THE DIFFICULTIES OF SHOWING PASS THROUGH IN INDIRECT PURCHASER COMPONENT CASES

By James Bo Pearl and Allison Smith[1]

Over the last decade, California federal courts have heard a number of antitrust suits alleging price fixing and other anticompetitive conduct by cartels of electronic component manufacturers. These alleged conspiracies have touched various components of everyday electronics that allow the devices to perform basic tasks.

The component cases almost invariably include claims by indirect purchasers seeking damages from the alleged cartelists, even though they did not purchase products directly from defendants. In most of these cases, the indirect purchaser class purchased finished products incorporating the electronic component at issue, such as a laptop computer.[2] The electronic component generally will have passed through multiple intermediaries in the distribution chain between the defendant manufacturer and the indirect purchaser plaintiff ("IPP"). Given the volume of commerce associated with these commonplace consumer products, the damages claims in these cases are often substantial.

Establishing damages incurred by indirect purchasers is complicated by their attenuated commercial relationship with the conspirators.[3] To recover, indirect purchasers must show that the original increase in price charged by the component manufacturer to a direct purchaser because of the conspiracy (the overcharge) made its way through all stages of the distribution chain. That is, "plaintiffs must demonstrate that defendants overcharged their direct purchasers . . . and that those direct purchasers passed on the overcharges to plaintiffs."[4]

The issue becomes more complex for large classes of indirect purchasers who purchased disparate finished products. The classes are generally defined based on the products purchased and time period of that purchase; they do not consider the diversity of upstream transactions involving the electronic component or the intermediaries from which the indirect purchaser bought the end product.[5] Although the electronic component cases have generally limited classes to indirect purchasers who purchased for their own use,

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2 One notable exception is the ongoing resistors litigation, where the proposed indirect purchaser class definition included purchasers of resistors from an intermediary between the purchaser and the defendant, but not finished products containing resistors. *See* Complaint, *In re Resistors Antitrust Litig.*, No. 5:15-cv-03820 (N.D. Cal. Aug. 20, 2015).

3 *See* Michelle M. Burtis et. al., *Pass-through, Common Impact, and Structural Modeling in Indirect Purchaser Class Certification*, 10 Econ. Comm. Newsl. 3, 3 (Summer 2010); Pierre Y. Cremiux et. al., *Assessing Conflict, Impact, and Common Methods of Proof in Intermediate Indirect-Purchaser Class Action Litigation*, 6 Econ. Comm. Newsl. 4, 6 (Spring 2006).

4 *In re Graphics Processing Units Antitrust Litig.*, 253 F.R.D. 478, 499 (N.D. Cal. 2008) ("*GPU*").

5 *See, e.g., In re TFT-LCD (Flat Panel) Antitrust Litig.*, 267 F.R.D. 583, 590 (N.D. Cal. 2010), *amended in part*, No. M 07-1827 SI, 2011 WL 3268649 (N.D. Cal. July 28, 2011) ("*LCD*"); *In re Static Random Access Memory (SRAM) Antitrust Litig.*, 264 F.R.D. 603, 608 (N.D. Cal. 2009) ("*SRAM*").

rather than for resale, this still leaves heterogeneity among class members, along factors such as customer size, customer type, and procurement channel.[6]

Given the complexity of some of the finished products at issue in these suits and their complicated routes to market, both plaintiffs and defendants need to carefully study the issue of pass through and plaintiffs' ability to show pass through on a class-wide basis. A recent case study, the lithium ion battery litigation, provides an example of the difficulty of showing pass through on a class-wide basis.

I. LEGAL BACKGROUND

Indirect purchaser suits for monetary damages are barred under federal antitrust law. In *Illinois Brick Co. v. Illinois*, the Supreme Court held that indirect purchasers do not have standing to pursue damages claims.[7] This holding built on the Court's prior decision in *Hanover Shoe, Inc. v. United Shoe Machinery Corp.* that a pass-on defense is normally not available to defendants, meaning they cannot reduce damages by proving that plaintiffs passed through some part of the anticompetitive overcharge to their customers.[8] The *Illinois Brick* Court reasoned that if defendants are liable for the full overcharge to the direct purchasers, they should not also be liable for the same overcharge to the downstream purchasers. In addition to this "serious risk of multiple liability," the Court was also concerned about the "evidentiary complexities and uncertainties" involved in demonstrating how much of the overcharge was passed on "at each point at which the price-fixed goods changed hands before they reached the plaintiff."[9]

Dissatisfied with this bar on recovery, numerous states passed so-called "*Illinois Brick* repealer" statutes, allowing indirect purchasers to bring damages claims under state antitrust laws. The Supreme Court later rejected arguments that these state statutes were preempted by federal law, and held that indirect purchasers may recover damages under state laws even if direct purchasers also have a right to recover damages under federal law for the same conduct.[10]

Pass through is central to showing impact and damages for a proposed class of indirect purchasers. At the class certification stage, the class representatives must be able to show class-wide impact using common proof.[11] At the merits stage (whether at summary judgment or trial), IPPs must show injury for the entire class, rather than only some class members or the class in the aggregate.[12] The pass through determination requires

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6 *See California v. Infineon Techs. AG*, No. C 06-4333 PJH, 2008 WL 4155665, at *11 (N.D. Cal. Sept. 5, 2008) (denying class certification).

7 *Illinois Brick Co. v. Illinois*, 431 U.S. 720 (1977).

8 *Hanover Shoe, Inc. v. United Shoe Machinery Corp.*, 392 U.S. 481 (1968).

9 *Illinois Brick*, 431 U.S. at 732-33.

10 *California v. ARC America Corp.*, 490 U.S. 93 (1989).

11 *See* Fed. R. Civ. P. 23; *In re Optical Disk Drive Antitrust Litig.*, No. 3:10-MD-2143 RS, 2016 WL 467444, at *11 (N.D. Cal. Feb. 8, 2016) ("The crucial point is that whether the IPPs theory is right or wrong, it is something that can be decided on a class-wide basis."); *GPU*, 253 F.R.D. at 505.

12 *See* Chris S. Coutroulis & D. Matthew Allen, *The Pass-on Problem in Indirect Purchaser Class Litigation*, 44 Antitrust Bull. 179, 185 (1999); *see also In re Optical Disk Drive Antitrust Litig.*, No. 10-MD-02143-RS, 2017 WL 6503743, at *8-9 (N.D. Cal. Dec. 18, 2017).

first identifying the "particular channel applicable to the class member's purchase, and tracing the overcharge through the various intermediaries that lie between the particular Defendant and the member."[13] The complexities of showing uniform pass through at each level of a complex distribution chain via common proof have often thwarted proposed indirect purchaser claims, including in electronic component cases.[14]

II. PASS THROUGH ANALYSIS IN ELECTRONIC COMPONENT CASES

The need to "trace the complex economic adjustments to a change in the cost of a particular factor of production" was one reason the Supreme Court barred indirect purchaser actions—seeking damages—under federal law.[15] Econometric analysis in litigation has become more sophisticated since the time of *Illinois Brick*, but proving pass through of overcharges through sometimes elaborate distribution chains can still be a formidable task.

The extent to which an overcharge caused by defendants' conduct affects an indirect purchaser plaintiff depends on the pricing decisions of the direct purchaser and other indirect purchasers further up the distribution chain from the plaintiff, that is, intermediaries between the direct purchaser and the indirect purchaser class members.[16] Each firm in the chain must balance a possible price increase to offset the higher cost from the overcharge on the component with the resulting lower demand for the product it sells.[17] The relative magnitudes of these effects could cause the firm to fully pass through the overcharge, or choose to absorb some or all of the overcharge. These decisions are also informed by the competitive situation in the firm's industry. Firms also may consider substituting other inputs to replace the price-fixed component, if possible. In short, pass through decisions are a function of the elasticity of supply and elasticity of demand, which differ among firms and stages of the distribution chain.[18]

To win class certification, a proposed indirect purchaser class must show class-wide impact from defendants' anticompetitive conduct using a common method and common

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13 *In re Flash Memory Antitrust Litig.*, No. C 07-0086 SBA, 2010 WL 2332081, at *11 (N.D. Cal. June 9, 2010) (denying class certification) ("*Flash Memory*"); *see GPU*, 253 F.R.D. at 499.

14 *See, e.g., In re Dynamic Random Access Memory (DRAM) Antitrust Litigation*, 516 F. Supp. 2d 1072 (N.D. Cal. 2007); *GPU*, 253 F.R.D. 478.

15 *Illinois Brick*, 431 U.S. at 732.

16 *See* George Kosicki & Miles B. Cahill, *Economics of Cost Pass Through and Damages in Indirect Purchaser Antitrust Cases,* 51 Antitrust Bull. 599, 601 (2006).

17 *See Illinois* ex rel. *Hartigan v. Panhandle Eastern Pipe Line Co.*, 852 F.2d 891, 894 (7th Cir. 1988) (describing determination of direct purchaser's trade-off between a higher price and lower demand as hard, "even by sophisticated techniques of economic analysis").

18 *See* Kosicki & Cahill, *supra* note 16, at 606-19 (discussing the economics of pass through in different market structures); William Landes & Richard Posner, *Should Indirect Purchasers Have Standing to Sue Under the Antitrust Laws? An Economic Analysis of the Rule of Illinois Brick*, 46 U. Chi. L. Rev. 602, 619 (1979); Fei Deng, John H. Johnson, & Gregory K. Leonard, *Economic Analysis in Indirect Purchaser Class Actions*, 26 Antitrust 51, 52 (2011); *see also SRAM*, 264 F.R.D. at 613.

evidence.[19] IPPs generally use econometric models to show an overcharge was passed through various steps in the distribution chain to their final purchases. These models must take into account real world behaviors, which depart from the classical assumptions underlying economic models and may cause actual pricing decisions to differ from the predicted responses.[20] These include, for example, buyer power for certain large buyers, market power for certain sellers, heterogeneous products, price protection contracts for buyers, promotional pricing by buyers, and barriers to entry in the seller's market.[21]

A number of factors affect the ease with which plaintiffs can show pass through and appropriately account for relevant market characteristics. One district court grouped these factors into "five classes" to consider: "temporal relationships, pricing practices, directness of affected costs, supply[,] and demand."[22] As examples:

- if a retailer uses price points, it may not shift a product to the next highest price point in response to a small increase in the cost of a component, decreasing the pass through rate;
- if a downstream firm can substitute to different inputs, the pass through rate will be lower than 100%;
- if the overcharge is on a component comprising a small amount of the finished product's total cost, the overcharge may not be passed through at all because it is "virtually unnoticeable" to the seller of the final product; and
- if customers are not sensitive to a change in price, the seller may be able to pass through more of the overcharge.[23]

With variances in demand, cost, and competitive conditions at different levels of the supply chain, indirect purchasers may be affected differently depending on the exact supply chain their finished product traveled along.[24]

The electronic component cases exhibit many of the factors that make estimating pass through, particularly on a class-wide basis, more difficult to show. In some instances, though, these difficulties have not prevented IPPs from obtaining class certification.

- Heterogeneity of the components

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19 *See GPU*, 253 F.R.D. at 504, 505 (addressing burden at class certification); *In re Cathode Ray Tub (CRT) Antitrust Litig.*, No. C-07-5944-SC, 2013 WL 5391159, at *5 (N.D. Cal. Sept. 24, 2013) ("*CRT*") (stating that at class certification, indirect purchaser plaintiffs need to show "a reasonable method for determining, on a classwide basis, the antitrust impact's effects on the class members,' not that every class member was injured).

20 *See* Burtis et. al., *supra* note 3, at 6 (describing empirical studies showing that firms' pricing strategies may depart from economic theory and modeling).

21 *See* Coutroulis & Allen, *supra* note 12, at 200.

22 *In re Lithium Ion Batteries Antitrust Litig.*, No. 13-MD-2420 YGR, 2017 WL 1391491, at *9 (N.D Cal. Apr. 12, 2017) ("*Lithium Ion Batteries*") (citing *SRAM*, 264 F.R.D. at 613).

23 *See* Deng, Johnson, & Leonard, *supra* note 18, at 52-54.

24 *Id.* at 54.

- In litigation over flash memory, the court noted that the defendants collectively produced about 2,000 different types of NAND flash memory chips, and the prices ranged from 1 cent to over $200 during the period at issue. The court denied class certification because the plaintiffs could not show class-wide injury.[25]

- In the optical disc drive ("ODD") litigation, IPPs removed CD drives and Blu-Ray drives from the components at issue for the second round of class certification. This cured one of the defects noted by the district court in denying the first attempt at class certification.[26]

- Heterogeneity of the finished products

  - The finished products at issue in the lithium ion batteries action included "devices ranging from smartphones to laptop computers to cameras to cordless power tools." The court denied class certification.[27]

  - Similarly, products incorporating graphics processing units "were particularly customized to the needs of a specific purchaser, meaning they could not be interchanged with any other GPU product sold by defendants." The court denied class certification.[28]

  - In contrast, cathode ray tubes were "not so variable as . . . graphics processing units," and their prices depended on a small number of variables. That minor heterogeneity did not defeat class certification.[29]

  - In litigation over ODDs, IPPs narrowed the scope of the class to reduce the types of finished products at issue. The class was limited to purchases of "computers containing ODDs and stand-alone ODDs only, removing videogame consoles such as the Xbox." The court certified the more limited class.[30]

- Cost of the input as a percentage of the total cost of the finished product

  - The low relative cost of an ODD to the total cost of a computer, given retailers' common use of price points, was a factor in IPPs' inability to show

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25 *Flash Memory*, 2010 WL 2332081, at *1.

26 *In re Optical Disk Drive Antitrust Litig.*, 2016 WL 467444, at *3.

27 *Lithium Ion Batteries*, 2017 WL 1391491, at *2.

28 *GPU*, 253 F.R.D. at 491.

29 *CRT*, 2013 WL 5391159, at *8.

30 *In re Optical Disk Drive Antitrust Litig.*, 2016 WL 467444, at *3.

pass through and common injury to the proposed class during the first round of class certification briefing in the *ODD* litigation.[31]

- CRT and LCD components represented a large portion of the cost of the finished product, and IPPs successfully sought class certification of both classes. CRTs "are the most expensive component in the finished products into which they are incorporated," and account for over 50% of the retail price of the finished product."[32] Likewise, LCD panels constituted "50%-80% of the price of computer monitors, 33%-70% of the price of televisions . . ., and 10%-25% of the cost of a notebook computer."[33]

- Number of levels in the distribution chain and competitive conditions at each level

  - The court denied class certification for indirect purchasers of flash memory, finding that a typical chain of distribution involved "five different transactions," and NAND flash was "typically resold (by itself or as altered) several times before reaching the final end-consumer."[34]

  - The *SRAM* court explained that IPPs "must find a way to account for the decision-making of a variety of resellers and manufacturers in an intricate distribution chain." To prove class-wide injury, IPPs had to account for sales of SRAM as a component of an end product, as a stand-alone product, and as part of a bundle with other products. Despite these challenges, the IPPs successfully moved to certify their proposed class.[35]

- Type of procurement methods and pricing negotiations

  - Defendants mostly sold NAND flash memory through frequent negotiations with purchasers, and this militated against a finding of common impact to the proposed class. Further, IPPs did not show pass through for the various channels through which indirect purchases bought the products at issue; their approach did not study the intermediaries in the distribution chain.[36]

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31 *In re Optical Disk Drive Antitrust Litig.*, 303 F.R.D. 311, 324-25 (N.D. Cal. 2014) ("Among other things, the IPPs have not presented a persuasive explanation as to why it would be reasonable to assume a uniform pass through rate given that ODDs typically make up a relatively small portion of the cost of the products into which they are incorporated, and given the existence of price points—i.e., the common practice in the industry of selling products costing in the hundreds of dollars at prices just under the next $100 mark."). The court later certified a revised IPP class, after additional analysis by the IPPs' expert.

32 *In re Cathode Ray Tube (CRT) Antitrust Litig.*, MDL No. 1917, 2013 WL 5429718, at *2 (N.D. Cal. June 20, 2013), *report and recommendation adopted*, No. C-07-5944-SC, 2013 WL 5391159 (N.D. Cal. Sept. 24, 2013).

33 *LCD*, 267 F.R.D. at 588.

34 *Flash Memory*, 2010 WL 2332081, at *2.

35 *SRAM*, 264 F.R.D. at 613.

36 *Flash Memory*, 2010 WL 2332081, at *11-12.

- Rigid pricing
    - In finding that IPPs could not show class-wide pass through, the *Flash Memory* court noted that prices varied across the hundreds of retailers at issue, and for the same retailer at different points in time, as different firms used different pricing strategies. Further, it acknowledged that "different retailers respond to cost changes in different ways, with some choosing not to pass-through cost changes in the form of higher prices for the end-user."[37]
    - In certifying the ODD indirect purchaser class, the court expressed concern that price points presented an issue that IPPs would have to account for at the merits stage. Inability to show pass through because of focal point pricing was a main reason for the grant of summary judgment against IPPs.[38]

III. CASE STUDY: LITHIUM ION BATTERIES

The recent class certification decision in the lithium ion batteries antitrust litigation turned on pass through and illustrates the economic challenges faced by indirect purchasers to establish injury. Lithium ion batteries are used to power a number of common portable electronics. Groups of direct and indirect purchasers filed suit in 2013, alleging that multiple electronics manufacturers conspired to maintain artificially high prices for these batteries. A sprawling multi-district litigation resulted, and some defendants settled prior to or during the class certification proceedings.

The indirect purchaser class first sought class certification in early 2016, but the court denied the motion in part because the proposed class did not demonstrate the alleged "antitrust impact is 'passed on' to each level of the indirect purchasers in the distribution chain."[39] The court explained that the plaintiffs' expert had not adequately accounted for the effects of bundling, rebates, discounts, and focal point pricing in his pass through analysis. The court also faulted the expert's pass through analysis for insufficiently capturing "the variety of different types of class members and product categories," including "packers" of cylindrical batteries because IPPs had not obtained any data from packers.[40] But the court allowed the IPPs to revise their analysis and renew their motion for class certification.

The indirect purchasers did so, with a motion supported by additional economic analysis designed to address the court's concerns from the first round of class certification. Despite the additional data and updated analysis, the court found that the IPPs still had not shown pass through to establish class-wide impact and damages, and again denied the motion for certification.[41]

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37 *Flash Memory*, 2010 WL 2332081, at *11.

38 *In re Optical Disk Drive Antitrust Litig.*, 2017 WL 6503743, at *8-10.

39 *Lithium Ion Batteries*, 2017 WL 1391491, at *12.

40 *Id.* at *12.

41 *In re Lithium Ion Batteries Antitrust Litig.*, No. 13-MD-2420 YGR, 2018 WL 1156797, at *3 (N.D. Cal. Mar. 5, 2018).

The court focused on the prevalence of focal point pricing, particularly at the retail level. It credited defendants' argument that retailers will not pass through small cost changes, as estimated by plaintiffs' expert, because retailers would have to price at the next higher price point, *e.g.*, $10 higher to retain a price that ends in the digit "9."[42]

IPPs countered the focal point pricing argument by asserting that the overcharge on the battery is instead passed through as a reduction in the quality of other components in the finished product. For example, if manufacturers design a notebook computer for a certain price point and the cost of the battery increases, they will reduce the quality (and therefore cost) of other components to deliver a finished product for the same price point.[43]

The court rejected plaintiffs' theory of a quality reduction injury because it was "theory without factual support."[44] The court was also troubled by the seeming conflict between the asserted quality reductions (rather than price of cost changes) and the expert's previous pass through regression calculations, which were based on actual price and cost data for entities at different levels of the distribution chain.[45] Additionally, the plaintiffs' expert did not explain how the quality adjustments, which would take place at the OEM level, would affect pass through later in the distribution chain, especially at the retail level where focal point pricing is most prevalent and pricing is most volatile.[46] The indirect purchasers did not adequately explain the effect of focal point pricing on their pass through analyses and thus could not show antitrust injury to the class on a common basis.[47]

IV. CONCLUSION

Pass through continues to be a hurdle to showing antitrust injury for a class of indirect purchasers of an allegedly price-fixed component, although the record in electronic component cases is somewhat mixed. While not dispositive, certain market characteristics impede indirect purchasers' ability to show pass through of an overcharge on a class-wide basis, particularly heterogeneity of the component or finished product and pricing strategies and pressures that influence intermediaries' pricing decisions.

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42 *Id.* at *4.

43 *Id.*

44 *Id.* The *ODD* court rejected for lack of factual support a similar argument that indirect purchasers were injured from purchasing lower-quality finished products. *In re Optical Disk Drive Antitrust Litig.*, 2017 WL 6503743, at *9. Likewise, the *GPU* court stated that indirect purchasers needed to show that they paid a higher price for their graphics card or computer than they would have without the alleged conspiracy. *GPU*, 253 F.R.D. at 505.

45 *Id.* at *5.

46 *Id.*

47 *Id.*