purchasers in other channel of distribution and, consequently, could not be affected by price differences across channels of distribution. *See* ROWE, *supra* note 1, at 173–178 (discussing analysis of price variations among "customer classes"); Michael Unger, *Protestors Picket Pfizer Over High Cost of Drugs*, NEWSDAY, June 8, 1990, at 52 ("Multitiered pricing hasn't been tested in court under antitrust laws, and last year [1989] an opinion issued by the [FTC] upheld long-standing pricing policies.").

Because of changes in the health care industry, purchasers of pharmaceutical products in one channel of distribution no longer are in an isolated class because those purchasers compete with purchasers in other channels of distribution. *See infra* note 115; *see also infra* note 159 (criticizing use of "classes" by pharmaceutical industry). For example, at least in the context of joint federal-state Medicaid programs, there is empirical evidence that efforts to contain prescription drug costs may "also cause substitution into higher-cost, health care services." LEVY, *supra* note 33, at 21–23 (footnote omitted). This is an indication that the effective area of competition is in the provision of a package of comprehensive health care services, and different drug prices to different health care providers inevitably will result in a competitive advantage to the price-favored health care provider. Thus, even if a price-favored purchaser complies with an "own use" provision, that purchaser will have a competitive advantage in attracting patients vis-a-vis a price-disfavored purchaser. *See also* Pollak, *supra* note 7, at 973–75 (noting development of nonprofit sector after enactment of Nonprofit Institutions Act such that nonprofit institutions increasingly compete with for-profit institutions). These changes indicate why prior analyses of differential pricing are, at best, unpersuasive. *See, e.g.*, Celnicker, *supra* note 65, at 517 (if price-favored purchaser does not resell, Robinson-Patman generally does not apply and Nonprofit Institutions Act irrelevant).

Where allegations of secondary (or tertiary) line discrimination in the pharmaceutical industry have been recently tested, there has been no presumption of no competitive injury, which would automatically negate a finding of illegal price discrimination. Indeed, in a recent

The practice in the pharmaceutical industry described above does not appear to satisfy a defined affirmative defense. Three affirmative defenses are found in the Robinson-Patman Act itself.[93] The "cost justification" defense permits price differences that reflect the "differences in the cost of manufacture, sale, or delivery resulting from

major case involving allegations of secondary-line price discrimination, "a federal judge approved a settlement between some of the [defendant] drug companies and [a plaintiff class of] retail pharmacies that included a $350 million cash settlement and an agreement by these companies to refrain from setting discriminatory prices against retail pharmacies . . . ." LEVY, *supra* note 33, at 82 (citing *In re* Brand Name Prescription Drugs Antitrust Litig., 1996-2 Trade Cas. (CCH) ¶ 71,449 (N.D. Ill. June 21, 1996)). Arguably, this settlement would not have been forthcoming if the pharmaceutical companies enjoyed an almost conclusive presumption of no competitive injury. *See also* Zaretsky, *supra* note 28, at 272 ("Evidence was presented during discovery that the favored purchasers received discounts that resulted in an average 10% cost advantage over retail purchasers. It is difficult for a large number of firms to sustain such a competitive disadvantage over the long run, especially with profit margins a small fraction of the cost-disadvantage percentage.").

93. Sometimes, courts refer to "functional availability" as though it is a non-statutory defense. Functional availability refers to a fact situation where a price-disfavored purchaser could have obtained the lower price but, for whatever reason, did not take advantage of the lower price. Properly understood, functional availability is not so much an affirmative defense as it is evidence that negates the required showings, in the prima facie case, of a price difference or a competitive injury. *See, e.g.*, Comcoa, Inc. v. NEC Tels., Inc., 931 F.2d 655, 664 (10th Cir. 1991) (finding that a jury instruction was proper that stated, "If you find that defendants' volume discounts were *functionally available* to the plaintiffs, then as a matter of law either there is no price discrimination or the discrimination is not the proximate cause of injury"); Shreve Equip., Inc. v. Clay Equip. Corp., 650 F.2d 101, 105 (6th Cir. 1981) ("Where a purchaser does not take advantage of a lower price or a discount which is functionally available on an equal basis, it has been held that either no price discrimination has occurred, or the discrimination is not the proximate cause of the injury."); Hanson v. Pittsburgh Plate Glass Indus., 482 F.2d 220, 227 (5th Cir. 1973) ("Any inferred competitive injury is negated by the fact that [plaintiff] had available comparable products from other suppliers at prices equivalent to the prices [defendant] gave to [plaintiff's] competitors.").

Sometimes, manufacturers who sell to both distributors (or wholesalers) and retailers claim a "functional discount" to justify a lower price to the distributor (wholesaler). The price difference is "functional" in the sense that the distributor and the retailer perform different functions in the channel of distribution. Used this way, the "functional discount" is justified under the cost justification or meeting competition defense. In *Texaco Inc., v. Hasbrouck*, 496 U.S. 543, 561 (1990), the Supreme Court stated that a "functional discount" would not offend the Robinson-Patman Act if the seller could "prove that a particular functional discount is reasonable and accordingly did not cause any substantial lessening of competition between a wholesaler's customers and the supplier's direct customers." With respect to the requirement of competitive injury, a "functional discount" might be justified where the distributor (wholesaler) sells only to retailers but not where the distributor (wholesaler) sells directly to consumers. *See* ANTITRUST LAW DEVELOPMENTS, *supra* note 37, at 464–69.

The reasonableness of the price favor is related to the distribution functions actually performed by the buyer. There is no requirement, under the Robinson-Patman Act, that a manufacturer seller must grant functional discounts. *See generally id.* at 468.

the differing methods or quantities in which such commodities are . . . sold or delivered."[94] Here, the seller has the burden of showing that the actual cost savings of selling to the price-favored buyer are greater than or equal to the price difference.[95] The "changing conditions" defense permits price differences that reflect a seller's "response to changing conditions affecting the market for or the marketability of the goods concerned."[96] Statutory examples of "changing conditions" include "actual or imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business."[97]

94. 15 U.S.C. § 13(a) (1994).

95. The burden is on sellers to establish the defense, which, in practice, is difficult. *See* ANTITRUST LAW DEVELOPMENTS, *supra* note 37, at 456. The seller may compare the cost of dealing with the favored buyer with the average costs of dealing with members of a broad group of similar buyers that includes the favored buyer. *Id.* at 457. A broad group is similar if they share essential factors that determine the cost of dealing. *See id.* To prevail, the seller must show actual cost savings equal to or greater than the price difference. *See id.* at 459. The seller's costs that may be considered include a broad range of factors in distribution costs (such as selling and delivery) and manufacturing costs. *See id.* at 460.

Under the Robinson-Patman Act, there is no such thing as an affirmative defense for volume discounts unless those discounts can be justified by cost savings. Indeed, one of the shortcomings of the price discrimination prohibition in the Clayton Act that was noted during the legislative history of the Robinson-Patman Act was that courts declined to read a cost-justification limit into exemptions for price differences based upon quantity discounts. *See* ABA ANTITRUST SECTION MONOGRAPH, *supra* note 1, at 12. The final version of the Robinson-Patman Act remedied that shortcoming by providing a cost-justification limit. *See id.* at 18. Thus, blanket judicial statements to the effect that volume discounts are accepted in the pharmaceutical industry are misleading where those statements fail to distinguish between those volume discounts that are cost justified and those that are not. By contrast, state pharmaceutical industry price discrimination statutes are not consistent on whether volume discounts must be cost justified. *Compare* WIS. STAT. ANN. § 100.31(2) (West 1997) ("Nothing in this subsection prohibits the giving of a discount for volume purchases.") *with* ME. REV. STAT. ANN. tit. 32 § 13802(1)(A) (West 1999) ("This paragraph does not prohibit discounts for volume purchases if the discounts are justified by the economies or efficiencies resulting from the volume purchases . . . .") *and* MINN. STAT. ANN. § 151.061 (West 1998) ("Unfair discrimination occurs when quantity discounts are not reasonably based on actual cost savings to all like purchasers.").

96. 15 U.S.C. § 13(a).

97. *Id.* The Supreme Court has stated that the seller can "show the existence of facts which would lead a reasonable and prudent person to believe that the granting of a lower price would in fact meet the equally low price of a competitor." United States v. United States Gypsum Co., 438 U.S. 422, 451 (1978) (quoting FTC v. A.E. Staley Mfg. Co., 324 U.S. 746, 759–60 (1945). The seller may not seek verification of the lower price from the competitor, but should instead seek out information from a reliable buyer or other source. *See* ANTITRUST LAW DEVELOPMENTS, *supra* note 37, at 452–56. This defense is available regardless of whether the seller sets its price on an area-wide or customer-by-customer basis. *See id.* at 454. In either situation, the lower price must be based upon a genuine, reasonable response to

The "meeting competition" defense permits price differences where the seller acts "in good faith to meet an equally low price of a competitor."[98] The lower price, which may respond to competition on a customer-by-customer or area-wide basis, must be based upon a genuine, reasonable response to price competition.[99]

Drug manufacturers who follow the practice of selling, at different prices, to an "open door" channel and a "closed door" channel facially fail to establish an affirmative defense.[100] Because, as noted already, the magnitude of the price differences are so substantial, those differences are not likely explained by cost savings.[101] Because pharmaceutical products are sold to buyers in both channels of distribution at the same time and in the same geographical area, the price differences are not likely explained as a response to changing circumstances. Because the price differences respond to different kinds of purchasers typically found in each channel,[102] the drug

competitive conditions. *See id.* The seller must intend to meet but not beat the competitor's lower price. *See id.* at 454–55. The defense is not available if the competitor's lower price is itself illegal. *See id.* The meeting competition defense may, under certain circumstances, be available in secondary-line discrimination where a seller enables its buyer to meet competition. *See id.* at 452–56.

98. 15 U.S.C. § 13(b).

99. In most cases, the defense is based upon changes in the marketability of the commodities that resemble the enumerated examples. Few cases have attempted, with mixed results, to show changes in the market. *See* ANTITRUST LAW DEVELOPMENTS, *supra* note 37, at 462–63.

100. Interestingly, in recent litigation, the reason proffered by drug manufacturers for selling at higher prices to retail pharmacies bears no relation to an established Robinson-Patman defense:

> Defendant drug manufacturers explain that their decisions not to discount prices on sales to retail pharmacies simply reflect each drug manufacturer's independent economic decision to discount prices on sales to managed-care organizations, but not on sales to retail pharmacies. These discounts generally are conditional on meeting certain sales or market share targets, and have been characterized as discounts for shifting [market] share. Defendant drug manufacturers argue that discounts for shifting share are individually profit-maximizing since the additional revenue each seller realizes from having sales shifted to its products more than offsets its lost revenue from reduced prices.

Weinstein & Culbertson, *supra* note 10, at 262; *see also* Elzinga & Mills, *supra* note 60, at 289–92 (describing how managed care organizations intervene in the market, induce competition within a therapeutic class of drugs, and obtain discounts, all in ways not available to retail pharmacies).

101. *See also* Celnicker, *supra* note 65, at 518 (basic scenario of differential pricing of medical products likely does not satisfy cost justification defense).

102. This is the case regardless of the reason for price discrimination. *See supra* text accompanying notes 44–48 (describing reasons). If lower prices are charged because of the bar-

manufacturer is not likely responding, in good faith, to meet price competition from other drug manufacturers.[103]

Thus, for the practice in the pharmaceutical industry described above, the issue of liability for secondary-line price discrimination under the Robinson-Patman Act facially turns upon the availability of the antitrust exemption in the Nonprofit Institutions Act.[104] Indeed, drug manufacturers or other suppliers who grant price favors to some purchasers and employ "own use" restrictions to prevent arbitrage seemingly concede that their distribution systems satisfy a prima facie case of unlawful price discrimination but fail to come within an affirmative defense. Of course, the words, "own use," are taken directly from the Nonprofit Institutions Act, and some "closed door" distribution contracts cite to the statute itself or to cases that interpret the statute.[105]

Further, an "own use" restriction is an awkward and indirect way to prevent arbitrage. Logically, there is no need to employ words that so strongly indicate compliance with an antitrust exemption instead of a direct prohibition on arbitrage if there is no prima facie case or there is an available affirmative defense. Consequently, the legality of the distribution systems, and the propriety of enforcing contract clauses that prevent arbitrage through "own use" restric-

gaining power of large institutional purchasers, the price difference responds to a purchaser's bargaining power. If lower prices are charged because of a marketing strategy to induce brand loyalty, the price difference responds to a purchaser's receptivity to a kind of marketing. If lower prices respond to demand characteristics of purchasers, the price difference responds to a purchaser's relative price sensitivity and elasticity.

103. Here it is important to distinguish the cost savings achieved through the recent and increased use of information technology by some organizations that distribute prescription drugs, see LEVY, *supra* note 33, at 43–71, and the different prices charged by drug manufacturers to those institutions, *see id.* at 63 (noting different rebates depending upon type of institution and/or change in market share). The available studies suggest that the reason for price differences in the pharmaceutical industry is the ability of some institutional purchasers to demand and receive lower prices from drug manufacturers. *Id.* at 77–81. "According to one account, '[d]rug companies forced to give deep discounts to managed health care plans are making up the difference by raising prices to the elderly, uninsured, and others least able to pay.'" *Id.* at 78 (quoting Steve Sakson, *Drug Discounts for HMOs May Shift Costs to Others*, WASH. POST, Dec. 10, 1995, at A3).

104. The fact that the pricing practices of drug manufacturers raise Robinson-Patman Act and other legal issues was recently noted: "Discounts to favored customers must be evaluated in light of mandatory rebates to the Medicaid System and to other federal government entities. The ongoing discriminatory pricing litigation in federal courts will also alter the pricing landscape." KOLASSA, *supra* note 16, at 26.

105. *See supra* text accompanying notes 69–71.

tions, certainly appear to depend upon the availability of the Nonprofit Institutions Act exemption, to which the discussion now turns.[106]

106. The Eighth Circuit thought differently in *Ferro II*, "We know from prior cases that pharmaceutical sellers often grant discounts to institutional customers such as hospitals, health maintenance organizations, and nursing homes, *without regard to whether they are non-profit or for-profit purchasers.*" 252 F.3d 964, 967 (8th Cir. 2001). After citing three authorities, the Eighth Circuit went on to say:

> This suggests that sellers perceive other bases for justifying the discounts under the Robinson-Patman Act, and therefore that the Non-Profit Institutions Act exemption is not the only determining factor in making such sales. This further suggests that, even when dealing with a for-profit institutional customer, a seller may wish to know, for Robinson-Patman Act compliance purposes, whether the customer is purchasing for its "own use." In these circumstances, the materiality of an "own use" misrepresentation may not be determined as a matter of law, and the district court erred in dismissing the indictment.

Id.

The problem with the Eighth Circuit's reasoning is twofold. First, the Eighth Circuit nowhere identifies how "own use" clauses can be used to comply with the Robinson-Patman Act outside of one of the elements of the Nonprofit Institutions Act exemption. Second, the Eighth Circuit provides no credible support for its remarkable proposition that, on the record presented in *Ferro*, "own use" clauses which explicitly refer to the Nonprofit Institutions Act, as well as case law interpreting the exemption, *see supra* text accompanying notes 69–71, just as likely sought representations for different (but not identified) Robinson-Patman Act compliance purposes. Because the above-quoted language in the Eighth Circuit's *Ferro II* opinion casts doubt upon the fact situation addressed in this article, it is appropriate to examine the authority upon which the Eighth Circuit relied.

In *Ferro II*, the Eighth Circuit cites *United States v. Costanzo*, 4 F.3d 658, 659 (8th Cir. 1993), a case that does identify business reasons why a drug manufacturer might employ price differences, and the *Costanzo* court did provide an example of an "own use" clause, although the clause in that case did not refer to the Nonprofit Institutions Act or to case law interpreting the exemption, *id.* at 660. While the *Costanzo* court states that pharmaceutical sellers employed "own use" clauses to prevent diversion, that is, "to ensure that the sale of deeply discounted drugs to institutional pharmacies does not undermine [the sellers'] ability to sell to other purchasers at normal wholesale prices," *id.* at 659–60, there is simply no credible basis to cite that discussion for the proposition that there are many reasons why pharmaceutical sellers routinely employ "own use" clauses for Robinson-Patman compliance purposes. In fact, in *Costanzo*, there is absolutely no discussion of antitrust issues, much less the Robinson-Patman Act or the Nonprofit Institutions Act.

The second case that the Eighth Circuit cites is *In re Brand Name Prescription Drugs Antitrust Litig.*, 186 F.3d 781 (7th Cir. 1999). This opinion is one of many that was produced during the course of a very protracted litigation, but the opinion selected and cited by the Eighth Circuit only addressed antitrust conspiracy issues under section 1 of the Sherman Act, 15 U.S.C. § 1 (1994). At the place cited by the Eighth Circuit, the Seventh Circuit describes the practice by which manufacturers of brand name prescription drugs sell at different prices and how those who purchase at low prices are tempted to engage in diversion. There, the Seventh Circuit does identify one business rationale for selling to wholesalers at a lower price: "A wholesaler is compensated for the warehousing and other functions that he performs in the distribution of his drugs through the difference between the price that he pays his supplier and

B. The Nonprofit Institutions Act Exemption

Where there is a prima facie violation of the Robinson-Patman Act but no affirmative defense, suppliers who grant price favors to eleemosynary institutions need to design their distribution channels so that lower-priced sales to those institutions come within an exemption to the prohibition of price discrimination. To come within the Nonprofit Institutions Act exemption, suppliers need to assure that lower-priced sales are exempt by granting price discounts only to those who meet the requirements for exempt purchasers under

the price at which he resells to retailers." *In re* Brand Name Prescription Drugs Antitrust Litig., 186 F.3d at 783. Throughout its opinion, the Seventh Circuit also opines that any seller can increase profits if that seller has market power, can prevent diversion, and can engage in economic price discrimination. *See id.* at 787. Importantly, however, the pharmaceutical sellers in *In re Brand Name Prescription Drugs* did not employ "own use" clauses to compensate wholesalers for services or to prevent wholesalers from engaging in diversion. Rather, the pharmaceutical sellers used a chargeback system. In fact, in *In re Brand Name Prescription Drugs*, there is no discussion whatsoever of "own use" clauses, much less the reasons why a pharmaceutical seller would employ those clauses. Moreover, the Seventh Circuit opinion never tests the practice of price discrimination in that case against the Robinson-Patman Act. The Seventh Circuit does not discuss "own use" clauses, much less the way that those clauses might be used for Robinson-Patman compliance purposes.

The third source that the Eighth Circuit cites is LEVY, *supra* note 33, a study that focuses not upon Robinson-Patman price discrimination but upon economic price discrimination, which "is not necessarily a violation of the Robinson-Patman Act." *Id.* at 75 n.166. In the place cited by the Eighth Circuit, the study describes several business rationales for price discrimination. *See supra* note 47. The study does not, however, indicate that the pharmaceutical sellers employed "own use" clauses to pursue any of these business rationales. Like the Seventh Circuit's opinion in *In re Brand Name Prescription Drugs*, the cited portion of the study contains no discussion whatsoever about "own use" clauses, much less the reasons why a pharmaceutical seller might employ those clauses. Moreover, the focus of the study is economic price discrimination, and the study explicitly cautions that "this discussion does not address the possibility that economic price discrimination may raise concerns under the Robinson-Patman Act." *Id.* at 83 n.189. If anything, the study provides an inference that price discrimination in the pharmaceutical industry violates the Robinson-Patman Act by reporting a $350 million dollar settlement paid by drug manufacturers to retail pharmacies. *See id.* at 82. *See also* Scherer, *Prescription Drug Litigation*, *supra* note 7, at 249–50 (describing settlement).

In summary, the Eighth Circuit in *Ferro II* asserts that, "even when dealing with a for-profit institutional customer, a seller may wish to know, for Robinson-Patman Act compliance purposes, whether the customer is purchasing for its 'own use,'" 252 F.2d at 967, but none of the three authorities cited in support of this remarkable proposition discusses the Robinson-Patman Act. All of the authorities discuss business reasons for practices that discriminate in price, but none addresses the issue of whether those business practices offend the Robinson-Patman Act, much less whether there is any need for compliance. Only one authority, the *Costanzo* case, identifies an "own use" clause, but that case does not discuss compliance with the Robinson-Patman Act.

the statute. In addition, suppliers need to restrict any resale or diversion of supplies by price-favored purchasers to price-disfavored purchasers who are willing to pay a higher price. This latter restriction is important for two reasons. First, as explained above, preventing arbitrage is crucial for any price discrimination strategy to succeed in the marketplace. Second, as explained below, suppliers risk losing the exemption if price-favored purchasers engage in arbitrage, a for-profit activity.[107]

When designing price-favored channels of distribution, such as the "closed door" channel in the pharmaceutical industry, suppliers can obtain important guidance from the Supreme Court's opinion in *Abbott Laboratories*, the only Supreme Court case that has squarely addressed an issue under the Nonprofit Institutions Act. The principal focus of the opinion in that case was the requirement of "own use." In *Abbott Laboratories*, a hospital purchased drugs at discriminatorily low prices but dispensed those drugs in a variety of ways. The Supreme Court placed the various uses of drug products into ten categories[108] and then determined which categories constituted "own use" under the exemption.[109]

The guidance provided by the Supreme Court in *Abbott Laboratories* is only the start of a correct understanding of the Nonprofit Institutions Act exemption because the requirement of "own use" is only one of three statutory requirements that must be met for the exemption to apply.[110] As the Ninth Circuit explained in *De Modena*

107. For example, arbitrage is present in fact situations where the buyer in the "closed door" channel sells to customers who otherwise would purchase in the "open door" channel. The extent to which a price-favored purchaser engages in this for-profit activity affects the availability of the Nonprofit Institutions Act exemption because the price-favored purchaser must meet the requirement of "not operated for profit." In addition, by engaging in arbitrage and selling in a context that does not further the charitable or other worthy goals of the eleemosynary institution, the price-favored purchaser may not meet the requirement of "own use." *Compare* Abbott Labs., v. Portland Retail Druggist Ass'n, 425 U.S. 1, 18 (1976) (holding that de minimis sales by hospital to walk-ins who are not patients of the hospital do not destroy exception) *with* Computronics, Inc. v. Apple Computer, Inc., 600 F. Supp. 809, 812 (W.D. Wis. 1985) (finding the university's unrestricted resale of computers to faculty, staff, and students not exempt).

108. *Abbott Labs.*, 425 U.S. at 8–10.

109. *Id.* at 14–18.

110. A question might arise, based upon the language of the Nonprofit Institutions Act, whether the three requirements should be read in the conjunctive, thus treating each as a necessary and separate element. While the statute might have been drafted more clearly, the better approach is to construe the three requirements as necessary and separate elements. This comports with the policy of construing antitrust exemptions narrowly. For example, not every hos-

v. Kaiser Foundation Health Plan, Inc.,[111] when it paraphrased the statutory language of the Nonprofit Institutions Act, suppliers can enjoy the benefits of this exemption if they grant price favors only to exempt purchasers who "are 1) non-profit institutions; 2) eligible institutions under the Act; and 3) made the purchases in question for their 'own use.'"[112] Each of these requirements is a separate and distinct element that must be satisfied for a price discrimination strategy to come within the exemption.[113] The discussion in this part of the article will examine each of the statutory requirements starting with the "own use" element and then turning to the eligible institution and the "not operated for profit" elements, respectively.[114]

pital may receive price favors. Only hospitals that are "not operated for profit" may receive price favors. Further, not every price-favored sale to a nonprofit hospital is exempt. Only those sales that are for the nonprofit hospital's "own use" are exempt. By construing each requirement as a necessary and separate element, the exemption will have a narrower reach.

111. 743 F.2d 1388 (9th Cir. 1984).

112. *Id.* at 1391; *see also In re* Brand Name Prescription Drugs Antitrust Litig., No. 94 C 897, MDL 997, 1995 U.S. Dist. LEXIS 12920, at *2 (N.D. Ill. Aug. 29, 1995) (three requirements stated as necessary and separate elements); Opinion Letter, 89 F.T.C. 689, 689 (1977) ("[T]he exemption was intended to insulate from Robinson-Patman application all purchases of supplies (for their own use) by the designated classes of institutions not operated for profit.").

113. While the prima facie case of price discrimination is limited to sales of "commodities," 15 U.S.C. § 13(a) (1994), the Nonprofit Institutions Act exemption extends to "supplies," 15 U.S.C. § 13(c) (1994). The use of different terms suggests that "supplies" are more limited than "commodities," and thus, "supplies" should be an additional element of the exemption. As one treatise has noted, however, "While one might think that the 'supplies' of this provision is narrower than the 'commodities' of the . . . basic § 2(a) prohibition, perhaps referring only to consumables, the courts have not so interpreted it. Indeed, the term 'supplies' seems to have about the same scope as the word 'commodities' in the main statute." HOVENKAMP, ANTITRUST, *supra* note 17, § 2354c, at 195. For example, in *Logan Lanes*, a case involving bowling alley equipment, the court stated that the term, "[supplies] embraces anything required to meet the institution's needs, whether it is consumed or otherwise disposed of, or whether it constitutes, or becomes part of, a material object utilized to enable the institution to carry on its activities." Logan Lanes, Inc. v. Brunswick Corp., 378 F.2d 212, 216 (9th Cir. 1967). If, as it seems, "supplies" are coextensive with "commodities," and "commodities" is an element that must be proved as part of the prima facie case, then there is no need to include "supplies" as an element of the exemption. Interestingly, the Ninth Circuit's opinion in *Abbott Laboratories* had defined "own use" as limiting the exemption to supplies that are consumed on the premises of an eligible institution, but this opinion was vacated by the Supreme Court. Portland Retail Druggists Ass'n v. Abbott Labs., 510 F.2d 486, 489 (9th Cir. 1974), *vacated*, 425 U.S. 1 (1976).

114. In the next part of the article, the discussion will turn to two additional concerns not anticipated in the statutory language. One is the supplier's obligation of routinely obtaining certification of compliance with the statutory requirements by assuring that price-favored purchasers are, in fact, exempt purchasers. Another arises in a fact situation where a supplier sells through an intermediary who, in turn, sells to the ultimate purchasers.

1. "Own use"

The "own use" requirement is the one that has received the greatest attention from the Supreme Court. As noted already, in *Abbott Laboratories*, the Court placed the various uses of drug products into ten categories, and then determined which categories constituted "own use" under the exemption. In making that determination, the Court noted that, when compared to the traditional functions performed by hospitals at the time the exemption was passed by Congress, modern hospitals had expanded the functions that they perform.[115] In doing so, the Court declined to expand the scope of the Nonprofit Institutions Act exemption to protect a hospital's use of price discounted supplies to perform functions not anticipated when the exemption was enacted:

> The modern American hospital developed from an institution originally intended for the sick poor. Language in the bill which became the 1938 Act, that would have exempted only sales to nonprofit institutions "supported in whole or in part by public subscriptions," was deleted, and the Act's exemption provision was not so restricted and confined. We thus do not relate the exemption to what might be described as the nonprofit hospital's original or "traditional" status. On the other hand, there is nothing in the Act that indicates that its exemption provision is to be applied and expanded automatically to whatever new venture the nonprofit hospital finds attractive in these changing days. The Congress surely did not intend to give the hospital a blank check. Had it so intended, it would not have qualified purchases by nonprofit institutions in the way it did in § 13c.[116]

The Court then articulated a standard that defines "own use" in terms of the traditional functions that were performed by hospitals:

> We therefore conclude that the exemption provision of the Nonprofit Institutions Act is a limited one; that just because it is a nonprofit hospital that is purchasing pharmaceutical products does not mean that all its purchases are exempt from Robinson-Patman; that the test is the obvious one inherent in the language of the statute, namely, "purchases of their supplies for their own use"; and

115. *See also* HOVENKAMP, ANTITRUST, *supra* note 17, § 2354c, at 196 ("the domain of the nonprofit hospital had expanded considerably in the previous decades, and hospitals had become major rivals with for-profit pharmacies in the retailing of pharmaceuticals").

116. *Abbott Labs*, 425 U.S. at 13 (citations omitted).

> that "their own use" is what reasonably may be regarded as use *by the hospital* in the sense that such use is a part of and promotes the hospital's intended institutional operation in the care of persons who are its patients. This implies the limitation and it turns the measure naturally from the purchase to the use, as § 13c requires.[117]

The Court then proceeded to place the ten categories of drug use into three groups, the first of which were those uses that clearly comply with the "own use" requirement. For example, "[d]ispensation to the bed-occupying inpatient and to the patient at the hospital's emergency facility, in either case for use on the hospital premises, is a part of the institution's basic function, and is dispensation for the hospital's 'own use.'"[118]

A second group of drug uses were those that clearly fail to comply with the "own use" requirement. Here, the Court used the example of a physician who is connected with the hospital and purchases drugs from the hospital, not for herself or for her dependents, but for others: "To the extent that the physician utilizes his proximity to the hospital pharmacy, and it permits him so to do, for other persons or other uses—even, as this record occasionally intimates, for dispensation in that portion of his private practice unconnected with the hospital—the requirement of the hospital's 'own use' is not fulfilled."[119]

The third group of drug uses were those that, although not for the hospital's "own use," were de minimis and, for that reason, would not negate a finding of compliance with the "own use" requirement.[120] Here, the Court used the example of an occasional walk-in prescription buyer who "is not within the statute's exemption."[121] Recognizing, however, "that there may be an occasion

117. *Id.* at 14; *see also* KINTNER, *supra* note 19, § 25.9 at 466 ("this element ["own use" requirement] excludes from the exemption goods which are not used by the institution for its normal non-profit function").

118. *Abbot Labs.*, 425 U.S. at 14.

119. *Id.* at 17.

120. It was by creating this third category, which permits nonexempt but de minimis uses, that the Supreme Court changed the analysis under the "own use" element from what had previously been an effort by courts to examine the overall character of an eligible institution's use of price-discounted supplies. *Cf.* Portland Retail Druggists Ass'n v. Abbott Labs., 510 F.2d 486, 489 (9th Cir. 1974) ("consumer role" test); Logan Lanes, Inc. v. Brunswick Corp., 378 F.2d 212, 213 (9th Cir. 1967) ("primary purpose" test).

121. *Abbott Labs.*, 425 U.S. at 18.

when the hospital pharmacy is the only one available in the community to meet a particular emergency situation," the Court concluded:

> We are content, however, to conclude that the occasional emergency is *de minimis*, in any event, and that its presence solitarily would not trigger litigation of the present kind. So long as the hospital pharmacy holds the emergency situation within bounds, and entertains it only as a humanitarian gesture, we shall not condemn the hospital and its suppliers to a Robinson-Patman violation because of the presence of the occasional walk-in dispensation of that type.[122]

One issue that has been litigated under the rubric of the "own use" requirement is the extent to which a purchaser can purchase supplies for nonexempt uses and yet remain in the somewhat subjective category of de minimis sales that do not negate a finding of "own use." *Logan Lanes, Inc. v. Brunswick Corp.*,[123] is an example of a case in which the court did not negate a finding of compliance with the "own use" requirement because nonexempt uses were de minimis.[124] There, bowling equipment, purchased at discriminatorily low prices, was installed in the Student Union Building on the Utah

122. *Id.* One court subsequently looked at de minimis use in a different light by using the fact of de minimis use as relevant to the issue of whether there was an anticompetitive effect, a showing that is required for one of the elements of a prima facie case of illegal price discrimination under the Robinson-Patman Act. *See* Rudner v. Abbott Labs., 664 F. Supp. 1100, 1107 (N.D. Ohio 1987) (noting defendant's argument that de minimis use negates plaintiff's required showing of competitive injury but court finding, in context of summary judgment, issue of fact on whether "there was only a *de minimis* effect on competition").

123. 378 F.2d 212 (9th Cir. 1967).

124. The Ninth Circuit decided *Logan Lanes* before the Supreme Court handed down its opinion in *Abbott Laboratories*. Understandably, the Ninth Circuit did not use the "*de minimis*" verbiage subsequently adopted by the Supreme Court. One treatise has pointed to other language in the Ninth Circuit's opinion to suggest that the Ninth Circuit employed a different test, a "primary purpose" test:

> The *primary purpose* of the purchases established beyond dispute, was to fulfill the needs of the University in providing bowling facilities for its students, faculty and staff. This being the case, any additional use of the bowling facilities by the general public for a fee, even if such use is substantial, would not establish that the purchases were not made for the use of the University.

Logan Lanes, Inc., 378 F.2d at 217 (emphasis added by KINTNER, *supra* note 19, § 25.9, at 467); *see also* Burge v. Bryant Pub. Sch. Dist., 520 F. Supp. 328, 332 (E.D. Ark. 1980) (adopting "primary purpose" test), *aff'd on other ground*, 658 F.2d 611 (8th Cir. 1981) (per curiam). In *Abbott Laboratories*, however, the Supreme Court cited *Logan Lanes* with approval. *Abbott Labs.*, 425 U.S. at 18 n.10. Thus, the Supreme Court's "*de minimis*" test follows on the Ninth Circuit's analysis but uses language that shifts the focus from the overall character of all uses to the quantity of nonexempt uses.

State University campus. A nearby private bowling alley filed the lawsuit, alleging competitive injury because the public was permitted to bowl at the Student Union, which enjoyed lower costs due to the lower price of the Student Union's bowling equipment. Early in the opinion, the court cited the following facts upon which it later relied in finding that the nonexempt use was de minimis:

> The bowling facilities were primarily for the use of students, faculty and staff of the University, but were also used by members of the public. One use the students make of such bowling equipment is to fulfill physical education requirements at the University. All income from the Student Union bowling alleys is used to finance student activity programs, or goes into a fund for expansion and improvement of the University.[125]

The court also noted that, over an almost two-year period, 128,349 lines were bowled at the Student Union, of which "125,415 were bowled by students, faculty, staff and guests, while 2,934 were bowled by others."[126]

By contrast, *Computronics, Inc. v. Apple Computer, Inc.*,[127] is an example of a case where nonexempt uses exceeded the bounds of de minimis and, therefore, precluded a finding of "own use." There, a computer manufacturer sold computers, at a significant discount, to the University of Wisconsin for resale to students and staff. The lawsuit for price discrimination was brought by a competing retail outlet. The computer manufacturer moved for summary judgment, arguing in part that the sales came within the exemption. In denying

125. *Logan Lanes, Inc.*, 378 F.2d at 214.

126. *Id.* at 215. These facts provide a context to distinguish the evidentiary standard for the competitive injury element of the prima facie case of secondary-line price discrimination and the outer bounds of the de minimis category. The evidentiary standard for the competitive injury element is a reasonable probability or possibility of injury to competition which, for secondary-line discrimination, can be shown if the favored and disfavored purchasers are in a competitive relationship coupled with either a loss of sales by the disfavored purchaser or by substantial price differences. In *Logan Lanes*, this standard was met because the nearby bowling alley lost sales as demonstrated by the 2934 lines bowled at the Student Union by members of the general public. The characterization of nonexempt uses as de minimis did not turn upon a comparison of the favored and disfavored purchasers, however. Rather, the characterization appears to rely, principally, on a percentage comparison of nonexempt uses to exempt uses. In *Logan Lanes*, the general public accounted for just under 2.3 percent of the lines bowled at the Student Union. *See id.* Similarly, in *De Modena v. Kaiser Foundation Health Plan, Inc.*, 743 F.2d 1388, 1394 (9th Cir. 1984), fewer than one percent of drug sales were made to nonmembers who walked in to fill a prescription, which the court deemed de minimis.

127. 600 F. Supp. 809 (W.D. Wis. 1985).

summary judgment, the court recognized that some of the uses might be exempt but noted,

> Even if it is assumed that providing faculty and students with computers serves an educational purpose, the Apple-University contract allows non-instructional staff, such as janitors, to purchase the product at a discount. Although purchasers through the University are forbidden to resell merchandise, there is no realistic way to forbid such purchasers from using the merchandise in other than an educational sense. After all, a student could purchase a computer shortly before leaving the University with the intention of using it in business after graduation.[128]

As these cases demonstrate, the opinion in *Abbott Laboratories* opened the possibility that, although some uses might comply with the "own use" requirement, others that do not comply might exceed the bounds of de minimis sales and, therefore, would negate a finding of "own use." To this possibility, the drug manufacturers in *Abbott Laboratories* argued on behalf of the hospitals that the Court's standard would require a clumsy and expensive system, first, to segregate exempt from nonexempt uses and, second, to account for those segregated uses.[129] The Court thought the concern was "overstated":

> Looking at the problem from the point of view of the purchasing hospital, two alternatives, and perhaps more, are presented. The first, and easier, is for the hospital pharmacy not to dispense in any way herein above held to be outside the exemption of § 13c. The second is for the pharmacy to do exactly what the [drug manufacturer] petitioners deplore, namely to establish a recordkeeping procedure that segregates the nonexempt use from the exempt use. This would be supplemented by the hospital's submission to its supplier of an appropriate accounting followed by the price adjustment that is indicated.[130]

128. *Id.* at 812.

129. *Abbott Labs.*, 425 U.S. at 19–20.

130. *Id.* at 20 (footnote omitted) (indicating in a footnote that the two alternatives described in the text were not meant to be exclusive of ways to comply with the "own use" requirement).

A leading treatise has drawn a distinction between the facts in *Logan Lanes* and those in *Abbott Laboratories* to suggest that a requirement of segregating exempt from nonexempt uses should not apply to every kind of price-discounted supply:

Although the definition of "own use" no doubt leaves difficult fact issues in some cases, those who design distribution systems under the Nonprofit Institutions Act can find guidance in three considerations. First, "own use" refers to a function performed, when the Nonprofit Institutions Act was enacted, by the kind of purchaser exempted by the Act. Second, the "own use" requirement permits a de minimis amount of nonexempt use, that is, use which does not otherwise qualify as "own use" under the statute. Third, if there is more

> But the issue in *Logan Lanes* is very different because the court there was considering the status of capital equipment—bowling lanes—which were purchased once and then used for students and nonstudents alike. The hospital [in *Abbott Laboratories*] at least had the option of purchasing pharmaceuticals at one price for its exempt use and at another price for its nonexempt use. By contrast, Utah State University could comply with a conclusion that the relatively small use made by nonstudents was nonimmune only by closing the lanes to nonstudents altogether or else closing them entirely.

HOVENKAMP, ANTITRUST, *supra* note 17, § 2354c, at 199–200. The treatise then recommends that, "[w]here the purchase in question is of capital or other equipment that must be shared" between exempt and nonexempt uses, a "primary purpose" rule should be adopted "where the transaction costs of complying with *Abbott* are too high in relation to the value of the product in question." *Id.* at 200.

With all due respect, this suggestion misses the import of *Abbott* with regard to when a segregation is required and overlooks relatively easy alternatives to comply with *Abbott* even where the price-discounted supply represents a capital or fixed cost. In *Abbott*, the creation of the third category of de minimis use means that exempt and nonexempt uses need to be segregated only if nonexempt uses exceed the bounds of de minimis. Indeed, the Supreme Court reached the issue of segregating exempt and nonexempt uses only after it found that the "own use" requirement had not been met because there were more than a de minimis amount of nonexempt uses. Thus, if the nonexempt use does not exceed the bounds of de minimis use, that will not negate a finding of "own use," and there is no need to segregate uses to assure compliance with the "own use" requirement, regardless of whether the price-discounted supply is a fixed or variable cost.

Moreover, even where nonexempt use of capital equipment exceeds the bounds of de minimis use, the facts in *Logan Lanes* suggest a relatively easy way to comply with the requirement of segregating exempt use from nonexempt use. In *Logan Lanes*, a survey indicated that the general public accounted for approximately 2.3 percent of the lines bowled at the Student Union. 378 F.2d at 215. As to the supplier, Brunswick Corp., the University should pay the price-discounted price of the bowling alley equipment plus 2.3 percent of the difference between the price-discounted price and the competitive price. As to the general public, the University should charge an additional fee equal to the amount paid to the supplier in excess of the price-discounted price that is prorated over the number of lines bowled by the general public during the useful life of the bowling alley equipment. Here, the survey can be used to estimate the total number of lines that the general public will bowl over the useful life of the equipment. Then, the general public's price for a line would equal the student price plus an amount determined by the extra amount paid for the equipment divided by the total number of lines that the general public will bowl. To enforce the system, the lower price per line bowled would be available only to those with a university identification card.

than a de minimis amount of nonexempt use, the supplier and buyer who enjoy the benefits of the exemption should not be heard to complain of the burdens of establishing a recordkeeping procedure that separates use that qualifies as "own use" from use that does not.[131]

The requirement that eligible institutions purchase supplies only for their "own use" furthers the purpose of the Nonprofit Institutions Act to preserve "price favors that sellers would wish to grant to eleemosynary institutions."[132] Congress fashioned this exemption so that the Robinson-Patman Act would not force eleemosynary institutions to pay higher prices for their supplies, all to the detriment of the charitable or other worthy goals that eleemosynary institutions pursue. Obviously, this purpose is not served, and the exemption would reach more broadly than intended, if price favors are granted to eleemosynary institutions for goals other than the charitable and other worthy goals that Congress sought to protect from the Robinson-Patman Act.[133] Thus, it makes perfect sense to define "own use," that is, an exempt use, in terms of the traditional functions or goals pursued by eleemosynary institutions when Congress enacted the Nonprofit Institutions Act.

2. Eligible institution

A second statutory requirement that must be met for the price-favored purchaser to be an exempt purchaser under the Nonprofit Institutions Act is that the purchaser must be an eligible institution. When determining if a purchaser is an eligible institution, the *De Modena* court followed a two-step inquiry.[134] First, the court asked

131. The practical result in this third and last scenario would seem to be that, because the price-favored purchaser ultimately will pay a higher price for supplies that are directed to a nonexempt use, the price-favored purchaser will have to charge its customers a higher price for goods or services sold or provided in the context of that nonexempt use. Thus, a price-favored purchaser who engages in a more than a de minimis amount of nonexempt use will need to maintain its own two-tiered pricing structure: a lower price associated with exempt uses of supplies that are appropriately price-discounted and a higher price associated with nonexempt uses of supplies that should not be price-discounted.

132. *Abbott Labs.*, 425 U.S. at 12.

133. *See* HOVENKAMP, ANTITRUST, *supra* note 17, § 2354c, at 195 ("The phrase ['own use'] was undoubtedly put in the statute to prevent nonprofits from obtaining an unfair advantage by purchasing at a lower price and then reselling in competition with for-profit firms. . . . For example . . . a pharmacy owned by a nonprofit hospital might undersell rival for-profit pharmacies.").

134. *See* De Modena v. Kaiser Found. Health Plan, Inc., 743 F.2d. 1388, 1391 (9th Cir.

whether the purchaser is among the kinds of institutions specifically enumerated in the exemption, that is, "schools, colleges, universities, public libraries, churches, [and] hospitals."[135] Second, if the purchaser is not one of the enumerated kinds of purchasers, the court then asked whether the purchaser falls within the catchall category of "charitable institutions."[136]

Case law has not yet indicated how courts will determine whether a purchaser is one of the kinds of institutions specifically enumerated in the exemption. It seems unlikely, however, that a purchaser can become an eligible institution simply by calling itself one of the institutions on the enumerated list. Here, as elsewhere in antitrust, courts are likely to look at substance rather than form.[137] While courts have not confirmed that they will take this approach, guidance can be gleaned from *Abbott Laboratories*. There, in the context of the "own use" requirement, the Court distinguished the status of an enumerated institution and looked, instead, to the traditional functions performed by an enumerated institution. Following this analysis, a purchaser is an eligible institution if a significant portion of the purchaser's business is to engage in the traditional functions performed by an enumerated institution at the time the exemption was enacted in 1938.

Where a purchaser is not among the kinds of institutions specifically enumerated, courts look to a variety of factors to determine whether a purchaser falls within the catchall category of "charitable institution."[138] For example, in *De Modena*, the court recognized

1984) ("The [Nonprofit Institutions] Act does not explicitly list [health plans]. Thus, we must determine whether such organizations are charitable institutions . . . .").

135. 15 U.S.C. § 13c (1994).

136. *Id.*

137. For example, when determining that a wholly owned subsidiary could not conspire with its corporate parent for purposes of liability under section 1 of the Sherman Act, the Supreme Court noted that, "if antitrust liability turned on the garb in which a corporate subunit was clothed, parent corporations would be encouraged to convert subsidiaries into unincorporated divisions. . . . Such an incentive serves no valid antitrust goals." Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752, 773–74 (1984); *see also* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 58–59 (1977) ("[D]eparture from the rule-of-reason standard must be based upon demonstrable economic effect rather than . . . formalistic line drawing."); United States v. Sealy, Inc., 388 U.S. 350, 352 (1967) ("[L]ook at substance rather than form.").

138. 15 U.S.C. 13c. In its pharmaceutical industry price discrimination statute, Maine provides an exception for charitable institutions that are defined solely in terms of "the requirements of the United States Internal Revenue Code, Section 501(c)(3) . . . ." ME. REV. STAT. ANN. tit. 32, § 13804(4) (West 1999). At the risk of oversimplification, compliance

that, "The definition of the term 'charitable' has never been static and has been broadened in recent years."[139] Noting that, originally, charitable organizations were those who served the indigent and received funds primarily from donations, the court found that an organization of health plans was charitable given modern and less restrictive interpretations. The *De Modena* court based its finding that a health plan was charitable by examining how the health plan was treated under the law of charitable trusts and by the Internal Revenue Service.[140] Another court also looked at how the institution characterized itself when incorporating.[141]

As the case law develops, hopefully the contours of this requirement will become clearer, especially with respect to the definitions of the kinds of institutions specifically enumerated in the exemption. Regardless of developments in that area, however, the catchall category of "charitable institutions" provides a relatively clear alternative for those who design distribution systems under the Nonprofit Institutions Act. If price-favored purchasers are not clearly performing the traditional functions of one of the enumerated institutions, the supplier should assure that price-favored purchasers are charitable institutions.[142]

The requirement that exempt purchasers must be eligible institu-

with § 501(c)(3) principally involves two requirements. The first requirement is no private inurement, which means no payment of profits to owners, as opposed to the retention of any profits and dedication of those profits to the charitable purposes of the organization. The second requirement is that a charitable organization must serve charitable purposes. *See generally* MICHAEL D. ROSE & JOHN C. CHOMMIE, FEDERAL INCOME TAXATION 630–37 (3d ed. 1988) (discussing § 501(c)(3) requirements). In this context, the term, "charitable," has itself been subject to a variety of interpretations, suggesting that there is not much coherence in this second requirement. *See* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 85–115 (7th ed. 1998) (discussing scope of the federal tax law definition of charitable).

139. *De Modena*, 743 F.2d. at 1391 (quoting Eastern Kentucky Welfare Rights Org. v. Simon, 506 F.2d 1278, 1286 (D.C. Cir. 1974)).

140. *See id.* at 1391–92 (law of charitable trusts and IRS treat health plans as charitable institutions).

141. *In re* Brand Name Prescription Drugs Antitrust Litig., No. 94 C 897, MDL 997, 1995 U.S. Dist. LEXIS 12920, at *4 (N.D. Ill. Aug. 29, 1995) (noting that IRS determination and certificate of incorporation is sufficient to show status as not-for-profit charity).

142. The analysis in this article suggests a different approach to defining an eligible institution, depending upon whether the purchaser qualifies as an eligible institution by being either one of the enumerated institutions or a charitable institution. Enumerated institutions likely will be limited by a historical view that looks to the traditional functions performed by those named institutions when the Nonprofit Institutions Act was enacted. Charitable institutions, by contrast, likely will be defined by an evolving view that is affected by the definition of charitable institutions in other areas of law.

tions demonstrates how Congress drafted the Nonprofit Institutions Act to further the purpose to preserve "price favors that sellers would wish to grant to eleemosynary institutions."[143] Congress might have used the term, "eleemosynary," and then left to the courts the task of defining the kinds of institutions that fell within that rubric. Instead, Congress defined eligible institutions slightly more precisely by way of a list of institutions and a catchall category.[144] Of course, any precision gained by the actual language of the Nonprofit Institutions Act is largely illusory because judicial interpretation is still needed to look behind labels and to define the kinds of institutions listed as well as the catch-all category of charitable institutions. Nonetheless, Congress eschewed an approach that would have included any institution with a worthy goal but sought instead to limit the exemption to the charitable and worthy goals of certain kinds of institutions.

3. "Not operated for profit"

A final statutory requirement that must be met for the price-favored purchaser to be an exempt purchaser under the Nonprofit Institutions Act is that the purchaser may not operate for profit.[145] Issues that arise under this requirement are conceptually distinct from those under the other two requirements, even though the factual inquiries may resemble those under one of the other requirements. For example, when determining whether a purchaser is a charitable institution, the analysis may likely blur the distinct requirements that the purchaser must be an (1) eligible institution that (2) is "not operated for profit." The reason appears to be that the very definition of a "charitable institution" includes the requirement that the institution does not operate for profit.[146] Also, an otherwise

143. Abbott Labs., v. Portland Retail Druggist Ass'n, 425 U.S. 1, 12 (1976).

144. *See id.* at 13 (noting that an earlier version "would have exempted only sales to nonprofit institutions 'supported in whole or in part by public subscriptions,' was deleted, 83 CONG. REC. 6065 (1938), and the Act's exemption provision was not so restricted and confined").

145. One case in the pharmaceutical industry seems to be a relatively straight forward application of this requirement, *In re Brand Name Prescription Drugs Antitrust Litig.*, 1995 U.S. Dist. LEXIS 18048, even though the marketplace outcome has been criticized as anti-competitive. Pollak, *supra* note 7, at 984–85. For a symposium that addresses the economic implications of this protracted litigation, see Symposium, *The US Brand Name Prescription Drug Antitrust Litigation*, 4 INT'L J. ECON. BUS. 237 (1997).

146. The potential for confusion when similar factual inquiries arise under conceptually

eligible "charitable institution" that engages in for-profit activity would lose the exemption for two reasons: (1) it is no longer a charitable institution, and (2) it is now operating for profit.

An issue that has arisen in this context concerns the extent to which an institution that overall operates not-for-profit can engage in limited for-profit operations without offending this requirement. The analysis here may resemble the one to determine whether purchases for nonexempt uses exceed the bounds of de minimis because resales for profit do not fall within "own use." A case which focuses upon the "not operated for profit" requirement and shows a strict approach is *Students Book Co. v. Washington Law Book Co.*[147] There, a publisher of law books granted price favors to campus book stores who, in turn, resold the books to law students and presumably, nonstudents.[148] The lawsuit was brought by a competing retail outlet that sold books and other supplies to law students. In rejecting the contention that the sales to the campus book stores came within the exemption, the court seemed to rely, in part, on the "not operated for profit" requirement:

> Although the appellee [publisher] has sold books to all three of the universities for their own use, *i.e.*, for their libraries, the transactions here in question were not actually with the universities, but with the self-sustaining campus book stores, and the books sold were not for the use of the universities, but for resale at a profit.

separate requirements is demonstrated by a concurring opinion in *Abbott Laboratories* and in a leading treatise. In his concurring opinion in *Abbott Laboratories*, Justice Marshall opined that, if hospitals did not make a profit on sales of price-discounted drugs to the general public, those hospitals would come within the exemption because they would be acting in a "charitable" capacity. *Abbott Labs.*, 425 U.S. at 21–23. In this analysis, Justice Marshall did not distinguish the separate requirements of being an eligible institution and "not operated for profit," and he did so in a case where the issue concerned the "own use" requirement. *Id.* In his treatise, Professor Hovenkamp implicitly collapses the eligible institution and "not operated for profit" requirements when he states that, "[w]hat constitutes a qualifying nonprofit institution has produced little dispute." HOVENKAMP, ANTITRUST, *supra* note 17, § 2354c, at 195 (citing and discussing *Students Book Co. v. Washington Law Book Co.*, 232 F.2d 49 (D.C. Cir. 1955)).

147. 232 F.2d 49 (D.C. Cir. 1955).

148. Because the court's opinion does not mention that sales were restricted to students, the fair inference is that the bookstores were open to the general public. *See* HOVENKAMP, ANTITRUST, *supra* note 17, § 2354c, at 195 ("[T]hey [Bookstores] purchased educational law books at a discriminatorily low price and resold them to students and nonstudents alike."). Such an inference raises concerns under the "own use" requirement because, to the extent that law books are resold to the general public, those sales do not further the traditional function associated with a university.

> The exemption provision is therefore inapplicable to these transactions.[149]

The campus book stores in *Students Book Company* were deemed operating for profit even though those bookstores were characterized as "self-sustaining." Although the court did not elaborate upon their methods of business, the "self-sustaining" characterization suggests that, financially, the book stores operated independently without receiving subsidies from the larger universities or, for that matter, passing along profits to those universities.[150] In fact, it does not appear that the campus book stores were considered to be a part of the larger university with which each was associated. Indeed, when the Supreme Court in *Abbott Laboratories* cited the case with approval, the Court noted that, "we are in accord with the District of Columbia Circuit's characterization of the bookstore purchases as not being transactions with the universities at all, but with the campus bookstores for resale at the latter's profit."[151]

On different facts, a different result was reached in *Logan Lanes*, a case that was discussed in the context of the "own use" requirement. As noted in that discussion, an eligible institution that does not operate for profit may engage in a de minimis number of sales that do not comply with the "own use" requirement. In *Logan Lanes*, the court found "own use" despite the fact that the bowling alleys at the Student Union were open to the public who did not use the bowling alleys for university purposes. On the issue of profits, that court looked, not to the fact that profits may have been made from a de minimis number of public sales, but to the use of those profits:

> The primary purpose of the purchases [of bowling equipment] established beyond dispute, was to fulfill the needs of the University in providing bowling facilities for its students, faculty and staff. This being the case, any additional use of the bowling facilities by the general public for a fee, even if such use is substantial, would not

149. Students Book Co. v. Wash. Law Book Co., 232 F.2d 49, 50–51 n.5 (D.C. Cir. 1955).

150. *See* HOVENKAMP, ANTITRUST, *supra* note 17, § 2354c, at 195 ("[The bookstores] were self-sustaining in the sense that they required no operating funds from the university.").

151. *Abbott Labs.*, 425 U.S. at 19 n.10.

> establish that the purchases were not made for the use of the University.[152]

Thus, the "not operated for profit" requirement was met because to the extent that the facilities are used by persons other than students, faculty and staff, the net proceeds of such additional use was directed to defray the costs of the university's overall operation.

Another issue that arises in this context concerns the extent to which an institution that is "not operated for profit" can be controlled by an institution that is operated for profit. In *De Modena*, retail pharmacies challenged price favors granted to a non-profit organization of health plans who "provide[d] interested members with a 'drug plan.'"[153] The retail pharmacies argued that, while the health plans were "organized as non-profit institutions," the health plans were actually operated for profit because those plans were "controlled by Permanente Medical Groups, which are for-profit corporations consisting of doctors who provide medical care for members [of the health plans]."[154] When rejecting this argument, the court examined the substance of the financial arrangements between the health plans and the doctors' for-profit corporations:

> The [doctors'] Medical Groups do not set their own fees. The HP's [health plans] pay the Medical Groups an agreed upon amount per member per month, and this amount does not vary with the volume of service the group provides to the membership. This fact greatly limits the amount of control the Medical Groups can exercise over the HP's. That the HP's and Kaiser Hospitals must fulfill their need for certain medical services by contracting with doctors who seek a profit does not make the HP's and Kaiser Hospitals themselves for-profit organizations.[155]

152. Logan Lanes, Inc., v. Brunswick Corp., 378 F.2d 212, 217 (9th Cir. 1967). The *Logan Lanes* court distinguished *Students Book Co.* because, there, profits were used to sustain the bookstores but not for university purposes. *Id.*

153. De Modena v. Kaiser Found. Health Plan, Inc., 743 F.2d 1388, 1390 (9th Cir. 1984). Thus, *De Modena* follows an aspect of the requirement of no private inurement for charitable organizations under § 501(c)(3) of the United States Internal Revenue Code. Provided that the profits from a business that is related to the charitable purpose are retained and dedicated to the charitable purpose, an organization will not lose its tax-exempt status under § 501(c)(3). *See supra* note 138.

154. *De Modena*, 743 F.2d at 1391.

155. *Id.* (footnote omitted) (noting also that the IRS had found that the health plans were not sufficiently controlled by the doctors' for-profit corporations to indicate that the

Although difficult fact issues no doubt will arise, the cases just discussed provide some guidance for those who design distribution systems under the Nonprofit Institutions Act. The *Students Book Company* and *Logan Lanes* courts examined the "not operated for profit" requirement where the price-favored purchaser operated as a discrete unit within a larger nonprofit institution. The *Students Book Company* court found that the requirement was not met because any profits were retained so that the discrete unit would be self-sustaining. By contrast, the *Logan Lanes* court found that the requirement was met because any profits from a de minimis number of nonexempt sales were used to defray the costs of the overall not-for-profit operations of the larger institution. Thus, if a purchaser is a unit within an eligible institution, the unit should either be operated strictly not-for-profit or direct any profits from de minimis nonexempt sales to defray the costs of the overall not-for-profit operations of the eligible institution.[156]

The *De Modena* court examined the "not operated for profit" requirement where an otherwise exempt purchaser maintained financial arrangements with an organization operated for profit. The *De Modena* court found that the requirement was met because the for-profit organization did not financially control the operations of the exempt purchaser. Specifically, the court examined the fees paid by the exempt purchaser to the for-profit organization, and the facts indicated that the amount of those fees were not related to the amount of discounted supplies purchased or used by the exempt purchaser. Thus, if an exempt purchaser has financial arrangements with an organization that is operated for profit, those arrangements should not transfer revenues to the for-profit organization based upon the

health plans operated for profit).

156. This is the approach taken by the Ninth Circuit in an opinion that was vacated by the Supreme Court:

> It was undisputed that the hospitals derived substantial profits from the sale of drugs and from time to time enjoyed over-all operating surpluses. However, the existence of such profits or surpluses is not in itself enough to foreclose availability of the exemption. In an integrated medical center it is to be expected that one department may provide financial support to another.

Portland Retail Druggists Ass'n v. Abbott Labs., 510 F.2d 486, 488 (9th Cir. 1974), *vacated by*, 425 U.S. 1 (1976). Perhaps because the facts in *Abbott Laboratories* demonstrated that, overall, the hospitals "operated not for profit," the Supreme Court disposed of the case by focusing upon another requirement, the "own use" requirement. *See also Abbott Labs.*, 425 U.S. at 6–7 (noting that hospitals' pharmacies operated at a profit but that the profits supported other activities).

amount of price-discounted supplies purchased or used by the exempt purchaser.

These results make sense in light of the purpose of the Nonprofit Institutions Act to preserve "price favors that sellers would wish to grant to eleemosynary institutions."[157] This purpose would be frustrated if the financial benefits of price favors intended for exempt purchasers were diverted to for-profit operations. A larger and otherwise exempt institution should not be allowed to secure price favors so that a discrete unit may gain a competitive advantage vis-a-vis price-disfavored competitors. So too, a for-profit organization that has financial arrangements with an exempt purchaser should not be allowed to increase its revenues based upon the price favors granted to the exempt purchaser. In either situation, the exemption would reach more broadly than intended because the financial benefits of price favors that Congress wanted to preserve for exempt purchasers would be diverted to nonexempt purposes.

4. Exempt purchasers, arbitrage, and "own use" clauses

Clearly, the Nonprofit Institutions Act exemption is available only to the supplier and purchaser in those transactions where the price-favored purchaser complies with each and every one of the three requirements just discussed. This much seems certain, not only from the express language of the statute, but also from the policy of construing antitrust exemptions narrowly. The exemption will necessarily have a narrower reach if each and every element must be satisfied before price discrimination is exempted. There simply appears no way for a supplier to benefit from the exemption by granting price favors to a purchaser who complies with only one or perhaps two of the three statutory requirements.

Perhaps surprisingly, this observation may have been lost on those who design distribution systems to come within the exemption. Consider, for example, the following "own use" clause:

> [Purchaser] certifies that although it is not a non-profit institution within the meaning of the Non Profit Institutions Act, pharmaceuticals purchased at contract pricing are for [purchaser]'s "own use," as defined in *DeModena, et al. v. Kaiser Foundation Health Plan*,

157. *Abbott Labs.*, 425 U.S. at 12.

> *Inc.*, *et al.*, 743 F.2d 13888 [sic] (9th Cir. 1984) applying the holding of the U.S. Supreme Court in *Abbott Laboratories, et al. v. Portland Retail Druggists Association, Inc.*, 425 U.S. 1 (1976).[158]

This clause simply does not make sense. In effect, the clause asks a purchaser who is not exempt, because it operates for profit, to certify that it is exempt, because it will comply with the "own use" requirement. While this "own use" clause may purport to prevent arbitrage indirectly, in no way does this clause bring an otherwise illegal price discrimination strategy within the Nonprofit Institutions Act exemption. To the contrary, this clause indicates that the exemption is not available because the price-favored purchaser does not meet the necessary requirement of "not operated for profit."[159]

In civil cases, a failure to analyze each of the three requirements of the Nonprofit Institutions Act might not reflect a misunderstanding of the exemption. In those cases, the party alleging illegal price discrimination can show that the exemption does not apply with proof that the distribution system fails to meet any one of the three statutory requirements. Thus, the parties or the court can focus upon the one requirement at issue, perhaps giving no more than a list of the other requirements. To address or resolve the dispositive issue, the parties or the court opinion do not need to venture beyond the particular requirement at issue to discuss facts which might show whether other requirements are met or not. This may give the erroneous impression that sales are exempt if the purchaser meets only one of what are three separate and necessary requirements. For example, in the Supreme Court's opinion in *Abbott Laboratories*, the principal focus was upon the "own use" requirement, and the Court

158. *Ferro I*, No. 99-00180-0104-CR-W-SOW, 2000 WL 33394614, at *3 (W.D. Mo. May 8, 2000) (first two sets of bracketed text added).

159. There is a more cynical view that is motivated, at least in part, by populist concerns for the survival of neighborhood retail pharmacies:

> [M]any states have price discrimination statutes and their function is to disallow the large corporation from starving the small neighborhood business and its patrons. Although the purposes of the statutes are to prohibit the creation of meaningless classes which are used as vehicles to afford major purchasers exorbitant discounts, manufacturers still manage to employ discount tactics. The creation of as many as eight different classes has permitted Maryland manufacturers to evade the impact of the Robinson-Patman Act. A different sales price is attached to each of the eight classes, thus the general public foots the bill and in effect subsidizes the low prices afforded to HMOs and hospitals for no justifiable reason.

Pisone, *supra* note 34, at 78–79 (footnotes omitted).

did not emphasize facts which would have indicated whether the supplier limited sales to eligible institutions who did not operate for profit. This may have led some—like the supplier who drafted the "own use" clause just quoted—to design a price-favored distribution channel with only the "own use" requirement in mind.

In criminal cases involving "own use" clauses, however, a failure to establish that the distribution system was designed to comply with all three of the requirements of the Nonprofit Institutions Act seems based upon a lack of an understanding that antitrust issues are present or, perhaps, of the exemption itself. In a criminal case, if an antitrust exemption is brought into play, it is in the prosecution's interest to show that antitrust policy issues need not be considered.[160] Indeed, in *Ferro*, where antitrust issues came into play and were explicitly considered, the District Court dismissed the indictment, in significant part, because the distribution system was not designed to meet all of the requirements of the Nonprofit Institutions Act exemption.[161] Thus, it is in the prosecution's interests to show that all of the requirements of the exemption are present. Such a showing would indicate that there is no antitrust violation thereby removing any need to consider antitrust policy issues.[162]

With respect to the "own use" requirement, it is worth emphasizing that a supplier's legal interests of avoiding antitrust liability by granting price favors only to exempt purchasers dovetails with the supplier's economic interests of preventing price-favored purchasers from engaging in arbitrage. For both interests, an "own use" clause plays an instrumental role. A supplier's price-favored purchasers must comply with the "own use" requirement to qualify for the Nonprofit Institutions Act exemption. By demanding an "own use" clause, a supplier can contractually assure that one of the three statutory re-

160. The District Court in *Ferro I* made this point implicitly by noting, "With respect to the contracts at issue in this case, the pharmaceutical manufacturers have the burden of establishing that a transaction falls within the exemption of the Nonprofit Institutions Act because it is the manufacturers who enjoy the benefit of the exemption." *Ferro I*, 2000 WL 33394614, at *4. If the burden does not fall on the defendants in a criminal case to prove that they did not comply with the Nonprofit Institutions Act, then the burden falls on the government who benefits by removing antitrust issues from consideration.

161. *Id.* at *3–*5.

162. Indeed, the Eight Circuit, which reversed the District Court in *Ferro*, indicated that Robinson-Patman Act compliance issues were relevant, *Ferro II*, 252 F.3d 964, 967 (8th Cir. 2001), and that, on remand, the burden was on the government to "present pharmaceutical seller witnesses to testify as to the materiality of any 'own use' misrepresentations." *Id.* at 968.

quirements will be met. Also, as noted already, a supplier who pursues a price discrimination strategy must prevent arbitrage for the strategy to be successful in the marketplace. By demanding an "own use" clause, a supplier can contractually prohibit arbitrage, thereby providing that the economic interests are met.

A supplier who pursues a price discrimination strategy and seeks the legal benefits of the Nonprofit Institutions Act exemption must also prevent arbitrage because a price-favored purchaser who engages in arbitrage will not likely meet one or both of the other two necessary requirements of the Nonprofit Institutions Act. Arbitrage is a quintessentially for-profit activity.[163] Thus, a price-favored purchaser who engages in arbitrage is not, to that extent, a charitable institution, the catchall category for the requirement of a qualified institution.[164] So too, a price-favored purchaser who engages in arbitrage is not, to that extent, meeting the requirement of "not operated for profit." Thus, for the supplier to assure that price favors are granted only to exempt purchasers, the supplier must assure that price-favored purchasers do not engage in arbitrage. Here as well, by demanding an "own use" clause, the supplier can contractually prevent a practice that would destroy the exempt status of the price-favored purchaser.

C. Statutory Requirements and Enforcing an "Own Use" Clause

Once a distribution system has been designed to comply with the Nonprofit Institutions Act, both the supplier and its price-favored

163. The discussion in the text uses "arbitrage" in the common language sense of buying from a seller and reselling at a profit to those who otherwise would purchase from the seller at a higher price. Of course, one can imagine a scenario where an exempt purchaser obtains supplies at a discount and then sells to others without charging a price that generates revenues above the original cost of the supplies and the transaction costs of resale. Such a sale would not generate an accounting profit. This scenario is not likely to involve a resale to another exempt purchaser because that other exempt purchaser presumably could obtain the supplies directly from the supplier at the original discount without paying the reseller for the transaction costs of resale. Thus, this scenario likely will involve resale to a nonexempt purchaser who is willing to pay any price less than that charged for supplies not sold at a discount. Here, there is no reason for the exempt purchaser to forgo profit opportunities.

164. Under the tax law, a charitable institution may earn profits and retain its charitable status, provided that those profits are used for charitable purposes but not distributed to private shareholders or other owners. *See supra* note 138. Under the Nonprofit Institutions Act, a different result may follow from a different focus under the "own use" requirement. Under the exemption, the question is whether the price-discounted supplies are used for exempt uses, allowing only for a de minimis amount of nonexempt uses.

purchasers benefit from ongoing compliance with the exemption's requirements. The supplier, as a for-profit entity, benefits because price discrimination enables the supplier to garner increased profits. The price-favored purchasers, as eleemosynary institutions, benefit because price discrimination allows them to pay lower prices for supplies. Those lower prices, in turn, translate into lower costs that enable the price-favored eleemosynary institutions to expand the products or services that they offer as they pursue their charitable or other worthy goals. Of course, these benefits are available only if the price-favored purchasers comply with each of the three requirements of the Nonprofit Institutions Act.

1. Incentives to cheat

A problem arises, however, because price-favored purchasers have strong incentives to cheat or chisel on the "own use" requirement that impliedly prevents arbitrage.[165] A price-favored purchaser who engages in arbitrage and diverts supplies to those who are willing to pay a higher price potentially can garner significant profits,[166] at least in the short run. This is especially true for industries like the pharmaceutical industry, where price-favored purchasers in the "closed door" channel have paid as little as twenty-five percent of the price paid by price-disfavored purchasers in the "open door" channel.[167] To garner profits through arbitrage, the price-favored purchaser aims to charge a price that is slightly less than the price charged by the supplier to price-disfavored purchasers. The profit garnered by the price-favored purchaser is the difference between the price charged to the price-disfavored purchasers and the price paid to the supplier, less any transaction costs incurred by the price-favored purchaser

165. Those incentives are almost indistinguishable from the incentives that lead a member of a price-fixing cartel to cheat or chisel on the agreement to maintain high prices by lowering price and expanding output to take advantage of profit opportunities. *See generally* HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE 147–52 (2d ed. 1999) (discussing cartels, incentives to cheat, and monitoring); CHARLES J. GOETZ & FRED S. MCCHESNEY, ANTITRUST LAW: INTERPRETATION AND IMPLEMENTATION 1–3 (1998) (numerical example of "chiselers" on price-fixing cartels).

166. United States v. Costanzo, 4 F.3d 658, 666 (8th Cir.1993) ("The record clearly supports a finding that Civella controlled the diversion operation, an operation that produced large profits with little work and almost no investment.").

167. *Id.* at 659 ("[D]rug manufacturers sell pharmaceuticals to institutional ["closed door"] pharmacies at prices that may be as low as twenty-five percent of the prices at which the companies sell drugs to other ["open door"] customers.").

when reselling to price-disfavored purchasers.

From an economic perspective concerned with success in the marketplace, the profit opportunities of arbitrage or diversion will likely be short lived, however. If the supplier knows the identity of the price-favored purchaser who resells, the supplier can end arbitrage simply by refusing to deal with that reseller.[168] If the supplier does not know the identity of the diverting reseller, when arbitrage starts, the supplier likely will respond by competing with the reseller, the price-favored purchaser who diverts and resells into the price-disfavored distribution channel. This competition will exert a downward pressure on price until every purchaser, price-favored and price-disfavored, pays the same, lower price. When this happens, the profit opportunities of arbitrage will evaporate. To be more precise, profit opportunities of arbitrage will evaporate as soon as the supplier charges a price to price-disfavored purchasers that equals the price the supplier charges the price-favored purchaser who engages in arbitrage plus that price-favored purchaser's transaction costs of arbitrage.

From a legal perspective concerned with antitrust compliance, the profit opportunities of arbitrage or diversion will also likely be short lived. The profit opportunities of arbitrage will evaporate because the supplier will lose the exemption of the Nonprofit Institutions Act. As noted already, by engaging in arbitrage, an otherwise exempt purchaser risks non-compliance with the requirements of the Nonprofit Institutions Act which would, in turn, jeopardize the antitrust exemption for both the supplier and the price-favored purchaser. If the price-favored purchaser no longer complies with all of the statutory requirements of the Nonprofit Institutions Act, the exemption does not apply, and the supplier may not sell to the price-favored purchaser at the lower price without offending the Robinson-Patman Act's prohibition of price discrimination. To avoid antitrust liability, the astute supplier will cease granting price favors to any price-favored purchaser who engages in arbitrage. When the price-favored purchaser who previously engaged in arbitrage is charged the same price that the supplier charges those to whom that purchaser had diverted supplies, arbitrage will cease.

168. *Id.* at 666 (diverting reseller terminated after discovery of diversion operation); *see also* Petersen, *supra* note 31, at C1 ("drug companies send auditors to wholesalers and pharmacies, and cut off those that raise suspicions [under the Prescription Marketing Act of 1987]").

Nonetheless, where incentives are sufficiently strong, arbitrage is likely. For example, a price-favored purchaser may believe that arbitrage will likely escape detection, thereby extending the time period over which the price favored purchaser expects to garner profits. Even where detection is likely and the profit opportunities of arbitrage are likely to be short lived, if the amount of profits are sufficiently high, the temptation to engage in arbitrage may still be strong. Indeed, in the criminal cases already cited, defendants diverted pharmaceutical products and pursued the profit opportunities of arbitrage despite the possibility of detection. The reason, it seems, is that the defendants thought that they could avoid detection, the profit opportunities were substantial, or both.[169]

2. Enforcement alternatives

Consequently, suppliers who seek to avoid illegal secondary-line price discrimination by complying with the Nonprofit Institutions Act have strong incentives to monitor price-favored purchasers to assure compliance with "own use" clauses and to enforce those clauses where necessary. Of course, suppliers might enforce "own use" clauses directly by filing an action for breach of contract. Damages likely would equal profits that the supplier lost to a price-favored purchaser who engages in arbitrage,[170] and a remedy of specific performance might direct the price-favored purchaser to comply with the "own use" restriction by refraining from diverting supplies and engaging in arbitrage.[171] Nonetheless, an action for breach of contract might not be an effective deterrent to price-favored purchasers who are tempted by the profit opportunities of arbitrage. Under the

169. Of course, one way to reap the profit opportunities of arbitrage and to avoid detection is to misrepresent that pharmaceutical products will not be diverted. As one court noted, "While it represents no illegality in itself, the diversion industry clearly presents unique opportunities for the development of fraudulent practices." United States v. Weinstein, 762 F.2d 1522, 1527 (11th Cir. 1985).

170. *See generally* 3 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.10, at 209–20 (2d ed. 1998) (discussing contract damages for non-breaching supplier, including lost profits). For a general statement of rules concerning the calculation of damages for breach of contract, see RESTATEMENT (SECOND) OF CONTRACTS § 347 (1979); 3 FARNSWORTH, *supra*, § 12.1, at 146–53.

171. For general statements of rules affecting the availability of specific performance, see RESTATEMENT (SECOND) OF CONTRACTS §§ 357, 359–69 (1981); 3 FARNSWORTH, *supra* note 170, §§ 12.4 to 12.7, at 159–87; U.C.C. § 2-716 (1977).

preferred measure of contract damages,[172] price-favored purchasers probably risk only the profits that the supplier would have earned had the price-favored purchasers adhered to the "own use" clauses, an amount that likely would approximate the price-favored purchaser's own gain from arbitrage.[173] Thus, in a contract action, the price-favored purchaser who engages in arbitrage likely risks only the profits from arbitrage, but no more. In addition to contract remedies, a price-favored purchaser who engages in arbitrage and loses its exempt status also loses its continuing ability to purchase supplies at lower costs, all to the detriment of any charitable or other worthy goals that the purchaser pursues.

Suppliers might indirectly enforce "own use" clauses by filing a tort action for fraud.[174] The theory here is that the price-favored purchaser induced a supplier to sell at a lower price by signing a contract containing an "own use" clause, even though the price-favored purchaser had no intention of adhering to the "own use" clause.[175] The

172. The preferred measure of damages is the expectation interest:

> How do courts encourage promisees to rely on promises? Ordinarily they do so by protecting the expectation that the injured party had when making the contract by attempting to put that party in as good a position as it would have been in had the contract been performed, that is, had there been no breach. The interest measured in this way is called the *expectation interest* and is said to give the injured party the "benefit of the bargain."

3 FARNSWORTH, *supra* note 170, § 12.1, at 147; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 347 cmt. a (1981) ("Contract damages are ordinarily based on the injured party's expectation interest and are intended to give him the benefit of his bargain by awarding him a sum of money that will, to the extent possible, put him in as good a position as he would have been in had the contract been performed."). For expectation measures of damages that apply to the sales of goods, see U.C.C. §§ 2-712, 2-713 (1977).

173. *See generally* 3 FARNSWORTH, *supra* note 170, § 12.20b, at 357–67 (discussing appropriateness of damages based upon disgorgement of the breaching party's gain). For a discussion of the circumstances under which an injured party's loss equals the injuring party's gain, see Dennis S. Corgill, *Measuring the Gains of Trademark Infringement*, 65 FORDHAM L. REV. 1909, 1917–24 (1997).

174. For a brief discussion of the elements of a civil action for fraud, see 2 FOWLER V. HARPER ET AL., THE LAW OF TORTS § 7.1, at 381 (2d ed. 1986).

175. *See* RESTATEMENT (SECOND) OF TORTS § 544 (1977) ("The recipient of a fraudulent misrepresentation of intention is justified in relying upon it if the existence of the intention is material and the recipient has reason to believe that it will be carried out."); 2 HARPER ET AL., *supra* note 174, § 7.10, at 445–46 ("Promises and statements of the speaker's intention or purpose are now generally recognized as involving a statement or implication of the speaker's own state of mind. . . . The question then arises whether it is a material fact and . . . the law has been readier to recognize the potential materiality of the speaker's intention than of his opinions."). As the source just cited explains:

> Promissory statements deserve separate treatment. "A promissory statement is not,

price-favored purchaser's subsequent diversion and arbitrage are evidence of the original, fraudulent intent.[176] In a tort action, the potential for punitive damages creates a greater deterrent to arbitrage.[177] The price-favored purchaser risks losing more than damages that would compensate the supplier for lost profits which, as already noted, likely would approximate the price-favored purchaser's own gain from arbitrage.[178] Thus, in a tort action, the price-favored purchaser may risk more than the profits from arbitrage. In addition to tort remedies, a price-favored purchaser who engages in arbitrage risks its continuing ability to purchase supplies at lower costs.

Another way for a supplier to enforce an "own use" clause indirectly is to enlist the government's assistance in bringing a criminal action for fraud. It is altogether possible that this may have happened in the criminal cases cited above. The court's opinion in *Costanzo* indicates that this is what happened.[179] Criminal sanctions effectively enforce a contractual provision like an "own use" clause if the threat of criminal sanctions provides incentives to adhere to such a clause.

> ordinarily, the subject either of an indictment or of an action." On the other hand, the promise itself is generally regarded as a representation of a present intention to perform. Hence, such a promise, made by one not intending to perform, is a misrepresentation—a misrepresentation of the speaker's present state of mind—and is actionable as a misrepresentation of fact.

Id. § 7.10, at 447 (footnotes omitted).

176. As with all misrepresentations, to be actionable, there must be reliance, and the reliance must be justifiable. RESTATEMENT (SECOND) OF TORTS § 537 (1977). "In order for reliance upon a statement of intention to be justifiable, the recipient of the statement must be justified in his expectation that the intention will be carried out." *Id.* at § 544 cmt. c. *See also* 2 HARPER ET AL., *supra* note 174, § 7.8, at 423–24 ("A person who relies on a misrepresentation can recover for losses caused to him thereby only if the law regards his reliance as justifiable."). Thus, to the extent that drug manufacturers are aware that price-favored purchasers will not adhere to an "own use" restriction, a tort action for fraud is not likely to prevail. *Cf.* United States v. Weinstein, 762 F.2d 1522, 1533 (11th Cir. 1985) (although defendants alleged that "some manufacturers 'wink' at representations of nonprofit or export status in order to use the diversion market as a 'dumping-ground' for drugs nearing expiration," jury finding of fraud upheld).

177. *See generally* RESTATEMENT (SECOND) OF TORTS § 908 (1977) (discussing punitive damages in tort actions). By contrast, in contract, the general rule is that punitive damages are not available unless the breach is also a tort for which punitive damages are available. RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981).

178. *See generally* RESTATEMENT (SECOND) OF TORTS § 549 (1977) (outlining damages for fraudulent misrepresentation); 2 HARPER ET AL., *supra* note 174, § 7.15, at 477–92 (discussing actual and consequential damages for fraud).

179. United States v. Costanzo, 4 F.3d 658, 666 (8th Cir. 1993) ("[E]mployees at Ciba-Geigy [pharmaceutical supplier] did discover Care's diversion within a period of months, reported it to the FBI, and subsequently discontinued selling to Care.").

Indeed, criminal sanctions potentially have a more widespread impact than a civil action brought by a supplier. A successful prosecution in one case not only has a specific deterrent effect on that defendant, but also a general deterrent effect on others who may be tempted by the profit opportunities of arbitrage. Thus, criminal sanctions, including the possibility of incarceration, provide a potentially effective mechanism to enforce "own use" clauses.

3. Civil contexts of enforcement

Any enforcement of "own use" clauses that are part of a price discrimination strategy should not proceed without a careful examination of antitrust issues, including the requirements of the Nonprofit Institutions Act exemption. If there is a prima facie case of illegal price discrimination and no affirmative defense, the legality of the distribution system turns upon compliance with the Nonprofit Institutions Act. If such a distribution system does not comply with all of the requirements of the Nonprofit Institutions Act, the distribution system constitutes illegal price discrimination. The seller would be liable under section 2(a) of the Robinson-Patman Act,[180] and a purchaser who knowingly accepts or induces the price favor would be liable under section 2(f).[181]

If analysis shows that the price discrimination strategy is illegal, the "own use" clause is integral to the illegality because the "own use" clause prevents arbitrage and thereby enables the illegal price discrimination scheme to be successful in the marketplace. Courts do not, however, enforce contract clauses that are part of an illegal scheme and therefore contrary to public policy. Thus, without careful consideration of whether a distribution system was designed to come within the Nonprofit Institutions Act exemption, a court risks lending its hand to enforce an "own use" clause that is integral to illegal price discrimination.

As an illustrative example of the problems that may arise when an "own use" clause is enforced without examining the broader context of the price discrimination strategy, consider the following facts which are based on those in *Ferro.* A price-favored purchaser of pharmaceutical products in the "closed door" channel of distribution signed a contract that included a clause indicating that the purchaser

180. 15 U.S.C. § 13(a) (1994).

181. *Id.* § 13(f).

will use the products for its "own use" by reselling only to patients in nursing homes.[182] At the same time, however, the purchaser truthfully represented to the drug manufacturers that it is a for-profit operation.[183] The drug manufacturers nonetheless charged a lower price to the purchaser for the same products that it sold, at higher prices, in the "open door" channel. The price-favored purchaser and price-disfavored purchasers were in the same geographic area and, but for the difference in price, the price-disfavored purchasers would have sold to the patients in nursing homes who were serviced by the price-favored purchaser. The price differences did not, however, reflect different costs, changed circumstances, or a good faith effort to meet competition. Subsequently, the price-favored purchaser pursued the profit opportunities of arbitrage and resold some of the pharmaceutical products to distributors in the "open door" channel.

On these facts, the reasons why the drug manufacturer required the purchaser to represent that the products are for its "own use" seem obvious. The manufacturer's objectives were twofold. First, by requiring the purchaser to represent that the drugs will be for its "own use," the manufacturer seeks to create a "closed door" channel that comes within the Nonprofit Institutions Act exemption. This seems obvious because the "own use" language is taken from the Nonprofit Institutions Act.[184] Second, by requiring the purchaser to represent that the drugs will be for its "own use," the manufacturer seeks to prevent the purchaser from engaging in arbitrage by reselling into the "open door" channel. This seems obvious because an "own use" clause is one way to prevent the arbitrage that would not allow the price discrimination strategy to achieve success in the marketplace. The manufacturer thus uses the "own use" restriction to come within an exemption to illegal price discrimination and, at the

182. Examples of the actual clauses signed by the defendant-purchasers in *Ferro* were included in the District Court's opinion and are reproduced, *supra* notes 68, 156, and text accompanying note 67.

183. *Ferro I*, No. 99-00180-0104-CR-W-SOW, 2000 WL 33394614, at *4–*6 (W.D. Mo. May 8, 2000) (with respect to four contracts, defendant-purchasers represented themselves as operating through a "Profit Corp.," "a 'for profit' entity," "For Profit," and "a for-profit organization"). Further, in that case, on one contract, one of the individual defendants "wrote 'N/A' next to a paragraph stating that the company was an eligible institution under the Non Profit Institutions Act, 15 U.S.C. § 13c." *Id.* at *2.

184. Indeed, in *Ferro I*, the District Court found that "own use" clauses referring to the Nonprofit Institutions Act exemption were employed for this purpose. *Id.* at *4; *see supra* note 71.

same time, to prevent arbitrage that would not allow the price discrimination strategy to be economically successful.

On these facts, the contract with an "own use" restriction nonetheless is part of an illegal secondary-line price discrimination strategy. The distribution system satisfies a prima facie case and does not fall within an affirmative defense such as cost justification, changed circumstances, or meeting competition. The legality of the price discrimination strategy therefore turns upon the availability of the Nonprofit Institutions Act exemption. That exemption is not available, however. The reason is that the purchaser is a for-profit organization, which indicates that the purchaser fails to comply with one of the necessary requirements of the exemption, the requirement of "not operated for profit."

On these facts, efforts to enforce the "own use" clause seem wholly misplaced. Indeed, the drug manufacturer no doubt could not bring a contract action to enforce the "own use" clause directly. Although the principal focus of this article is not upon judicial enforcement of illegal contracts, it is worth noting that there is doctrinal support for this conclusion. Courts do not allow themselves to become a party to illegality by enforcing contracts that are illegal and therefore contrary to public policy.[185] Even where courts exercise their discretion to enforce some aspects of a contract, courts refrain from enforcing the particular clause or clauses that are integral to the illegality.[186] The "own use" clause, of course, is integral to the illegality: the "own use" clause, because it prevents arbitrage, is

185. Kaiser Steel Corp. v. Mullins, 455 U.S. 72, 81–82 (1982) ("the illegality defense should be entertained in those circumstances where its rejection would be to enforce conduct that the antitrust laws forbid"); Kelly v. Konsuga, 358 U.S. 516, 520 (1959) (contract defense of illegality should be limited to situations that would "make the courts a party to the carrying out of one of the very restraints forbidden by the Sherman Act"). *See* Resolution Trust Corp. v. Home Sav. of Am., 946 F.2d 93, 96–97 (8th Cir. 1991) (contracts entered into in violation of federal statutory laws are unenforceable). *See generally* KINTNER, *supra* note 19, § 3.3 (common law courts have long refused to enforce contracts in restraint of trade); 3 FARNSWORTH, *supra* note 170, §§ 5.1 and 5.3, at 2–8 and 18–31 (public policy as a ground to deny contract enforcement generally and contracts in restraint of trade particularly).

186. *See generally* 3 FARNSWORTH, *supra* note 170, at §§ 5.7 to 5.8, at 78–87 (discussing "divisibility" whereby courts may "hold[] agreements unenforceable only in part"). For example, in *Kelly*, 358 U.S. 516, a purchaser of onions sought to avoid payment, arguing that the contract violated the antitrust laws because the seller agreed to refrain from delivering additional onions to the futures market so that the price of onions would be fixed and the quantity limited. The Court declined to extend the defense of illegality that far:

> Past the point where the judgment of the Court would itself be enforcing the precise conduct made unlawful by the Act, the courts are to be guided by the overriding general policy, as Mr. Justice Holmes put it, "of preventing people from getting

gality: the "own use" clause, because it prevents arbitrage, is necessary for the illegal price discrimination strategy to be successful in the marketplace.[187] If the drug manufacturer brought a breach of contract action against the purchaser for failing to adhere to the "own use" clause, the purchaser could successfully defend by pointing out that the "own use" clause is unenforceable as contrary to public policy because the "own use" clause is integral to the illegal price discrimination strategy.[188]

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other people's property for nothing when they purport to be buying it."

Id. at 520–21 (quoting Cont'l Wall Paper Co. v. Louis Voight & Sons Co., 212 U.S. 227, 271 (1909) (dissenting opinion)). The Court then pointed out that the defense of illegality would not extend to those parts of the contract that were not tainted by the illegality:

> Accordingly, while the nondelivery agreement between the parties could not be enforced by a court, if its unlawful character under the Sherman Act be assumed, it can hardly be said to enforce a violation of the Act to give legal effect to a completed sale of onions at a fair price.

Id. at 521; *see also* Kaiser Steel Corp. v. Mullins, 455 U.S. 72, 81 n.7 (1982) ("A defendant proffering the defense seeks only to be relieved of an illegal obligation and does not ask any affirmative remedy based on the antitrust . . . laws."); Bruce's Juices, Inc. v. Am. Can Co., 330 U.S. 743, 755 (1947) (rejecting defense to payment by a price disfavored purchaser who claimed that price discounts given to favored purchasers constituted illegal price discrimination). *See generally* KINTNER, *supra* note 19, § 30.14 (discussing holding in *Bruce's Juices*); 3 FARNSWORTH, *supra* note 170, § 5.9, at 88 (exception to rule against restitution of unenforceable agreement where "forfeiture . . . is disproportionate to the contravention of public policy involved"). For cases that have adopted this approach in the context of alleged Robinson-Patman violations, see Delta Marina, Inc. v. Plaquemine Oil Sales, Inc., 644 F.2d 455, 458–59 (5th Cir. 1981); El Salto, S.A. v. PSG Co., 444 F.2d 477, 482–83 (9th Cir. 1971).

187. This analysis explains why the court correctly declined to consider allegedly illegal price discrimination in United States v. Weinstein, 762 F.2d 1522 (11th Cir. 1985). There, defendants were able to purchase price-discounted pharmaceutical products by misrepresenting that the products would be resold overseas in the export market where the Robinson-Patman Act does not apply. The defendants then diverted the products into the domestic market where the Robinson-Patman Act does apply. The defendants argued that they should not be liable for mail fraud because the suppliers were engaging in illegal price discrimination in the domestic market. Although the *Weinstein* court did not explain its reasoning in so many words, the result was correct because the contract term at issue was not integral to the alleged illegality. There was, at best, only a tenuous connection between, on the one hand, a misrepresentation and a breach of contract in the export market where price discrimination is legal and, on the other, different contracts in the domestic market where price discrimination can be illegal.

188. These principles indicate why the "own use" clauses in cases like *Ferro* are unenforceable, even if other parts of the contract are. The purchaser could not defend a lawsuit, brought by the drug manufacturer, seeking payment for the pharmaceutical products by pointing to the "own use" clause because there is nothing illegal about a simple contract for the sale and purchase of drugs. The purchaser could, however, defend a lawsuit seeking to enforce the "own use" clause because that clause is integral to the illegal price discrimination strategy. Only by following the "own use" clause does the purchaser cross the line and help to enable the illegal scheme. If the court did not allow a defense to the "own use" clause and, instead, enforced the "own use" clause, the court would lend its hand to an illegal scheme by enforcing

Nor on the given facts should the drug manufacturer be allowed to enforce the "own use" clause indirectly by way of a civil action for fraud. Consider first that the drug manufacturer sought the purchaser's representation that the products would be for "own use" because the manufacturer sought a representation that the purchaser would not engage in arbitrage by reselling the products into the "open door" channel. Because the purchaser's participation in the distribution system does not bring price-favored sales to that purchaser within the Nonprofit Institutions Act exemption, however, the distribution system is illegal secondary-line price discrimination under the Robinson-Patman Act. In this context, the purchaser's representation is that the purchaser will adhere to an "own use" clause that is integral to the economic success of an illegal price discrimination strategy. The inference from the given facts is that the drug manufacturer entered into the contract as a way to enlist the participation of the price-favored purchaser in an illegal secondary-line price discrimination strategy. For the same reasons that courts do not enforce illegal contracts directly in contract actions, courts should not enforce illegal contracts indirectly in tort actions.

Consider next that the drug manufacturer sought the purchaser's representation that the products would be for "own use" because the manufacturer sought a representation that the purchaser's participation in the distribution system would bring price-favored sales to that purchaser within the Nonprofit Institutions Act exemption. The purchaser did not, however, represent every fact necessary for the drug manufacturer to believe that price-favored sales to that purchaser would be exempt from the prohibition of secondary-line price discrimination. To the contrary, on facts like those that were present in *Ferro*, the purchaser represented that it was a for-profit organization; the purchaser represented that its participation would not meet one of three necessary requirements for lower-priced sales to be exempt. On facts such as these, the drug manufacturer could not reasonably believe that its price discrimination strategy would come within the Nonprofit Institutions Act exemption.[189]

The principal focus of this article is not upon the law of fraud,

a clause that is integral to an illegal price discrimination strategy.

189. *See* RESTATEMENT (SECOND) OF TORTS § 547 cmt. a (1977) ("Ordinarily one who makes an investigation will be taken to rely upon it alone as to all facts disclosed to him and all facts that must have been obvious to him in the course of it.").

but here as well there is doctrinal support for the conclusions just reached. Every misrepresentation is not a fraud; a misrepresentation is fraudulent only if it is material.[190] In this context, a useful definition of materiality is matter that "a reasonable [person] would attach importance to its existence or nonexistence in determining his choice of action in the transaction in question."[191] As soon as a price-favored purchaser truthfully represents that it operates for profit, the drug manufacturer knows or should know that lower priced sales to that purchaser cannot meet all of the requirements of the Nonprofit Institutions Act exemption. Any further representation or misrepresentation cannot affect a reasonable manufacturer's choice to sell to the purchaser at lower prices if the manufacturer sought representations to assure that the purchaser's participation in the distribution system would bring the system within the Nonprofit Institutions Act.[192] Simply put, the purchaser's truthful representation that any one of the three requirements is not met renders immaterial any representation or misrepresentation as to the remaining requirements.[193]

190. Oftentimes, this statement is made in the context of the requirement that the necessary reliance must be justifiable: "Reliance upon a fraudulent misrepresentation is not justifiable unless the matter misrepresented is material." RESTATEMENT (SECOND) OF TORTS § 538(1) (1977). *See also* 2 HARPER ET AL., *supra* note 174, § 7.9, at 435 ("The notion of justifiable reliance is limited by the rule of materiality: Even a fraudulent misrepresentation is not actionable if the representation is 'immaterial.'").

191. RESTATEMENT (SECOND) OF TORTS § 538(2)(a) (1977). *See also* 2 HARPER ET AL., *supra* note 174, § 7.9, at 436 (quoting RESTATEMENT formulation of materiality).

192. *See* RESTATEMENT (SECOND) OF TORTS § 545 cmt. d (1977) ("Thus, as between bargaining adversaries there can ordinarily be no justifiable reliance upon an opinion, as stated in § 542. The recipient is not justified in accepting the opinion of a known adversary on the law and is expected to draw his own conclusions or to seek his own independent legal advice."); *id.* at § 546 ("reliance [on misrepresentation must be] a substantial factor in determining the course of conduct that results in his loss"). *See also* 2 HARPER ET AL., *supra* note 174, § 7.8, at 433–35 ("But the more clearly the statement reflects only the speaker's legal judgment, the less likely courts are to hold that reliance on it is justified unless the speaker has special legal skill or knowledge, including, e.g., that he could reasonably be expected to have special knowledge of settled legal rules as they apply to routine transactions in his business, or unless he stands in a fiduciary capacity to the person to whom the statement is made.") (footnotes omitted).

193. Of course, materiality is an issue of fact. RESTATEMENT (SECOND) OF TORTS § 538 cmt. e. (1977) ("As in all cases in which the conduct of the reasonable man is the standard, the question of whether a reasonable man would have regarded the fact misrepresented to be important in determining his course of action is a matter for the judgment of the jury subject to the control of the court."). Thus, the determination of whether a truthful representation of noncompliance of one requirement renders immaterial a false representation of compliance of a separate requirement will turn on the facts of each case.

In an analogous fact situation, a developer of condominiums faced two requirements:

There are additional problems for a civil cause of action for fraud, and these do not turn upon whether a price-favored purchaser makes a truthful representation of noncompliance with one or more of the three necessary requirements of the Nonprofit Institutions Act. Under the general law of fraud, the one defrauded must "part with a thing of value or . . . surrender a legal right."[194] First, if the facts show that a price-discriminating seller engaged in a strategy that was thwarted by a purchaser's arbitrage, any fraud associated with a promise not to engage in arbitrage did not cause the seller to part with anything of value. The reason is that the seller never came into possession of those profits. A price-favored purchaser's failure to adhere to a promise not to engage in arbitrage prevents a price discriminating seller from recovering increased profits from price-disfavored purchasers. Arbitrage does not take profits already in the seller's possession; arbitrage prevents profits from coming into the seller's possession.

Second, if the facts show that a seller is engaging in illegal price discrimination, the seller is not legally entitled to any prospective economic advantage from the price discrimination strategy. When expanding the prohibition on price discrimination to include secondary-line discrimination, the Robinson-Patman Act was intended to assure that purchasers who resell to the same consumers compete on

(1) subdivision review and (2) sanitation approval. Young v. Flathead County, 757 P.2d 772 (Mont. 1988). The county first stated that the project was not a "subdivision" and, therefore, did not require subdivision review. After the county later changed its position on the requirement of subdivision review, the developer encountered additional obstacles, and the developer eventually abandoned the project. The developer brought an action for, inter alia, negligent representations, seeking to recover, as damages, expenses incurred on the project. The trial court excluded evidence that the sanitation approval would not have been forthcoming and found in favor of the developer. The Supreme Court of Montana reversed, finding that the trial court erred in excluding evidence that the sanitation approval would not have been forthcoming. The Supreme Court also found that, "the [negligent mis]representations did not 'proximately cause' the damages in this case." *Id.* at 777.

> [S]ince other factors—the economy, failure to secure additional financing, and especially the inability to secure approval of the sewer system—has an impact on the resulting damage, developers cannot claim the County's representations alone "proximately caused" the damage. Where more than one possible cause of damage appears, the plaintiff must eliminate causes other than those for which the defendant is responsible.

Id.

194. 1A KEVIN F. O'MALLEY, ET. AL., FEDERAL JURY PRACTICE AND INSTRUCTIONS § 16.08 (5th ed. 2000).

a level playing field by paying the same price for supplies.[195] A seller who engages in illegal discrimination is not entitled to profit by charging price differences because, under the Robinson-Patman Act, purchasers who compete in the same geographic area are entitled to pay the same price. Any fraud associated with a promise not to engage in arbitrage does not cause an illegally price discriminating seller to part with prospective profits to which the seller is entitled.[196]

4. The criminal context

When an "own use" clause is at the heart of a criminal action, additional considerations come into play, largely because some criminal offenses have an incredibly broad reach. For example, under the federal general conspiracy statute,[197] a conspiracy to violate one of the laws of the United States is actionable as soon as the agreement is made and one conspirator engages in one overt act in furtherance of the conspiracy.[198] Criminal conspiracy liability attaches even if the conspirators do not complete the target or substantive offense that violates the underlying federal law or, for that matter, take a substantiated step that is needed for an attempt offense.[199] Thus, as

195. Federal Trade Comm'n v. Sun Oil Co., 371 U.S. 505, 520 (1963) ("In short, Congress intended to assure, to the extent reasonably practicable, that businessmen at the same functional level would start on equal competitive footing so far as price is concerned.").

196. Only by ignoring antitrust analysis and assuming that a seller is entitled to profits on higher-priced sales to price-disfavored purchasers would a court come to an opposite conclusion. For example, in *United States v. Stewart*, 872 F.2d 957 (10th Cir. 1989), before reaching a truncated and flawed analysis of antitrust issues, *see infra* notes 209–13 and accompanying text, the court stated, "the effect of the scheme was to deprive the manufacturers of money which they should have received on sales of pharmaceuticals to wholesalers." *Stewart*, 872 F.2d at 960.

197. The general conspiracy statute provides, in significant part, that "If two or more persons conspire . . . to commit any offense against the United States . . . and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined . . . or imprisoned . . . or both." 18 U.S.C. § 371 (1994).

198. The elements of a general conspiracy under 18 U.S.C. § 371 are "(1) the parties make an agreement; (2) to achieve an illegal goal; (3) with the knowledge of the conspiracy and with actual participation in the conspiracy; and (4) at least one conspirator committed an overt act in furtherance of the conspiracy." Julia Cheung et al., *Federal Criminal Conspiracy*, 31 AM. CRIM. L. REV. 591, 595 (1994). Although the word "defraud" appears in a portion of the statute omitted in the preceding quotation, *see supra* note 197, a general federal conspiracy can reach activity that does not involve fraud or deceptive means, Cheung et al., *supra*, at 593. Further, "in prosecutions for conspiracy to import, possess, or distribute narcotics, the government need not prove any overt acts." *Id.* at 601.

199. Chueng et al., *supra* note 198, at 600–01.

soon as a supplier and a price-favored purchaser knowingly enter into a contract that violates the Robinson-Patman Act and one sale is made to either a price-disfavored or price-favored purchaser, criminal liability may attach, regardless of whether other sales are made pursuant to that contract.[200] By contrast, in a civil action, at least two sales at different prices to at least two buyers are necessary elements of a prima facie case. Thus, where an "own use" clause is at issue, criminal liability may lie regardless of whether a price-favored purchaser acquired price-discounted supplies and adhered to the "own use" clause. Moreover, if this theory were pursued, criminal liability would be available against both the seller and the purchaser as co-conspirators.

Similarly, mail fraud[201] is a prophylactic offense that reaches broadly with few limitations.[202] For example, although mail fraud is based upon common law fraud, mail fraud does not import every limitation of common law fraud.[203] Mail fraud might attach even

200. After the overt act of making one sale, a price-favored purchaser could not avail itself of the defense of withdrawal by claiming that it did not adhere to the "own use" clause. "To escape liability for the conspiracy, an actor must unequivocally withdraw before the commission of any overt act in furtherance of the conspiracy." *Id.* at 620.

201. The federal mail fraud statute, in significant part, proscribes the use of the mails "[1] to devise any scheme or artifice to defraud, or [2] for obtaining money or property by means of false or fraudulent pretenses, representations or promises, or [3] to sell . . . exchange . . . distribute . . . or procure for unlawful use any counterfeit . . . coin . . . security, or other article." 18 U.S.C. § 1341 (1994).

202. As one treatise has summarized,

> While the proscriptions of the mail fraud statute reach three species of schemes, what has become the heart of the provision is the use of the mails for the purpose of executing a scheme or artifice to defraud. The statute neither defines the term "defraud" nor attempts to categorize the various forms of fraud it might reach, however. Judicial decisions in which the fraud element has been considered tend generally to give the term a broad, nontechnical reading. Inasmuch as "the forms of fraud are as multifarious as human ingenuity can devise," one court observed, "it is difficult, if not impossible, to formulate an exact, definite and all-inclusive definition" of it.

2 KATHLEEN F. BRICKEY, CORPORATE CRIMINAL LIABILITY § 8.32, at 88–89 (1993 & Supp. 2000) (footnotes omitted).

203. *See* United States v. Brown, 79 F.3d 1550, 1557 (11th Cir. 1996) (mail fraud reaches more broadly than common law fraud); Atlas Pile Driving Co. v. Di Con Fin. Co., 886 F.2d 986, 991 (8th Cir. 1989) (same). This is not to say that mail fraud does not import some of the limitations, or requirements, of common law fraud. For example, mail fraud has essentially the same requirement that the misrepresentation or omission must be material. *See* Neder v. United States, 527 U.S. 1, 21 (1999) (materiality is an element of mail fraud). *Neder* further states that materiality is present where a statement has "a natural tendency to influence, or [is] capable of influencing, the decision of the decision making body to which it was ad-

though the one defrauded has not yet come into possession of the property targeted by the scheme to defraud[204] and the one defrauded is not entitled to that property.[205] Theoretically, there is nothing to prevent mail fraud from reaching illegal activity where one wrongdoer attempts to cheat another wrongdoer out of proceeds of the target offense. To borrow from a phrase, if a thief can steal from a thief, a wrongdoer can commit mail fraud against a wrongdoer. For example, mail fraud theoretically reaches a fact situation where a supplier and a price-favored purchaser knowingly enter into a conspiracy to violate the Robinson-Patman Act, and the price-favored purchaser agrees not to engage in arbitrage, but all along the price-favored purchaser secretly and deceptively intended to engage in arbitrage, thereby depriving the supplier of anticipated profits from the price-disfavored channel of distribution. Thus, applying mail fraud in the context of an "own use" clause opens the possibility of criminal sanctions for a failure to adhere to a price discrimination strategy that violates the antitrust laws.

A hypothetical can illustrate how the incredibly broad reach of the general conspiracy and mail fraud statutes can bring a criminal prosecution into conflict with the policies of another area of law.[206] Consider a buyer who purchases a house by way of a contract which contains a racially restrictive covenant that prohibits the buyer from reselling to minorities. Of course, racially restrictive covenants are unenforceable as contrary to the public policy of nondiscrimina-

dressed." *Id.* at 16 (quoting United States v. Gaudin, 515 U.S. 506, 509 (1995)). *Cf. supra* text accompanying note 191 (definition of materiality in civil fraud context).

204. United States v. Regent Office Supply Co., 421 F.2d 1174, 1182 (2d Cir. 1970) ("Although proof that the injury was accomplished is not required to convict under 1341, we believe the statute does require evidence from which it may be inferred that some actual injury to the victim, however slight, is a reasonably probable result of the deceitful representations if they are successful."); *see also* United States v. Mack, 159 F.3d 208, 215–16 (6th Cir. 1998) (mail fraud conviction under 1341 and 1346 of public official who deprived public of honest services need not show "concrete business harm"); United States v. Lemire, 720 F.2d 1327, 1337 (D.C. Cir. 1983) (wire fraud requires "a failure to disclose something which in the knowledge or contemplation of the employee poses an independent business *risk* to the employer") (emphasis added). *See generally* Geraldine Szott Moohr, *Mail Fraud Meets Criminal Theory*, 67 U. CIN. L. REV. 1, 16–17 (1998) (mail fraud is an inchoate crime and "the prosecutor need not prove an injury").

205. *See Neder*, 527 U.S. at 24–25 ("The common-law requirements of 'justifiable reliance' and 'damages,' for example, plainly have no place in the federal fraud statutes.").

206. The author is indebted to G. Ray Warner for pointing to this hypothetical to demonstrate how the expansive application of the mail fraud statute can lead to nonsensical results.

tion.[207] The buyer signs the contract fully aware of the racially restrictive covenant but fully intending to resell to anyone, including a racial minority, should the opportunity arise. Provided that the mails have been used, there seems to be nothing to prevent criminal liability from attaching to the buyer, especially when the buyer enters into a contract of resale to a racial minority. Mail fraud liability attaches because, by signing the contract with the racially restrictive covenant and purchasing the house, the buyer obtained the original seller's property by falsely representing that the buyer would not resell to minorities. Further, criminal conspiracy liability attaches because, by signing the contract of resale with the minority and using the mails in connection with the proposed sale, the buyer has made an agreement and taken an overt act in furtherance of a scheme to violate the federal mail fraud statute by defrauding the original seller of the house. Because of the incredibly broad reach of these criminal statutes, criminal prosecution can conflict with nondiscrimination policy because criminal sanctions can be used to punish those who intend to disregard racially restrictive covenants that are contrary to public policy and therefore unenforceable.

The analogy to the conflict in the preceding illustration is complete as soon as an "own use" clause is substituted for the racially restrictive covenant and antitrust policy is substituted for nondiscrimination policy. The conflict between criminal prosecution and public policy is similarly present if the government brings a lawsuit seeking criminal sanctions for a purchaser's failure to follow an "own use" clause that is integral to an illegal price discrimination strategy. There is no reason to ignore antitrust policy issues simply because the loose requirements of incredibly broad criminal statutes may technically apply. Criminal sanctions, perhaps more so than civil remedies, effectively require a court to enforce an illegal scheme by punishing those who breach a clause that is integral to the illegality. Indeed, the *in terrorem* effect of potential criminal sanctions, including incarceration, might lead a party to an illegal contract to adhere to a clause that is integral to the illegal scheme, even though that clause is unenforceable in a civil lawsuit. Criminal prosecution of a purchaser who

207. The classic case is Shelley v. Kraemer, 334 U.S. 1, 13–14 (1948), which held that, because judicial enforcement of contracts constitutes state action, courts may not enforce racially restrictive covenants without violating the Fourteenth Amendment. *See generally* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW PRINCIPLES AND POLICIES § 6.4 (1997) (discussing application of nondiscrimination policy to private conduct).

declines to adhere to the "own use" clause that is part of an illegal price discrimination strategy leads to the nonsensical result that criminal sanctions can and will enforce an "own use" restriction even though civil remedies are not available.

Indeed, in criminal cases that have not considered the seemingly inevitable conflict with antitrust policy, the results seem nonsensical. For example, in two criminal cases cited above, *Costanzo* and *Stewart*, neither court considered whether the drug manufacturers designed their seemingly illegal price discrimination strategies to comply with each of the separate and distinct requirements of the Nonprofit Institutions Act exemption. In *Costanzo*, the defendant-purchasers knowingly entered into contracts that contained "own use" restrictions, diverted pharmaceutical products to wholesalers in the "open door" channel, and falsified reports to the manufacturer-suppliers of the quantities of pharmaceutical products sold to nursing homes so as to hide their diversion.[208] Nowhere, however, did the court even discuss the exemption contained in the Nonprofit Institutions Act. Nowhere did the court establish that the drug manufacturers, who demanded the "own use" restrictions, had carefully designed their distribution systems to come within the Nonprofit Institutions Act exemption. Instead, when the opinion is read against the backdrop of price discrimination analysis, the court left the impression that the drug manufacturers were engaging in an illegal secondary-line price discrimination strategy that had been frustrated when the defendants diverted products and engaged in arbitrage. The court left the impression that criminal sanctions punished a price-favored purchaser for failing to adhere to an illegal price discrimination strategy.

In *Stewart*, the defendants also knowingly entered into contracts that contained "own use" restrictions. The defendants in *Stewart* additionally represented that they operated through a not-for-profit buying agency for hospitals and that the drugs were for the "own use" of the hospitals.[209] At trial, the defendants did request instructions on "certain provisions of the antitrust laws, including the Rob-

208. United States v. Constanzo, 4 F.3d 658 (8th Cir. 1993).

209. United States v. Stewart, 872 F.2d 957, 958 (10th Cir. 1989) ("The defendants then sent letters to several manufacturers, stating that HSSI was a nonprofit shared services group representing thirty-one hospitals. The defendants later represented that pharmaceuticals purchased from the manufacturers were for the 'own use' for HSSI's member hospitals.").

inson-Patman Act."[210] The court in *Stewart* did cite to the Nonprofit Institutions Act,[211] and the court did conclude that the defendants did not enjoy the exemption for sales made when diverting supplies to for-profit wholesalers.[212] The court's focus was misplaced because the court should have asked whether drug manufacturers, who demanded the "own use" restrictions, had assured that their price-favored sales to the defendants complied with each of the separate and distinct requirements of the Nonprofit Institutions Act exemption. Nowhere, however, did the court make that determination. Specifically, the court did not examine whether the drug manufacturers limited lower-priced sales to exempt purchasers by assuring that the hospitals to whom defendants were to resell pharmaceutical products came within the exemption.[213] Instead, as in *Costanzo*, the court left the impression that the drug manufacturers were engaging in an illegal secondary-line price discrimination strategy that had been frustrated when the defendant diverted products and engaged in arbitrage. And, as in *Costanzo*, the *Stewart* court left the impression that criminal sanctions punished a price-favored purchaser for failing to adhere to an illegal price discrimination strategy.

In *Costanzo* and *Stewart*, the criminal sanctions that followed convictions under the federal mail and wire fraud statutes seem illogical for at least two reasons. In both cases, the drug manufacturers included the "own use" restriction presumably because they sought a representation that the purchaser's participation in their distribution systems would bring the price discrimination strategies within the Nonprofit Institutions Act exemption. Yet, the courts' opinions never establish that the purchasers represented every fact necessary for the manufacturers to believe that, by selling to the defendants, their distribution systems would be exempt from the prohibition of price discrimination. The courts never established that the drug manufacturers were defrauded into believing that their distribution

210. *Id.* at 961.

211. *Id.* (quoting portion of Nonprofit Institutions Act).

212. *Id.* ("HHSI [the defendant] was not entitled to obtain reduced prices on the purchases at issue in this case and the trial court did not err in refusing the requested instructions [on antitrust issues].").

213. There was evidence that the defendant-purchasers represented that they operated through a nonprofit entity and that they would resell to hospitals. *See supra* note 209. The court did not, however, look behind the label of "hospital" or, for that matter, even discuss whether the hospitals met the requirement of "not operated for profit." *Stewart,* 872 F.2d at 961.

systems were legal price discrimination because price-favored purchasers met all three of the requirements necessary to come within the exemption.

The results in *Costanzo* and *Stewart* seem illogical for a second reason. Neither court considered the possibility that criminal sanctions were being used to enforce an unenforceable "own use" restriction. As noted already, both opinions left the impression that the drug manufacturers were engaging in illegal price discrimination, especially given the lack of any finding that the manufacturers granted price favors only to purchasers who complied with all three of the requirements of the Nonprofit Institutions Act exemption. The fraud of which the defendants were convicted, however, was their single representation that the products would be for their "own use" coupled with their subsequent but originally intended plan to resell the products to others. On these facts, the manufacturers could not likely have enforced the "own use" restrictions in a breach of contract action because it appears that the "own use" clauses are unenforceable as integral to violations of the Robinson-Patman Act. Nonetheless, the government was allowed to impose criminal sanctions for the same breach of contract. The nonsensical lesson that is left by these cases is that criminal sanctions may be used to enforce a contract restriction that, in a civil case, is unenforceable as contrary to public policy.

It is beyond the scope of this article to explore all of the considerations that arise when incredibly broad criminal statutes may reach those who decline to violate public policy. Given the brief analysis that has been urged, perhaps a preliminary suggestion is appropriate: Criminal sanctions should not be applied if the effect of those sanctions would provide incentives to adhere to contract clauses that are contrary to a clearly articulated statutory policy. This is not so much a situation where a thief steals from a thief or a wrongdoer commits mail fraud against a wrongdoer and the means of stealing or defrauding are illegal in and of themselves. Rather, it is more of a situation where an individual, even if culpable at some level, would be punished for specific conduct that actually furthers a public policy goal. A buyer who signs a racially restrictive covenant should not be criminally punished for later refusing to discriminate. Without more, the resale is a perfectly legitimate sale that is consistent with nondiscrimination policy. So too, a purchaser who obtains a price discount from a distribution system that illegally discriminates in price should

not be criminally punished for later refusing to refrain from arbitrage. Without more, the resale to price-disfavored purchasers is a perfectly legitimate sale that is consistent with the antitrust policy favoring free and open competition.

Without some limit upon enforcing contracts that are contrary to public policy, the two previously discussed cases—*Costanzo* and *Stewart*—demonstrate how direct or indirect judicial enforcement of "own use" clauses may conflict with congressional policy. The Robinson-Patman Act prohibits defined instances of price discrimination, and the Nonprofit Institutions Act provides a limited exemption where suppliers grant price favors to eleemosynary institutions that meet all three requirements of the exemption. These enactments reflect a congressional policy that some price discrimination is prohibited and some price discrimination is permitted. If a supplier employs an "own use" clause to prevent a price-favored purchaser from engaging in arbitrage, the "own use" clause must be followed or enforced for the supplier's price discrimination strategy to be successful in the marketplace. Before enforcing an "own use" clause directly or indirectly, courts should carefully examine the kind of price discrimination to which the "own use" clause is integral. Otherwise, a court may find itself assisting a supplier in price discrimination without knowing whether the supplier's price discrimination strategy is one that Congress has prohibited or permitted.

IV. ADDITIONAL CONSIDERATIONS FOR THE EXEMPTION

While the statutory language of the Nonprofit Institutions Act defines three requirements that must be met to come within the exemption, two additional concerns have arisen in the case law. This part of the article examines, first, the nonstatutory requirement of routinely obtaining certification which was discussed in the Supreme Court's *Abbott Laboratories*[214] opinion and, second, the fact situation, present in some cases, where the supplier sells through an intermediary who then resells supplies to the ultimate purchasers.

214. Abbott Labs. v. Portland Retail Druggist Ass'n, 425 U.S. 1 (1976).

A. Requirements Not Found in the Statute

1. Certification

In *Abbott Laboratories*, the Supreme Court included language which indicated that, to come within the exemption, a supplier should assure that its purchaser is, in fact, an eligible institution that is "not operated for profit" and that purchases supplies for its "own use." This language followed the court's direction, noted already, that a purchaser with both exempt and nonexempt uses could submit appropriate accounting to its supplier as a way to meet the "own use" requirement with respect to the exempt uses.[215] The Court then opined that the supplier has obligations as well:

> The supplier, on the other hand, properly may expect to be protected from antitrust liability for reasonable and noncollusive reliance upon its hospital customer's certification as to its dispensation of the products it purchases from the supplier. But it is not unreasonable to expect the supplier to assume the burden of obtaining the certification when it seeks to enjoy, with the institutional purchaser, the benefits provided by § 13c. It clearly does this with respect to responsibility for identification of its purchaser under that statute's standard, and little additional burden is imposed if it is required to take the small second step of routinely obtaining a representation from its hospital customer as to the use of the products purchased.[216]

Although not explicitly noted in the Court's opinion, an important consideration for allocating the burden of obtaining certification to the supplier is the different way that the supplier benefits from the exemption. Of course, as the Court noted, both the supplier and the purchaser benefit from the exemption. The purchaser, as a not-for-profit entity that pursues charitable or other worthy goals, benefits by paying a lower price for supplies, thereby enabling the purchaser to expand the products or services that it offers by lowering the costs of providing those products or services. By definition, an exempt purchaser does not recover additional profits from price favors because the purchaser must not operate for profit. The supplier, however, is a for-profit entity. By permitting the supplier to price dis-

215. *Id.* at 20 (quoted at *supra* note 130).

216. *Id.* at 20–21.

criminate, the exemption enables the supplier to garner additional profits by expanding output by way of the price discrimination strategy.[217] Thus, although both the supplier and the price-favored purchaser benefit, the supplier is the one who recovers the additional profits that are available to pay for the transaction costs of certification.[218]

Some courts have read *Abbott Laboratories* as establishing a nonstatutory requirement that a supplier must routinely obtain a certification that the purchaser is a qualified institution that does not operate for profit and that purchases supplies for its "own use." For example, in *Rudner v. Abbott Laboratories*,[219] the court discussed the language just quoted and concluded that

> [b]ecause the supplier enjoys the benefits of the Nonprofit Institutions Act exemption, however, a two-part burden is imposed upon it: first, it must identify its purchaser as a nonprofit institution; and, second, it must routinely obtain a representation from the nonprofit institutional customer as to the use of the purchased products.[220]

The court then refused to grant summary judgment in favor of the supplier, in part because, "The record before this court leaves too many open questions relating to . . . whether Abbott fulfilled its periodic certification obligation . . . ."[221]

It bears emphasis that language just quoted is misleading insofar

217. Even if the price discriminating seller (1) does not raise price or expand output on sales to price-disfavored purchasers and (2) does not recover accounting profits on sales it would otherwise not have made to price-favored purchasers, it is likely that the seller will be better off. Assuming that the seller has a not insignificant amount of fixed costs and does not operate at a loss in sales to price-favored purchasers, the increased quantity allows fixed costs to be spread over a greater volume, thereby reducing average total costs for all sales.

218. Of course, an exempt purchaser who uses price-discounted supplies for more than a de minimis amount of nonexempt uses must incur the transaction costs of, first, segregating exempt from nonexempt uses and, second, accounting for those nonexempt uses. *See supra* notes 129 & 130 and accompanying text. The exempt purchaser can avoid these transaction costs simply by refraining from using price-discounted supplies for more than a de minimis amount of nonexempt uses.

219. 664 F. Supp 1100 (N.D. Ohio 1987).

220. *Id.* at 1103–04.

221. *Id.* at 1106. *See also* Lago & Sons Dairy, Inc. v. H.P. Hood, Inc., No. 92-200-SD, 1994 U.S. Dist. LEXIS 12909, at *20–*21 (D.N.H. Sept. 6, 1994) (finding proper certification where bid forms "generally state that the milk is to be used for the school lunch program" and "no evidence . . . to suggest that the dairy products sold by Hood to nonprofit schools were used for any purpose other than consumption by school children").

as the nonstatutory requirement of routinely obtaining certification is stated in terms of only two of the three statutory requirements of the Nonprofit Institutions Act exemption. As noted above, the exemption is available only to the supplier and purchaser in those transactions where the purchaser is an eligible institution that is "not operated for profit" and that purchases supplies for its "own use." In *Rudner*, the buyer was a "not-for-profit corporation which operates an acute care hospital."[222] Thus, the buyer was an eligible institution because it was a hospital and, it seems, because it also fell within the catchall category of a "charitable institution." Certainly, where a buyer is a charitable institution, the separate and distinct requirements of being an eligible institution and "not operated for profit" might seem to collapse into one factual inquiry in one particular case. Nonetheless, a general statement of the supplier's certification obligations should state those obligations in terms of routinely obtaining certification of all three statutory requirements.

In an unpublished opinion, one court reached a different conclusion about the import of the Supreme Court's language in *Abbott Laboratories*:

> We do not agree, as argued by the Defendants, that *Abbott* imposes upon suppliers a requirement to obtain certification from purchasers as to the purchaser's compliance with the Nonprofit Institutions Act. The Court's language is not mandatory, but rather permissive. It merely outlines an alternative method by which a manufacturer can demonstrate that it is not liable for its sales to certain customers. While periodically obtaining a certification or representation from its customer as to the use of the products purchased is not unreasonable, and certainly not unwise, it is not yet a requirement.[223]

This unpublished opinion can be criticized for reading *Abbott Laboratories* too loosely. The portion of the *Abbott Laboratories* opinion upon which this district court relied is the portion quoted previously and directed to methods of segregating exempt use from nonexempt use.[224] Fairly read, this portion of the Supreme Court's

222. *Rudner*, 664 F. Supp. at 1102.

223. *In re* Brand Name Prescription Drugs Antitrust Litig., No. 94C897, MDL997, 1995 U.S. Dist. LEXIS 18048, at *15–*16 (N.D. Ill. Dec. 4, 1995) (footnote and quotation omitted).

224. Abbott Labs. v. Portland Retail Druggist Ass'n, 425 U.S. 1, 20 (1976) (quoted at *supra* note 130).

opinion indicates that the suggested methods of assuring compliance are not mandatory because other methods might be available in different fact situations. By indicating that other methods might suffice, the Supreme Court did not, however, imply that a supplier has no responsibility to use at least one method to obtain certification routinely. Thus, although no one method of obtaining certification is mandatory, the requirement of routinely obtaining certification is.

Even though an unpublished opinion suggests, perhaps erroneously, that routinely obtaining certification is not required, the better reasoned approach is to impose a requirement that suppliers routinely obtain certification that their purchasers are exempt under the Nonprofit Institutions Act. One reason arises from language in the *Abbott Laboratories* opinion itself. There, the Supreme Court rejected an argument, made by the drug manufacturers on behalf of the hospitals, that compliance with the "own use" requirement might be burdensome.[225] By parity of reasoning, suppliers should not complain if a requirement of routinely obtaining certification imposes a burden in exchange for the benefits of an antitrust exemption. Moreover, as noted already, the supplier benefits from the exemption by garnering additional profits that are available to pay the transaction costs of routinely obtaining certification.

A second reason to impose a requirement of routinely obtaining certification upon suppliers arises from the purpose of the Nonprofit Institutions Act to preserve "price favors that sellers would wish to grant to eleemosynary institutions."[226] Obviously, this purpose would be frustrated if sellers inadvertently gave price favors to for-profit organizations and did not assure that price favors were limited to eleemosynary institutions who are, in fact, exempt purchasers. A requirement of routinely obtaining certification implements congressional intent by requiring suppliers to assure that their otherwise illegal price discrimination furthers the express purpose of the Nonprofit Institutions Act. In addition, the benefit, to the purchaser, of receiving a price favor would be thwarted if the responsibility of routinely providing certification is placed on the purchaser. If the burden is placed upon the purchaser, the purchaser would incur the transaction costs of providing certification which only reduces the

225. *Id.* (quoted at *supra* note 130).

226. *Id.* at 12.

beneficial impact of a price favor.[227]

A third reason to impose a routine certification requirement upon suppliers arises from the fact that the exemption in the Nonprofit Institutions Act, like other antitrust exemptions, should be construed narrowly.[228] The exemption will have a narrower reach if this additional requirement is imposed. A requirement of routinely obtaining certification will narrow the exemption to those suppliers who, in exchange for the benefits of an antitrust exemption, undertake the additional burden of assuring that their purchasers are exempt institutions. In addition, a requirement of routinely obtaining certification will narrow the exemption to fact situations in which suppliers assure that their otherwise illegal price discrimination furthers the purpose of the Nonprofit Institutions Act.

2. Channel of distribution with intermediary

An issue that has not been adequately addressed by the courts is how the exemption might apply in a fact situation in which the price-favored channel of distribution involves an intermediary between the supplier and the ultimate purchasers.[229] In *Stewart*, for example, the drug manufacturers sold to defendant-purchasers who represented that they would, in turn, sell to other entities, including hospitals.[230] In this context, there is not so much a single price-favored purchaser as there is a price-favored channel of distribution with at least one purchaser who resells to another. This fact pattern raises the following issue: Assuming that the ultimate purchasers are eligible institutions that are "not operated for profit" and that use the supplies for

227. The statement in the text is based upon the assumption that transaction costs will be lower if incurred by the supplier rather than the purchasers. Indeed, there may be economics of scale if the supplier sets up a system of routinely obtaining certification rather than requiring each purchaser to set up separate systems. In any event, the seller's costs of certification no doubt will be passed along to purchasers in the form of a higher price, and thus the beneficial impact of a price favor depends upon the assumption that transaction costs will be lower if incurred by the seller. Where this assumption does not hold, the parties should be free to allocate certification responsibilities with the aim of reducing overall transaction costs.

228. *Id.* at 14 (quoted at *supra* note 80 and accompanying text).

229. For an overview of the various ways that intermediaries are used in channels of distribution in the pharmaceutical industry, see ABA ANTITRUST SECTION COMMITTEE REPORT, *supra* note 31, at 5–7. *See also* KOLASSA, *supra* note 16 at 2–3 (noting, from a perspective favoring profit maximizing for drug companies, that, "too much attention has been paid to intermediaries . . . that have wrongly been classified as market segments").

230. *See supra* note 209.

their "own use," is the exemption no longer available because the supplier sold through an intermediary who does not meet the requirements of the Nonprofit Institutions Act exemption?

Although the facts may not have squarely raised this issue, the only case in which an intermediary's status was addressed in the context of the Nonprofit Institutions Act was *Logan Lanes*.[231] There, the bowling equipment was initially purchased by the Utah State Building Board before the equipment was, in turn, transferred to Utah State University, an exempt purchaser.[232] Plaintiff argued that the court should "limit the exemption to the purchasing party, and not extend it to the party selling the goods to a non-profit institution."[233] In effect, plaintiff argued that while the exemption might apply to the transaction between the Utah State Building Board, the intermediary, and the Utah State University, the exempt purchaser, the exemption should not apply to the transaction between Brunswick Corporation, the supplier, and the Utah State Building Board, the intermediary. Thus, plaintiff argued that the supplier could not benefit from the exemption because the supplier was not in privity with the exempt purchaser.[234]

Unfortunately, the *Logan Lanes* court does not provide much guidance because the court did not develop facts that might have elaborated upon the character of the Utah State Building Board.[235] The case presents a unique fact situation if, as seems likely, the Utah State Building Board is a not-for-profit state agency charged with the exclusive responsibility of arranging construction of state-owned buildings such as the Student Union. If so, the university was prevented by law from purchasing supplies directly from a supplier but, instead, was required to purchase through a state agency. Thus, *Logan Lanes* may not provide much support for the proposition that

231. Logan Lanes, Inc. v. Brunswick Corp., 378 F.2d 212 (9th Cir. 1967).

232. *Id.* at 214 ("The bowling equipment purchased by the Board was installed in the Student Union Building on the Utah State University campus at Logan, Utah.").

233. *Id.* at 215.

234. Apparently, the supplier did not argue that the channel of distribution was exempt because each purchaser was exempt, albeit under a different exemption. The Utah State Building Board, the intermediary with whom the supplier was in privity, may have been exempt under the so-called government entity exemption. *See infra* notes 244–51 and accompanying text. The Utah State University, the purchaser with whom the Board was in privity, was exempt under the Nonprofit Institutions Act. *Logan Lanes*, 378 F.2d at 215.

235. *See also Logan Lanes*, 378 F.2d at 217 (declined to "reach the question of . . . so-called governmental exemption").

a supplier complies with the Nonprofit Institutions Act exemption when that supplier deals through a nonexempt intermediary who, in turn, sells to an exempt purchaser.

Nonetheless, the *Logan Lanes* court's language on this point is not constrained by the factual character of the Utah State Building Board. The court's language is consistent with the common sense proposition, now accepted by the courts,[236] that, if a purchaser is exempt, the other party to the transaction, the supplier, also enjoys the benefits of the exemption:

> For every purchase, however, there must be both a purchaser and a seller. It follows that if a particular purchase is exempt from the Act, both the seller and purchaser involved in that transaction are exempt. Moreover, the benefits in the form of lower prices which are expected to accrue to non-profit institutions by reason of this statute would be illusory if only the purchasing institution, but not the sellers thereto, were exempted. No seller would be able to give a non-profit institution the benefit of a lower price which was discriminatory under the Act, if such seller was not exempt from the sanctions of the Act in making the sale.[237]

The language just quoted also is consistent with a limited fact situation in which Utah State University and the Board were treated as a single economic entity because the University could obtain supplies only from the Board and the Board was acting as the University's affiliated purchasing agent.[238] As such, the transfer within a sin-

236. Burge v. Bryant Pub. Sch. Dist., 520 F. Supp. 328, 332 (E.D. Ark. 1980), *aff'd on other grounds*, 658 F.2d 611 (8th Cir. 1981) (per curiam). As pointed out in one treatise:

> The Supreme Court implicitly accepted this conclusion in [*Abbott Laboratories*]. . . . The Court's conclusion was that most such sales fell within the provision, and that therefore the seller was immunized from § 2(a) liability. . . . [T]he Court stated that "a supplier . . . properly may expect to be protected from antitrust liability for reasonable and noncollusive reliance upon its . . . customer's certification as to its dispensation of the products it purchases from the supplier."

KINTNER, *supra* note 19, § 25.9, at 465 n.118 (quoting *Abbott Labs.*, 425 U.S. at 20–21). *See also* HOVENKAMP, ANTITRUST, *supra* note 17, § 2354c, at 194 ("Without any significant dissent, however, the courts have construed the statute to protect the seller as well as the buyer.").

237. *Logan Lanes*, 378 F.2d at 215–16. *See also* Bridges v. MacLean-Stevens Studios, Inc., 35 F. Supp. 2d 20 (D. Me. 1998) (quoting *Logan Lanes* and holding that seller is exempt if purchaser meets requirements of Nonprofit Institutions Act).

238. The analysis of whether two or more persons are within a single economic entity typically arises where defendants assert that, because they are part of a single economic entity, they are incapable of conspiring under section one of the Sherman Act. 15 U.S.C. § 1 (1994). *See generally* ANTITRUST LAW DEVELOPMENTS, *supra* note 37, at 21–29. Sometimes, a fact

gle economic entity would not be a sale to a buyer under the Robinson-Patman Act.[239]

The Federal Trade Commission ("FTC") has issued two opinion letters that address an analogous fact situation. In 1977, the FTC opined on the sale of pharmaceutical products, at cost, by a not-for-profit hospital to a not-for-profit nursing home.[240] With respect to the proposed sales to the nursing home, the FTC noted:

> The Supreme Court in *Abbott Laboratories* . . . held that the phrase "for their own use" limited the classes of individuals to whom the supplies could be resold. However, the Commission does not believe these limitations were intended to apply to resales of supplies, at cost, by one charitable institution to another that are limited, in turn, to the latter charitable institution's own use. A resale of this nature would constitute a not-for-profit transfer of supplies from one institution, eligible under the exemption, to another such institution, also eligible under the exemption. In the Commission's view, the exemption was intended to insulate from Robinson-Patman application all purchases of supplies (for their own use) by the designated classes of institutions not operated for profit. The transactions, as above described, would not appear in conflict with such a purpose.[241]

Similarly, in 1993, the FTC opined on the sales, at cost, of pharmaceuticals by not-for-profit hospitals to affiliated not-for-profit long-term care facilities.[242] Quoting from *Abbott Laboratories* and its opinion letter just discussed, the FTC noted that "we believe that

situation that involves an agreement among persons within a single economic entity is called an "intraenterprise conspiracy." *Id.* at 21, 27. Also, the proposition that persons within a single economic entity cannot conspire is sometimes called the "*Copperweld* doctrine" after *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 771 (1984), which held that a parent corporation cannot conspire with its wholly-owned subsidiary.

239. ANTITRUST LAW DEVELOPMENTS, *supra* note 37, at 441 n.76 (citing cases holding that sale to a wholly owned subsidiary is not one of two sales required under Robinson-Patman Act). *See also* ABA ANTITRUST SECTION, 1998 ANNUAL REVIEW OF ANTITRUST LAW DEVELOPMENTS 137 (1999) (same).

240. 89 Op. F.T.C. 689 (1977).

241. *Id.* at 689. The hospital also requested an opinion on the sale of pharmaceutical products, at cost, to the general public in the event that pharmaceuticals become difficult or impossible to obtain because of an emergency caused by a Medicaid strike. Relying on language from *Abbott Laboratories*, the FTC opined that "if needed pharmaceuticals are not available or difficult to obtain, your client may resell the needed pharmaceuticals to the general public as a humanitarian gesture." *Id.* at 690.

242. Presentation Health Sys., FTC Advisory Opinion, [1993–97 Transfer Binder, FTC Complaints and Orders] Trade Reg. Rep. (CCH) ¶ 23,519 at 23,198 (Dec. 21, 1993).

the sales you describe would be similarly exempt under the Non-Profit Institutions Act, as long as the long-term care facilities purchase the pharmaceuticals for their own use."[243] Taken together, these opinion letters support the proposition that an intermediary should meet the requirements of an exempt purchaser under the Nonprofit Institutions Act.

A fact situation in which a for-profit supplier sold through a for-profit intermediary to an exempt purchaser has been examined, albeit in the context of a different exemption. This exemption, the so-called governmental entity exemption, has its origins in a 1936 opinion letter by the United States Attorney General. Shortly after the Robinson-Patman Act was enacted in 1936, Attorney General Cummings opined that the prohibition on price discrimination did not apply to government contracts.[244] The Attorney General noted that the government oftentimes receives special prices below market price, but based his opinion upon the general rule that "statutes . . . in matters affecting commerce do not ordinarily apply to the Government unless it is expressly so provided" and the absence of any express provision in the Robinson-Patman Act.[245] Like the Nonprofit Institutions Act which sought to preserve price favors for eleemosynary institutions, the so-called governmental entity exemption sought to preserve price favors for the government. Of course, in both contexts, dealing through a for-profit intermediary jeopardizes the extent to which price favors will be passed through to the ultimate purchaser.

Subsequently, several courts relied upon the Attorney General's opinion and applied the so-called governmental entity exemption.[246]

243. *Id.* at 23,198. Here, the FTC also opined that an additional basis for applying the exemption arises because affiliated institutions could be regarded as a single "unit having purchased the pharmaceuticals for its 'own use,' comprised of the use by its hospitals *and* its long-term care facilities." *Id. See supra* note 238.

244. 38 Op. Att'y. Gen. 539 (1936).

245. *Id.* at 540.

246. *E.g.*, Champaign-Urbana News Agency, Inc. v. J.L. Cummins News Co., 632 F.2d 680, 688 (7th Cir. 1980) ("There is strong evidence in the legislative history that the Robinson-Patman Act Amendments were not intended to include purchases by the federal government."); Pac. Eng'g & Prod. Co. of Nev. v. Kerr-McGee Corp., 1974-1 Trade Cas. (CCH) ¶ 75,054 at 96,721 (D. Utah 1974) ("government actions are excluded from the coverage of the [Robinson-Patman] Act"), *rev. on other grounds*, 551 F.2d 790 (10th Cir. 1977); Gen. Shale Prods. Corp. v. Struck Const. Co., 37 F. Supp. 598, 602–03 (W.D. Ky. 1941) ("the [Robinson-Patman] Act does not apply to sales to the government, state or municipalities"), *aff'd*, 132 F.2d 425 (6th Cir. 1942). The so-called governmental entity exemption has not

In two of the cases just cited in the margin, the courts faced a fact situation involving a for-profit intermediary, but those courts reached different results. In *Pacific Engineering & Production Co. of Nevada v. Kerr-McGee Corp.*, the defendant sold a component of solid rocket fuel to a for-profit contractor who, in turn, manufactured rockets for the federal government.[247] As to the Robinson-Patman claims brought by defendant's competitor, the defendant argued that, because the ultimate purchaser was the federal government, the defendant should enjoy an exemption on its sales to the contractor. The court rejected this argument, noting that:

> [Defendant] has cited no support for the proposition that sales to private parties are exempt merely because the ultimate consumer is the government. Since the government as ultimate consumer would benefit by vigorous competition among those it buys from and their suppliers, no public policy would be served by such an exception.[248]

In effect, the *Pacific Engineering* court held that a manufacturer who engages in price discrimination does not benefit from the ultimate purchaser's exemption if the manufacturer deals through a for-profit intermediary.

In *General Shale Products Corp. v. Struck Construction Co.*, the court reached the opposite conclusion, although in the context of an alternate holding. There, the defendant furnished brick and tile to a for-profit contractor who built new housing for a municipal housing commission. The price discrimination claim was brought by defen-

been allowed, however, for sales of pharmaceuticals to state and local government hospitals who resold the pharmaceuticals in competition with private pharmacies. Jefferson County Pharm. Ass'n, v. Abbott Labs., 460 U.S. 150, 171 (1983). There, the Supreme Court found that there was no Robinson-Patman exemption for "purchases by a State for the purpose of competing in the private retail market with a price advantage." *Id.* at 170. This result parallels the "own use" requirement of the Nonprofit Institutions Act exemption because the government does not appear to be furthering governmental purposes by competing with retail outlets.

247. In effect, the plaintiff complained that the defendant won the subcontract to supply rocket fuel to the rocket manufacturer because the defendant bid a price lower than the price that the defendant was charging its other customers. Thus, this case involves an allegation of primary-line discrimination where the alleged competitive injury takes place at the level of the entity charging different prices. While different than the typical case involving the Nonprofit Institutions Act exemption which concerns allegations of secondary-line discrimination, the case nonetheless addresses the ability of a supplier to deal through an intermediary and to claim an exemption based upon the status of the intermediary's customer.

248. *Pac. Eng'g*, 1974-1 Trade Cas. (CCH) at 96,742.

dant's competitor.[249] Noting that the Robinson-Patman Act applies only to discriminatory sales of commodities, the court first held that the Act did not apply because "[t]he contract [between the contractor and the housing commission] was essentially a construction [service] contract, not a contract of sale [of commodities]."[250]

The *General Shale Products* court, as an alternate holding, considered whether the defendant could benefit from the governmental exemption if the contract between the contractor and the housing commission was for the sale of commodities and, thus, subject to the Robinson-Patman Act. In effect, the court was responding to the defendant who sought to cloak itself with the exemption of the ultimate purchaser, the housing commission. Here, the court stated that, "even if the transaction could be construed as a sale of brick . . . it would not be within the purview of the Act because the Act does not apply to sales to the government."[251] In effect, the *General Shale Products* court allowed the defendant to cloak itself with the exemption of the ultimate purchaser. The decision thus stands for the proposition that a supplier who engages in price discrimination does benefit from the ultimate purchaser's exempt status even though the supplier deals through a for-profit intermediary.

Even if language in some judicial opinions may suggest that a supplier enjoys the benefits of an antitrust exemption where the supplier deals through a nonexempt intermediary, the better reasoned approach under the Nonprofit Institutions Act is to require that every entity in the supplier's price-favored chain of distribution must, as much as is reasonably possible, meet all three of the statutory requirements of the Nonprofit Institutions Act. The reasons mirror those given above in the context of the nonstatutory requirement for a routine certification.

One reason to require that intermediaries must be exempt institutions arises from language in the *Abbott Laboratories* opinion. In that case, the Supreme Court rejected an argument, made by the

249. Like the *Pacific Engineering* case just discussed, this case also involved an allegation of primary-line price discrimination. Here as well, the case nonetheless addresses the ability of a supplier to deal through an intermediary and to claim an exemption based upon the status of the intermediary's customer.

250. *Gen. Shale Prods.*, 37 F. Supp. at 602. Because the Robinson-Patman Act applies only to sales of commodities, the prohibition of illegal price discrimination does not apply to contracts that predominately concern the provision of services. *See supra* note 87.

251. *Gen. Shale Prods.*, 37 F. Supp. at 602.

drug manufacturers on behalf of the hospitals, that establishing a recordkeeping procedure to assure compliance with the "own use" requirement might be burdensome.[252] In so doing, the Court suggested administrative alternatives that the drug manufacturers and their purchasers might implement.[253] There are obvious administrative alternatives that would allow suppliers to avoid dealing through nonexempt intermediaries. Suppliers might deal directly with the exempt purchasers or, perhaps, deal through a truly not-for-profit intermediary that purchases solely on behalf of exempt purchasers.[254] In addition, and following the admonition in *Abbott Laboratories*, a supplier should not complain if these or other administrative alternatives impose a burden in exchange for the benefits of an antitrust exemption.

A second reason to require that intermediaries must be exempt institutions arises from the express purpose of the Nonprofit Institutions Act to preserve "price favors that sellers would wish to grant to eleemosynary institutions."[255] Obviously, this purpose would be frustrated if suppliers dealt through for-profit intermediaries who are not concerned about passing on price favors but, instead, seek to maximize profits, even if that means raising price and restricting output. A requirement that intermediaries must be truly not-for-profit institutions that purchase solely on behalf of exempt purchasers implements Congressional intent. By requiring suppliers to deal though exempt intermediaries, suppliers deal through intermediaries who are most likely to pass on price favors to eleemosynary institutions instead of pocketing those discounts as their own profits.

A third reason to require that intermediaries must be exempt institutions arises from the fact that the exemption in the Nonprofit Institutions Act that, like other antitrust exemptions, should be construed narrowly.[256] The exemption will have a narrower reach if this

252. Abbott Labs. v. Portland Retail Druggist Ass'n, 425 U.S. 1, 20 (1976) (quoted at *supra* text accompanying note 130).

253. *See supra* note 130 and accompanying text.

254. The latter possibility is, in fact, one that has been used by intermediaries who purchase with the objective of reselling outside of the United States. *See* United States v. Weinstein, 762 F.2d 1522, 1529 (11th Cir. 1985) ("IMA was a well-known and well-regarded umbrella organization acting on behalf of protestant churches in the solicitation of pharmaceutical supplies and the distribution of those supplies to sponsored medical missions in developing nations.").

255. *Abbott Labs.*, 425 U.S. at 12.

256. *Id.* at 14.

additional requirement is imposed. Requiring suppliers to deal only through exempt intermediaries will narrow the exemption to those suppliers who, in exchange for the benefits of an antitrust exemption, undertake the additional burden of assuring that their intermediaries are indeed exempt institutions. In addition, requiring suppliers to deal only through exempt intermediaries will narrow the exemption to fact situations in which suppliers assure that their intermediaries further the purpose of the Nonprofit Institutions Act.

The conclusion that intermediaries must qualify as exempt purchasers under the Nonprofit Institutions Act needs to be tempered with the recognition of the particular role that an intermediary performs in a channel of distribution. Almost by definition, an intermediary does not purchase for "own use"; the intermediary purchases for resale to others. To assure that the purposes of the Nonprofit Institutions Act are served, however, there is no reason to allow the intermediary to resell to for-profit purchasers who, in theory, likely have a relatively inelastic demand for the supplies, are price insensitive, and consequently can and will pay a higher price. There is no reason to permit price discrimination under the Nonprofit Institutions Act and then to allow an intermediary to engage in arbitrage and thereby defeat the price discrimination strategy in the marketplace. Rather, to further the statutory purpose, the intermediary should be required to resell only to exempt purchasers. Thus, where a supplier deals through an intermediary, the "own use" requirement should be modified to require the intermediary to resell price-discounted supplies solely to exempt purchasers.

Similarly, the requirement that the intermediary must be an eligible institution needs slight modification. Of course, an intermediary whose sole function is to resell to others is not among the kinds of institutions specifically enumerated in the exemption. Under a liberal interpretation of the catchall category of "charitable institutions," an intermediary might fall within the catchall category of a "charitable institution" if the intermediary's sole purpose is to resell only to exempt purchasers. In other words, the intermediary would not be able to use revenues from the sale of supplies to exempt purchasers to defray the costs of engaging in other activities, including the distribution of entirely unrelated products. Otherwise, the intermediary might be tempted not to pass on price favors to exempt purchasers but, instead, to use the discounts to subsidize those other activities. Thus, where a supplier deals through an intermediary, the

eligible institution requirement should be modified to require the intermediary to engage in no other economic activity than reselling price-discounted supplies to exempt purchasers.[257]

If an issue arises regarding instances in which the intermediary resells to nonexempt purchasers, an approach should be taken that mirrors the Supreme Court's treatment of de minimis sales in *Abbott Laboratories*. There, an occasional sale in extraordinary circumstances of limited supplies was de minimis and would not negate a finding of compliance with the "own use" requirement. So too, in the context of an intermediary, an occasional sale to a nonexempt purchaser in extraordinary circumstances should not result in a loss of the intermediary's exemption. If more than such extraordinary de minimis sales occur, however, the supplier and the intermediary should, first, segregate exempt from nonexempt transactions and, second, account for those segregated transactions. As the Supreme Court explained in *Abbott Laboratories*, the supplier and the intermediary should not seek the benefits of the Nonprofit Institutions Act exemption and then complain about the burdens of establishing a recordkeeping procedure to assure compliance with the exemption's requirements.[258]

The requirement of "not operated for profit," however, does not need to be modified for an intermediary in a price-favored channel of distribution. As already noted, the purpose of the Nonprofit Institutions Act is not furthered if an intermediary is not concerned about passing on price favors to eleemosynary institutions but, instead, seeks to garner profits by selling to the highest bidder or to use any profits to subsidize other economic activity. Rather, if the intermediary is a truly not-for-profit entity, the intermediary's incentive will be to pass along price favors to exempt purchasers whose purchase and use of the price-discounted supplies will further the express purpose

257. It is altogether possible that a fact situation may arise where economies of scale dictate that the most efficient distribution system for a local area requires one intermediary who resells to both exempt and nonexempt purchasers. If such a fact situation should arise, accounting controls should be employed to assure that price-discounted supplies are resold only to exempt purchasers and that revenues from the resale of price-discounted supplies do not subsidize other economic activities. This may necessitate the complexities of, for example, allocating fixed costs between exempt transactions and nonexempt transactions. Nonetheless, these kinds of accounting methods are likely no less burdensome than those used to assure compliance with other Robinson-Patman Act provisions such as the cost justification defense.

258. *Abbott Labs.*, 425 U.S. at 20 (quoted at *supra* text accompanying note 130).

of the Nonprofit Institutions Act.[259]

To avoid confusion, perhaps it is useful to summarize the preceding discussion by distinguishing an "exempt purchaser" from an "exempt intermediary." An "exempt purchaser" is the ultimate purchaser who meets all three statutory requirements discussed earlier. An "exempt intermediary," by contrast, is an entity who purchases supplies for resale and meets the requirements that were modified to reflect the particular role that intermediaries perform in a channel of distribution. Thus, an "exempt intermediary" purchases for resale only to exempt purchasers, does not engage in other economic activities, and is "not operated for profit."

3. Certification with an intermediary

Where a supplier deals through an intermediary, the requirement of routinely obtaining certification should apply, not only to the ultimate purchasers to whom the intermediary resells supplies, but also to the intermediary. Routine certification of the intermediary should assure that the intermediary resells solely to exempt purchasers, does not engage in other economic activity, and is "not operated for profit." Routine certification of the ultimate purchaser should assure that the purchaser purchases supplies for its "own use," is an eligible institution, and is "not operated for profit." In other words, routine certification should assure that all of the entities in the price-favored channel of distribution are exempt intermediaries or exempt purchasers.

The supplier is the one who, in the first instance, should be responsible for obtaining certification of the intermediary as well as the ultimate purchasers. The three reasons given for imposing a certification requirement upon the supplier where the supplier deals directly with the ultimate purchaser apply with as much force as where a supplier deals through an intermediary. In addition, an important consideration here is that the supplier typically is the one who designs and arranges its distribution channels. The supplier could, for example, deal directly with the ultimate purchasers or, perhaps, assist the ultimate purchasers by organizing a not-for-profit buying agency

259. Again, it is altogether possible that a fact situation may arise where economies of scale dictate that the most efficient distribution system for a local area requires one intermediary who resells to both exempt and nonexempt purchasers. If such a fact situation should arise, the same accounting procedures should be applied as noted above. *See supra* note 257.

that purchases supplies on behalf of a group of ultimate purchasers.[260] Given these and no doubt other options that are available to a supplier, the initial burden should be on the supplier to design and arrange the price-favored channel of distribution to comply with the Nonprofit Institutions Act.

The supplier should also have ongoing responsibility for routinely obtaining certification of intermediaries and ultimate purchasers. Again, the reasons mirror the ones already noted in the context where the supplier deals directly with the ultimate purchaser. An important consideration here is that the supplier, who may operate for profit, is the one who stands to garner additional profits from the ongoing operation of the price-favored channel as part of the price discrimination strategy. Another consideration stems from the purpose of the Nonprofit Institutions Act to preserve "price favors that sellers would wish to grant to eleemosynary institutions."[261] This purpose would not be served if the intermediary or the ultimate purchasers incur the transaction costs of certification and the supplier has lower transaction costs of certification. Of course, the entities in the price-favored distribution channel should be allowed to allocate certification responsibilities by way of contract. Presumably, the entities will do so with a view toward allocating responsibilities to the entity who can obtain or provide certification at the lowest cost. Nonetheless, because the supplier is the one who benefits through additional profits, the supplier is the one who should be legally responsible for assuring that the requirements of initially and routinely obtaining certification are met.

B. Nonstatutory Requirements and Enforcing an "Own Use" Clause

The additional concerns discussed in this part of the article do not change the basic structure of incentives or enforcement alternatives or, for that matter, the need to examine "own use" clauses in the broader context of an overall price discrimination strategy that may violate the antitrust laws. The requirement of obtaining certification, initially and routinely, adds a fourth requirement to the three

260. If the latter option is taken, and the buying agency deals exclusively with exempt purchasers, the buying agency might be an affiliated agent that forms a single economic entity with the exempt purchasers and, for that reason, avoids the additional considerations that arise for a truly independent intermediary. *See supra* notes 238, 243.

261. *Abbott Labs.*, 425 U.S. at 12.

requirements expressly stated in the Nonprofit Institutions Act. A difference is that the nonstatutory requirement of routinely obtaining certification focuses upon the obligations of suppliers whereas the three statutory requirements focus upon the character of purchasers. The presence of an intermediary no doubt requires slight modification of the three statutory requirements and additional certification obligations. Nonetheless, where a supplier chooses to deal through an intermediary in the price-favored channel of distribution, these concerns should be met to assure that the purpose of the Nonprofit Institutions Act is furthered.

Even with these additional concerns, every entity in the price-favored channel of distribution benefits from ongoing compliance with the Nonprofit Institutions Act. The supplier and the ultimate purchaser benefit in the ways already discussed and regardless of the presence of an intermediary. Suppliers garner more profits, and exempt purchasers receive price favors that better enable them to pursue their charitable or other worthy goals. An intermediary benefits as well. By receiving price favors from the supplier, the exempt intermediary can sell more supplies to exempt purchasers. Given that selling to exempt purchasers is an exempt intermediary's *raison d'être*, an exempt intermediary has every incentive to perform its functions and to expand its sales to its customer base of exempt purchasers.

1. Incentives and enforcement alternatives

The presence of an intermediary, however, may lead to greater incentives to "cheat" or "chisel" on any requirement that impliedly prevents arbitrage, such as a contract clause which requires the intermediary to sell only to exempt purchasers.[262] Of course, these in-

262. Some suppliers have designed price-favored channels of distribution with intermediaries and have used "own use" clauses to prevent arbitrage by those intermediaries. For example, all of the "own use" clauses already provided in this article were taken from the District Court's opinion in *Ferro I*, s*ee supra* notes 68, 156, and text accompanying note 67, where the individual defendants operated through an intermediary that resold to nursing homes. As already noted, an "own use" clause is, at best, awkward for an intermediary because, by definition, an intermediary purchases, not for its own consumption or use, but for resale to others. A more logical way to prevent arbitrage in a contract with an intermediary is to require the intermediary not to sell to nonexempt purchasers or, alternately, to sell only to identified exempt purchasers. An "own use" clause in a contract with an intermediary might make sense if, as the District Court in *Ferro* found, that clause seeks representation of compliance with the requirements of the Nonprofit Institutions Act. *See supra* note 71.

centives exist for any purchaser in the price-favored channel of distribution. The temptation to engage in arbitrage may be stronger for an intermediary to the extent that the intermediary does not identify with the charitable or other worthy goals of the exempt purchasers to whom the intermediary should restrict its sales of price-discounted supplies. Even if the profit opportunities of arbitrage will likely be short lived, an intermediary who perceives of itself as merely a reseller in a channel of distribution may succumb more quickly to the lure of profit opportunities. Indeed, in the criminal cases already discussed, the defendants who pursued the profit opportunities of arbitrage were not eleemosynary institutions that provided health care services but, rather, were distributors of pharmaceutical products.[263]

The additional certification requirements or the presence of an intermediary do not change the incentives for suppliers to monitor the price-favored channel of distribution to assure compliance with "own use" clauses and to enforce those clauses where necessary. Suppliers who seek to avoid otherwise illegal price discrimination by complying with the Nonprofit Institutions Act cannot allow purchasers in the price-favored channel of distribution to engage in arbitrage. By engaging in arbitrage, an exempt intermediary, no less than an exempt purchaser, risks noncompliance with the requirements of the Nonprofit Institutions Act which would, in turn, jeopardize the antitrust exemption for the price-favored channel of distribution. Consequently, suppliers who detect arbitrage by an intermediary need to enforce contractual prohibitions of arbitrage either directly in an action for breach of contract, indirectly in an action for fraud, or perhaps by enlisting the government's assistance in bringing a criminal action for fraud.

2. Contexts of enforcement

While the additional concerns do not change the need for those who seek to enforce contractual prohibitions of arbitrage to examine those clauses in the broader context of an overall price discrimination strategy, the supplier's certification obligations add a wrinkle to that

263. United States v. Costanzo, 4 F.3d 658, 659 (8th Cir. 1993) (institutional pharmacy that resold to patients in nursing homes); United States v. Stewart, 872 F.2d 957, 958 (10th Cir. 1989) (nonprofit group reselling to hospitals); *Ferro I*, No. 99-00180-0104-CR-W-SOW, 2000 WL 33394614, at *3 (W.D. Mo. May 8, 2000) (institutional pharmacy that resold to patients in nursing homes). *See also* United States v. Weinstein, 762 F.2d 1522 (11th Cir. 1985) (purchaser intended to resell in export market).

context. As an illustrative example, consider the following facts which are based upon *Costanzo*. A purchaser of pharmaceutical products signs a contract that includes an "own use" clause, thereby putting the purchaser into the "closed door" channel.[264] The supplier makes no inquiries, and the purchaser makes no representations regarding the statutory requirements that the purchaser must be an eligible institution that is "not operated for profit."[265] Although not obtaining the required certification, the supplier nonetheless charges a lower price to the purchaser for the same products that it sells, at higher prices, in the "open door" channel. The price differences do not, however, reflect different costs, changed circumstances, or a need to meet competition. Subsequently, the purchaser pursues the profit opportunities of arbitrage and resells some of the products to distributors in the "open door" channel.

In the illustrative example, the contract with an "own use" restriction is part of an illegal price discrimination strategy. On the assumed facts, the distribution system satisfies a prima facie case and does not fall within an affirmative defense such as cost justification, changed circumstances, or meeting competition. The legality of the price discrimination strategy therefore turns upon the availability of the Nonprofit Institutions Act exemption. That exemption is not available, however. The reason, on the assumed facts, is that the supplier did not obtain certification from the purchaser that the purchaser was an eligible institution that was "not operated for profit." It matters not whether the purchaser, in fact, meets those requirements. Following the language of *Abbott Laboratories*, for a supplier to enjoy the benefits of the exemption, the supplier must routinely obtain certification. In the illustrative example, the supplier did

264. In *Costanzo*, the court provided the following example of an "own use" clause, which it described as "fairly typical":

> Products purchased from CIBA-GEIGY at other than standard prices or terms are to be used exclusively for long term care facility inpatients for whom we are the pharmacy provider. Any other use of these products will be cause for immediate termination of this account as well as any pricing Agreements then in force with CIBA-GEIGY.

Costanzo, 4 F.3d at 660.

265. The opinion in *Costanzo*, unlike the District Court's opinion in *Ferro*, *see supra* notes 182, 183, did not comment on facts that might bear upon these other requirements of the Nonprofit Institutions Act. The reason, to be fair to the *Costanzo* court, appears to be that the defendants did not invite the court to analyze the antitrust issues surrounding price discrimination. "The principal challenge that defendants raise on appeal is to the sufficiency of the evidence [regarding intent to defraud]." *Costanzo*, 4 F.3d at 664.

not.[266]

The extra wrinkle added by the supplier's certification obligations arises where the supplier seeks to enforce a contractual prohibition of arbitrage indirectly in an action for fraud or by enlisting the government's assistance in bringing a criminal action for fraud. Consider, in the illustrative example, that the supplier sought the purchaser's representation that the products would be for "own use" because the manufacturer sought a representation that the purchaser's participation in the distribution system would bring the system within the Nonprofit Institutions Act exemption. The supplier did not, however, obtain every representation necessary for the supplier to believe that, by selling to the purchaser, the distribution system would be exempt from the prohibition of price discrimination. To the contrary, in the illustration, the supplier did not seek representations regarding the other two statutory requirements. The supplier elicited no representation that the purchaser was an eligible institution or, in the case of an intermediary, did not engage in economic activity other than reselling to exempt purchasers. Nor did the supplier elicit a representation that the purchaser was "not operated for profit." On the assumed facts, because the supplier did not elicit representations of compliance with regard to all three statutory requirements, the supplier never obtained the required certification and therefore was not defrauded into believing that its price discrimination strategy would come within the exemption.

Although the principal focus of this article is not upon the law of fraud, it is worth noting that there is doctrinal support for the conclusion just reached. In general, fraud can be found for a failure to disclose a material fact, but only where there is a duty to disclose.[267]

266. This example is not meant to suggest that all or even a good number of pharmaceutical manufacturers are knowingly ignorant of how intermediaries resell their products or, for that matter, of the diversion market in the pharmaceutical industry. As one court explained:

> While there was testimony in this case that in many instances pharmaceutical manufacturers used nonprofit and export organizations as a "dumping ground" for pharmaceutical products nearing expiration, it was clear that many pharmaceutical houses actively seek to prevent diversion of products sold to export and nonprofit organizations. Some companies, in fact, go so far as to maintain investigators whose sole function is to trace sources of diversion supply.

Weinstein, 762 F.2d at 1527. *See also* Petersen, *supra* note 31 ("Some [drug companies] have even hired investigators to track wholesalers that may be violating the [Prescription Drug Marketing Act of 1987]. Other drug companies send auditors to wholesalers and pharmacies, and cut off those that raise suspicions.").

267. RESTATEMENT (SECOND) OF TORTS § 551(1) (1977) ("One who fails to disclose to

In the illustrative example, the purchaser might be liable for a fraudulent omission provided that, first, the purchaser knew that facts about whether it was a qualified institution (or, if an intermediary, did not engage in economic activity other than reselling to exempt purchasers) and was "not operated for profit" were material to the supplier's decision to enter into the contract[268] and, second, the purchaser owed a duty to disclose those facts to the supplier. Of course, whether there is a duty to disclose often is a fact-intensive inquiry that is context dependent.[269] Nonetheless, courts should be reluctant to find a duty to disclose where the one allegedly defrauded has an affirmative duty to investigate the material facts.[270] The supplier's certification obligations, however, place just such an affirmative duty on the supplier because the supplier has an obligation to assure that the purchaser meets the requirements of the Nonprofit Institutions Act. Thus, in the illustrative example, the supplier was not defrauded by the purchaser's silence because the purchaser did not have a duty to disclose facts that would indicate whether the purchaser meets all three of the statutory requirements of the exemption.[271]

another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question."). If, on different facts, the purchaser actively conceals material facts or prevents the supplier from routinely obtaining certification, liability would lie for fraudulent concealment. *Id.* at § 550.

268. *Id.* § 551 cmt. c ("A person under the duty stated in this Subsection [(2)] is required to disclose only those matters that he has reason to know will be regarded by the other as important in determining his course of action in the transaction in hand.").

269. *See id.* § 551 cmt. *l* ("It is extremely difficult to be specific as to the factors that give rise to this known, and reasonable, expectation of disclosure."); *id.* § 551 cmt. m ("If there are disputed facts bearing upon the existence of the duty, as for example the defendant's knowledge of the fact, the other's ignorance of it or his opportunity to ascertain it, the customs of the particular trade, or the defendant's knowledge that the plaintiff reasonably expects him to make the disclosure, they are to be determined by the jury under appropriate instructions as to the existence of the duty.")

270. *See id.* § 551 cmt. k ("The defendant may reasonably expect the plaintiff to make his own investigation, draw his own conclusions and protect himself; and if the plaintiff is indolent, inexperienced or ignorant, or his judgment is bad, or he does not have access to adequate information, the defendant is under no obligation to make good his deficiencies.").

271. In the illustrations to another comment to § 551, a common factor that appears where nondisclosure leads to liability is that the plaintiff could not reasonably discover the nondisclosed fact by an ordinary inspection or investigation. *Id.* § 551 cmt *l*, illus. 9–12. In the context of the requirement of routinely obtaining certification that intermediaries and purchasers comply with the statutory requirements of the Nonprofit Institutions Act, the supplier is

Additional doctrinal support for the conclusion just reached can also be found in the general common law rule that the one defrauded must rely upon the alleged fraud and that reliance must be justified.[272] In the context of the Nonprofit Institutions Act exemption, the supplier has an affirmative duty to obtain certification that price-favored sales are made only to exempt purchasers. In this context, the supplier's certification obligations effectively mean that a supplier should rely upon its own efforts to assure that price-favored purchasers meet all three of the statutory requirements of the exemption. Where the supplier makes no effort to obtain certification of one of the requirements, any reliance on the purchaser's silence seems misplaced.[273] Thus, in the illustrative example, the supplier was not defrauded by the purchaser's silence because any reliance by the supplier on that silence was not reasonable.

The preceding discussion shows how enforcement of an "own use" clause or, for that matter, any contractual prohibition of arbitrage, may appear nonsensical if the examination does not expand to the broader context of price discrimination, including an analysis of the supplier's routine certification obligations. If the supplier fails to obtain certification, an otherwise illegal price discrimination strategy does not come within the Nonprofit Institutions Act exemption and, therefore, is illegal. An "own use" or other clause that prevents arbitrage is integral to the economic success of the price discrimination strategy, however. Consequently, where the supplier fails to comply with the requirement of routinely obtaining certification, the "own use" clause should not be enforced because that clause is contrary to the public policy against illegal price discrimination. If indirect enforcement is sought through a civil or criminal action for fraud, the results seem illogical. Where the supplier has an affirmative duty to investigate material facts but fails to do so, the supplier is misled by its own failure to investigate by routinely obtaining certification, not

merely expected to "obtain[ ] a representation from its . . . customer" as to compliance. Abbott Labs. v. Portland Retail Druggist Ass'n, 425 U.S. 1, 21 (1976). Thus, unless and until the supplier undertakes this "little additional burden" and "small . . . step," *id.*, the purchaser should not be liable for nondisclosure.

272. RESTATEMENT (SECOND) OF TORTS § 537 (1977).

273. This is an extension of the growing acceptance by courts of a "duty to inspect" which negates a finding of fraud where the misrepresentation "would be shown up as false on the most casual inspection." 2 HARPER ET AL., *supra* note 174, § 7.12, at 455–64. Where there is an affirmative obligation to obtain certification, the inspection should be more than casual.

by the purchaser's silence. The nonsensical result is that allegations of fraud effectively claim that the supplier was defrauded by its own failure to comply with a requirement of an antitrust exemption.

Examples of seemingly nonsensical results can be found in two of the criminal cases previously discussed at length. In *Costanzo* and *Stewart*, the courts did not inquire as to whether the allegedly defrauded drug manufacturers had met their obligations to obtain a certification that the defendant intermediaries were exempt or, for that matter, that the ultimate purchasers were exempt. Rather, both opinions focus principally upon contractual prohibitions of diversion and defendants' efforts to disguise the diversion. Certainly, both courts mention facts that might bear upon some of the requirements other than the "own use" requirement or, for an intermediary, a slightly altered requirement to purchase supplies only for resale to exempt purchasers.[274] Neither court, however, explains how the defendants' silence on material facts constitutes fraud where, under the Supreme Court's decision in *Abbott Laboratories*, the drug manufacturers had an affirmative duty to investigate those material facts. Neither court explains how the drug manufacturers suppliers failure to obtain certification of compliance with the Nonprofit Institutions Act defrauded those same drug manufacturers into reasonably believing that their price discrimination strategies came within the Nonprofit Institutions Act exemption.

The recent appellate opinion in *Ferro II*, which reversed the District Court, can be faulted on several grounds,[275] but at least the opinion is a step in the right direction. As background to its discussion, the *Ferro* appellate court recognized that, at a minimum, "A brief review of federal price discrimination law and pricing practices

274. In *Costanzo*, the "own use" clause restricted resales to nursing home inpatients, and those nursing homes may have been "charitable institutions" that were "operated not for profit," but the court never specifically addressed those facts. United States v. Costanzo, 4 F.3d 658, 660 (8th Cir. 1993). In *Stewart*, the defendant-purchasers did resell to hospitals, but the court did not go further to determine if those hospitals were "operated not for profit." *See supra* notes 208–212.

275. Some of the Eighth Circuit's errors already have been discussed in the margin. The Eighth Circuit applied the wrong standard of review. *See supra* note 71. The Eighth Circuit failed to apply the standard of review that it did select to the "own use" clauses quoted by the District Court but, instead, made factual inferences from two cases and a study, none of which examined analogous clauses, the Robinson-Patman Act, or the Nonprofit Institutions Act. *See supra* note 106. The Eighth Circuit cited to misleading authority when discussing the competitive injury requirement of secondary-line discrimination under the Robinson-Patman Act. *See supra* note 89.

in the pharmaceutical industry is necessary to an understanding of the[] issues."[276] The *Ferro* appellate court also focused, correctly, upon the materiality of the "own use" clauses and the question of whether those clauses were employed to seek representations of compliance with the Nonprofit Institutions Act exemption.[277] Inexplicably, however, the *Ferro* appellate court never examined the "own use" clauses in the record and quoted in the District Court's opinion, much less the facts that these "own use" clauses explicitly referred to the Nonprofit Institutions Act as well as controlling case law.[278] Instead, the *Ferro* appellate court suggested, without citing

276. *Ferro II*, 252 F.3d 964, 966 (8th Cir. 2001).

277. *Id.* at 967–68.

278. The Eighth Circuit may have ignored the record because of its belief that, "The district court also erred procedurally in taking up this issue [materiality] prior to trial." *Id.* at 967. This statement is curious for two reasons. The first is that, if a factual determination on the issue of materiality cannot be made before trial, the Eighth Circuit could have rested on that ground without attempting to create an issue of fact by making factual inferences from inapposite sources. *See supra* note 106. The second is that the Eight Circuit failed to examine, with care, United States v. Gaudin, 515 U.S. 506, 523 (1995), the authority upon which it relied, not only for the statement just quoted, but also for the conclusion that, "so long as the indictment contains a facially sufficient allegation of materiality, federal criminal procedure does not provide for a pre-trial determination of sufficiency of the evidence." *Ferro II*, 252 F.3d at 967 (quoting United States v. Critzer, 951 F.2d 306, 307–08 (11th Cir. 1992)).

Gaudin provides no basis for the results suggested by the Eighth Circuit. The issue in *Gaudin* did not arise in the context of a pre-trial evidentiary hearing but, instead, at the conclusion of a trial on the merits when the judge refused to submit the question of materiality to the jury. Prior to *Gaudin*, some courts had held that materiality was not an issue of fact that could ever go to the jury. *E.g.*, United States v. Gribben, 984 F.2d 47, 51 (2d Cir. 1993) (appellate court may review pre-trial hearing dismissing portion of indictment on materiality because materiality is an issue of law); Unites States v. Chandler, 752 F.2d 1148, 1151 (6th Cir. 1985) (same). Both cases were cited by *Gaudin*, 515 U.S. at 510 n.1.

The *Gaudin* Court's reasoning, and its holding, are limited to the stage of criminal proceedings where issues of fact are presented to the jury. The Court reasoned that, because materiality involves issues of fact and the defendant has a constitutional right to have the jury make ultimate decisions of guilt on every element of the charged crime, the judge may not deprive the defendant of the jury's determination of any issue of fact, including an issue of mixed law and fact. *See Gaudin*, 515 U.S. at 510, 513–15, 522–23. A motion to dismiss an indictment in a pre-trial evidentiary hearing implicates neither the defendant's right to a jury trial nor an ultimate finding of guilt. To the contrary, a motion to dismiss an indictment in a pre-trial evidentiary hearing allows the district court to be a gatekeeper and to halt factually unfounded criminal prosecutions before the trial stage of the proceedings where the defendant's right to a jury trial and any ultimate findings of guilt come into play.

Moreover, the Supreme Court in *Gaudin* explicitly distinguished procedural pre-trial contexts that do not implicate a defendant's right to a jury's determination of guilt on each element of the charged offense. At one point, the Court parenthetically noted that, "The prosecution's failure to provide minimal evidence of materiality, like its failure to provide minimal evidence of any other element, of course raises a question of 'law' that warrants dis-

any credible support, that there were lots of reasons why a seller might use an "own use" clause to comply with the Robinson-Patman Act.[279] Nonetheless, the *Ferro* appellate court took a step in the right direction when it concluded by noting that, on remand, "the government may present pharmaceutical seller witnesses to testify as to the materiality of any 'own use' misrepresentations the government is able to prove."[280] The factual issues on remand thus will focus, in significant part, upon whether drug manufacturers were seeking representations of compliance with the Nonprofit Institutions Act.[281]

missal." *Id.* at 517. The Court then cited, without criticism, to cases in which courts granted demurrers to indictments after hearing arguments pertaining to materiality. The Court additionally distinguished other cases by noting that

> some of the other cited cases involve the convicted *defendant's* claim that materiality should not have been decided by the jury, so that even if the issue was not one of the prosecution's failure to make a threshold case, it did not arise in a context in which the defendant's right to jury trial was at issue.

Id. at 517–18. The Court then cited, without criticism, to cases involving post conviction proceedings. *Id.* at 518.

Properly read, *Gaudin* provides no support for the Eighth Circuit's far reaching proposition that issues of materiality may never be addressed by a district court in a pre-trial evidentiary hearing. Properly read, *Gaudin* held that, because materiality involves issues of fact, the defendant is entitled to a jury determination of materiality at the trial stage of the proceedings where the defendant's constitutional right to have the jury make ultimate decisions of guilt on every element of the charged crime is implicated. The *Gaudin* Court did not address, and expressly distinguished, the pre-trial and other contexts where the defendant's constitutional right to a jury determination of guilt does not come into play. Contrary to the Eighth Circuit's misreading, *Gaudin* did not discard the long-established and well-accepted practice that allows a defendant to seek dismissal of an indictment by showing at a pre-trial evidentiary hearing that the government cannot prove one or more elements of the charged offense, a possibility that the Eighth Circuit begrudgingly recognized, *Ferro II*, 252 F.3d at 968 ("*possibility* [of] pre-trial determination that no reasonable jury could make the requisite finding of materiality"). Moreover, contrary to the Eight Circuit's assertion ("no decision since Gaudin in which a federal fraud indictment was dismissed [pretrial]," *id.*), after *Gaudin*, courts have continued to dismiss indictments prior to trial. *E.g.*, United States v. Adkinson, 135 F.3d 1363, 1372 (11th Cir. 1998); United States v. Seitz, 952 F. Supp. 229, 238 (E.D. Pa. 1997); United States v. Finn, 919 F. Supp. 1305, 1338 (D. Minn. 1995).

279. *Ferro II*, 252 F.3d at 967; *supra* note 107.

280. *Id.* at 968.

281. One other aspect of the Eighth Circuit's opinion merits a response. The Eighth Circuit thought that the defendant's theory in *Ferro* was "seriously flawed," and asserted that "the critical flaw is defendants' assumption that a price discount on pharmaceuticals is either exempt from the Robinson-Patman Act, or it is unlawful." *Id.* at 967. Rather than cite to the record to show where defendants supposedly made or relied upon such an assumption, the Eighth Circuit dropped a footnote that, curiously, spoke to "defendants materiality theory" and criticized this author's testimony as having "little or no support in Robinson-Patman Act treatises and judicial opinions." *Id.* at 967 n.2. A response is in order.

The Eighth Circuit's juxtaposition of Robinson-Patman analysis and materiality only

V. CONCLUDING IMPLICATIONS

This article's analysis and discussion has produced relatively straightforward guidelines for those who design distribution systems to come within the Nonprofit Institution Act exemption to illegal price discrimination. The supplier should design the price-favored channel so that all purchasers are either exempt intermediaries or exempt purchasers. An exempt intermediary is an entity that purchases for resale only to exempt purchasers, does not engage in other economic activities, and is "not operated for profit." An exempt purchaser is an entity that purchases supplies for its "own use," is an eligible institution, and is "not operated for profit." The supplier has ongoing obligations as well. The supplier, who reaps economic rewards from an otherwise illegal price discrimination strategy that comes within the exemption, should routinely obtain certification that all of the purchasers in the price-favored channel of distribution are either exempt intermediaries or exempt purchasers. Of course, there are specific issues and fact situations that the courts have yet to address. Here, the article has identified underlying policy considerations, including the practice of defining antitrust exemptions narrowly and the statutory purpose of the Nonprofit Institutions Act, that provide additional guidance.

This article's analysis and discussion has also produced relatively straightforward guidelines for those who enforce distribution systems that come within the Nonprofit Institutions Act exemption to illegal price discrimination. The discussion focused upon the enforcement of "own use" clauses, not only because case law has already addressed "own use" clauses, but also because the profit opportunities of arbitrage or diversion tempt purchasers in price-favored channels of distribution to breach "own use" clauses. Here, courts should examine the "own use" clause at issue in the broader context of the overall price discrimination strategy. If that strategy comes within a prima facie case of illegal price discrimination and does not come within an affirmative defense, the context should be expanded to account for, first, all of the requirements to be an exempt intermediary

demonstrates the Eight Circuit's confusion regarding price discrimination. *See also supra* note 89. Materiality is not an issue under either secondary-line discrimination or, for that matter, the Nonprofit Institutions Act; materiality is an issue under mail fraud. It should have been evident to the Eighth Circuit that any discussion of materiality, by this author or anyone else, would not find support in Robinson-Patman literature or case law.

or exempt purchaser and, second, the supplier's obligation of routinely obtaining certification of those requirements. Only then will a court be able to determine if the "own use" clause is integral to a price-discrimination strategy that Congress has prohibited or permitted. If allegations of fraud are at issue, only by expanding the context of analysis will a court be able to determine if the supplier was defrauded into believing that an otherwise illegal price discrimination strategy does not offend the Robinson-Patman Act because price-favored sales qualify for the Nonprofit Institutions Act exemption.

What may be less evident in this article's discussion and analysis are implications for those who question the prohibition of price discrimination in light of shifts in the focus of antitrust policy. As noted in the introduction, the 1936 amendments of the Robinson-Patman Act were meant to counter the market power of large retail chains that enabled those chains to extract price favors from manufacturers, all to the competitive disadvantage of small retailers who paid higher prices for the same commodities. These concerns resonated well with the then prevailing antitrust policy which had a populist bias aimed at preserving those small retailers. Today, antitrust policy has shifted toward the goal of consumer welfare and the concomitant goal of encouraging suppliers to expand output. Under this view, price discrimination should not be prohibited because, where a supplier can successfully price discriminate by charging different prices to groups of consumers with different demand characteristics, the supplier can expand output beyond the profit-maximizing output associated with a single price.

Key to the current and favorable view of price discrimination is the supplier's ability to separate consumers into groups with different demand characteristics, that is, different elasticities of demand and corresponding degrees of price sensitivity. Indeed, the economic theory underlying this favorable view of price discrimination presupposes that the price-disfavored group of purchasers has a relatively inelastic demand and price insensitivity, that is, price-disfavored consumers can and will purchase the same amount at higher prices. The other group of consumers, the price-favored group, has a relatively elastic demand and price sensitivity, that is, price-favored consumers will purchase more at lower prices. To be sure, this theory was developed in the context of utility industries that are characterized by high fixed costs and exceedingly low marginal costs. At the risk of oversimplification, the theory is that price-disfavored consumers with

a relatively inelastic demand and price insensitivity are willing to pay a price that not only covers the total costs of providing the services provided to them, but also a price that is high enough to defray or subsidize a good portion of the fixed costs associated with the services provided to price-favored consumers with a relatively elastic demand curve and price sensitivity.[282]

Even in industries that are not characterized by high fixed costs and exceedingly low marginal costs, a strategy of price discrimination that separates consumers should also be based upon identifying groups with different demand characteristics. Under the goals of consumer welfare and output maximization, it makes no sense for a price discrimination strategy to charge a lower price to those who are not likely to increase the quantity of goods purchased and, at the same time, to charge a higher price to those who are likely to decrease the quantity of goods purchased. Put another way, consumer welfare and output are not likely increased if price insensitive consumers pay lower prices while price sensitive consumers pay higher prices.[283]

Following these observations, a consumer welfare interpretation of the Nonprofit Institutions Act is that the exemption is an exception to a general prohibition of price discrimination for one fact

282. *See generally supra* note 14 (all cited sources). The price differentials in the pharmaceutical industry do appear to shift costs by having price-disfavored purchasers in the "open door" channel subsidize or defray costs associated with the "closed door" channel. *See* Pisone, *supra* note 34, at 65 ("Discriminatory pricing practices, or cost shifting, has made drug manufacturing one of the most lucrative businesses in the marketplace."); Zaretsky, *supra* note 28, at 272 ("The losses attributed to these preferred payers are partially offset by inflated charges to the dwindling group of retail (i.e., billed-charges paying) payers."); Patricia M. Danzon, *Price Discrimination for Pharmaceuticals: Welfare Effects in the U.S. and the E.U.*, 4 INT'L J. ECON. BUS. 301 (1997) (examining price discrimination while incorporating R & D costs as global joint costs). If the analogy to utility regulation is followed, the issue is not whether there is cost shifting, but whether relatively elastic and price insensitive consumers improperly subsidize relatively inelastic and price sensitive consumers.

283. Some commentators have suggested that the price discrimination practiced by the pharmaceutical industry did not produce the typical result of increased profits. Scherer, *Prescription Drug Litigation*, *supra* note 7, at 253–54; Weinstein & Culbertson, *supra* note 10, at 259. Weinstein and Culbertson have observed that the current practice of granting discounts to managed care organizations is designed to shift market share, that is, to shift sales on other branded drugs within a therapeutic class of drugs to the branded drug, also within that class, sold by the price discriminating seller. *Id.* at 262. This suggests that the price discrimination strategy does not so much increase total market output by all drug manufacturers but only changes the market shares among drug manufacturers. *See also* Elzinga & Mills, *supra* note 60 at 292–98 (evaluating welfare effects of prescription discounts from perspective of elasticized demands and non-cooperative oligopolistic reactions).

situation in which a price discrimination strategy will likely lead to greater output and increased consumer welfare. Under the exemption, consumers are divided into two groups depending upon whether those consumers obtain goods or services from eleemosynary institutions. While this division may be a rough proxy, the distinctions inherent in the requirements for exempt intermediaries and exempt purchasers are consistent with an attempt to separate consumers into groups with different elasticities of demand and corresponding price sensitivities. Consumers who purchase goods and services from nonexempt and for-profit entities in the price-disfavored channel of distribution are likely to have a relatively inelastic demand and to be price insensitive. By contrast, consumers who receive goods or services from exempt and not-for-profit entities in the price-favored channel of distribution are likely to have a relatively elastic demand and to be price sensitive. Thus, the Nonprofit Institutions Act exemption can be interpreted as a way to permit a price discrimination strategy where that price discrimination strategy makes the kinds of distinctions that advance the twin goals of consumer welfare and output maximization.[284]

It is in light of these antitrust policies that the failure of courts to examine the broader context of the overall price discrimination strategy has led to results that seem illogical and at odds with public policy. For example, in the cases arising out of the pharmaceutical industry, if reasons have been noted for the design of distribution channels that discriminate in price, those reasons are unrelated to the traditional consumer welfare and output maximization justifications of regulated price discrimination. Lower prices are charged to large institutional purchasers,[285] not because they are eleemosynary institutions who serve patients with a relatively elastic demand and price sensitivity, but because those large institutional purchasers have bar-

284. Those who have a deeply held belief that price discrimination should be permitted, or that business rationales should be presumed pro-competitive and efficiency enhancing, may urge that the exception of the Nonprofit Institutions Act should swallow the rule of the Robinson-Patman Act. In other words, the presumption against price discrimination should be replaced with a presumption in favor of price discrimination that could be rebutted with a showing of anti-competitive effects that harm consumer welfare or restrict output. Such an outcome would effectively relegate claims of illegal price discrimination to analysis under the Sherman Act, 15 U.S.C. §§ 1–2 (1994), the situation that existed prior to the Clayton Act and the Robinson-Patman Act, 15 U.S.C. § 13 (1994).

285. *See supra* note 46.

gaining power.[286] Or, lower prices are charged to institutional buyers as a marketing tool to introduce doctors and patients to a pharmaceutical product in a low-price, institutional setting with the hopes that the same doctors and patients would continue to prescribe and purchase the same brand in a high-price, non-institutional setting.[287] While there may be business reasons for these practices, those reasons do not readily appear to be related to the justification of price discrimination that hinges upon separating consumers into groups with different demand characteristics.[288] Unless and until those who design and enforce distribution systems under the Nonprofit Institutions Act expand the context of analysis to include the design of the overall price discrimination strategy, the results will likely remain at

286. United States v. Costanzo, 4 F.3d 658, 659 (8th Cir. 1993) ("One reason that drug manufacturers offer institutional pharmacies low prices is that manufacturers recognize that the amount that insurance companies and the government, which pay for many of the patients in institutions, will reimburse for pharmaceuticals is relatively low.") Institutional purchasers may have the economics of scale to institute accounting or other cost-containment techniques that enhance their bargaining power. *See* LEVY, *supra* note 33, at 8–9 ("Indeed, until recently, aggressive price competition among drug companies typically was found only in certain segments of the industry, primarily in sales to hospitals. . . . [H]ospitals typically negotiated lower prices than others, partly because [an accounting] change . . . encouraged hospitals to minimize their prescription drug expenditures. Hospitals were also among the first buyers to apply cost-containment measures to their drug purchases."). Further, institutional buyers may increase their bargaining power by instituting programs that switch purchases from brand-name to generic drugs. *Id.* at 20–21 ("Survey evidence indicates that HMOs are expanding their use of incentive payments and programs to increase the use of generic alternatives to brand-name drugs.") (footnote omitted). Pharmacy benefit management services, which are used by insurance companies, control prescription drug costs, in part, by negotiating drug price rebates. *Id.* at 51–54. Finally, and with respect to Medicaid and veterans health care, federal and state law requires that pharmaceutical companies provide "rebates that are based on the lowest prices available to other customers." *Id.* at 23–24.

287. *See supra* note 48.

288. Of interest here is the fact that, in a 1994 survey concerning prescription drugs, "[t]herapeutic substitution programs . . . ranked as the least popular cost-containment strategy" for HMOs. LEVY, *supra* note 33, at 32–34. While there is evidence that therapeutic substitution is more costly than other prescription drug cost-containment strategies, the fact that therapeutic substitution is the least popular is an indication that a patient's elasticity of demand for the prescription drug component of treatment does not vary greatly depending upon the context within which the drug is prescribed. On the other hand, to the extent that institutional purchasers have relatively greater abilities to create competition between generic and brand-name prescription drugs, demand elasticities facing drug manufacturers increase. *Id.* at 56–57, 70–71. *See also id.* at 75 ("[I]nformation technology has permitted these groups of buyers [HMOs, PBMs, and Medicaid programs] to substitute more easily among alternative drug treatments.").

odds with the goals of antitrust policy to increase consumer welfare and to expand output.[289]

289. As suggested in a debate regarding a recent case involving allegations of price discrimination in the pharmaceutical industry, "[t]he consumers who were most likely to pay the higher retail prices were those who were also the most likely be forced to forego medication due the cost—the poor and the uninsured." Harrison, *supra* note 37, at 268. *See also* Elzinga & Mills, *supra* note 60, at 288 ("unlike conventional third-degree price discrimination where a firm actively sorts its consumers into classes to exploit *existing* differences in demand elasticities, discounts on prescription drugs are commandeered by managed care organizations who intervene between manufacturers and consumers in a way that *alters* some consumers' demands for drugs.").

For an analysis of how true elasticities of demand lead consumers to select different kinds of health care plans with, apparently, an assumption that all consumers will, in fact, enroll in a health care plan, see Danzon, *supra* note 282, at 311 (suggesting that "pattern of drug price discounts across health plans can be explained by differences in price elasticity of demand of consumers"). Of course, if consumers with the most elastic demands for health care cannot afford an available health plan, or do not work for an employer who makes one available, and, therefore, are left to purchase drugs at high prices from retail pharmacies, the existing pattern of drug price discounts is not explained by differences in the elasticity of demand of consumers. Further, to the extent that consumer choice among health care alternatives is restricted by employers who often choose what plans will be available, so too the existing pattern of drug discounts is not explained by differences in the elasticity of demand of consumers. *See* LEVY, *supra* note 33, at 75 (noting that higher prices are charged to the uninsured).