When Most-Favored Is Disfavored: A Counselor's Guide to MFNs

BY W. STEPHEN SMITH

THE U.S. ANTITRUST AGENCIES HAVE turned the spotlight on most-favored-nation (MFN) clauses. The Department of Justice is currently litigating two high-profile cases that challenge the use of MFNs in the health insurance and e-book industries.[1] The DOJ's most senior officials have given speeches and testimony describing the potential anticompetitive effects of MFNs.[2] And the DOJ and the Federal Trade Commission recently held a public workshop to discuss "the evolution of economic and legal thinking on MFNs and their implications."[3]

How does an antitrust counselor determine whether an MFN is likely to become the subject of an investigation or challenge in the current environment? Like any other agreement between a buyer and seller about the terms of a transaction, MFNs are vertical restraints and therefore evaluated under the rule of reason. Notwithstanding the recent attention they have attracted, there is general consensus that most MFNs do not have anticompetitive effects.[4] The agencies' concern is that the use of MFNs in certain market circumstances may result in higher market prices because—to borrow a phrase from a DOJ report of an earlier era—a firm that is required "to reduce prices to *some* only at the cost of reducing prices to *all* may well end up by reducing them to *none*."[5] The task, therefore, is to identify those circumstances in which MFNs may have such effects, and determine whether use of a particular form of MFN in those circumstances is likely to lessen competition. This article provides an analytical framework and guideposts designed to aid counselors in assessing the antitrust risks of MFNs under U.S. law.

Step 1: Gather the Key Facts

As with any antitrust analysis, the evaluation of the competitive effects of an MFN requires a basic understanding of the nature of the restraint and the market context in which it arises. There is nothing inherently suspect about an MFN; at its core, it is a mechanism to combat price discrimination. An MFN is typically a commitment by a seller to treat a buyer as well as it treats its best—most favored—customer.[6] The commitment is usually embodied in a contract, although in some cases it may be a unilaterally announced policy. MFNs often relate to price but may extend to other terms of the sales relationship as well, such as payment terms or access to supply.

To assess the likely competitive effects of an MFN, a counselor should begin by gathering the following key facts:

- Product: What product or service is the subject of the MFN?
- Market Context: Is the market for the product or service highly concentrated? Does either party to the MFN have a high market share?
- Impetus: Which party is requesting the MFN? Which party is the beneficiary of the MFN?
- Nature and Terms: Does the beneficiary receive the best terms available to others (an "MFN-equal"), or better terms (an "MFN-plus")? Does the beneficiary receive the best terms provided to others at the time of purchase (a "contemporaneous MFN") or the best terms provided to others in the future (a "retroactive MFN")?
- Rationale: Why does the party want the MFN? How will the party benefit from it?
- Industry Usage: Are MFNs commonly used in the industry? Is the party seeking to obtain an MFN from several counterparties simultaneously? Have horizontal competitors agreed to use MFNs?

For many MFNs, it will be easy to conclude from this basic information that the provision does not give rise to material antitrust risk. Some MFNs, however, will require more rigorous analysis.

Step 2: Assess Whether Parties to the MFN Have Market Power

Having collected the key facts, the next step in evaluating the antitrust risk of an MFN is to apply a market power screen. An MFN could not lessen competition unless it affects the prices of products in markets in which buyers or sellers, either individually or collectively, have market power. Although defining relevant markets and measuring market power is not a simple task, it is often easy to confirm that there is no plausible market—however defined—in which the buyers or sell-

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ers covered by a proposed MFN have the ability to control market price or output. Generally speaking, it is very unlikely that market power exists where the buyers or sellers do not, individually or collectively, control 30 percent or more of the market.[7] Firms that control more than 30 percent of a market may also lack market power, but additional market analysis may be required to confirm that conclusion.

In assessing market power, it is important to tailor the inquiry in light of the nature of the MFN and the market context. For example, in the case of a conventional MFN between one buyer and one seller, the key considerations are whether the input and output markets in which the buyer participates are unconcentrated, the buyer controls a low share of each market, and the seller controls a low share of the input market. In these circumstances, neither the buyer nor seller has market power. On the other hand, in the case of an MFN between multiple sellers and buyers, the fact that no single seller or buyer has market power is not dispositive; the parties' collective market power in each market must be evaluated.

It is also important to evaluate market power in both the input and output markets. For example, consider a case in which buyers that do not have market power in the purchase of an input obtain conventional MFNs from the suppliers of that input. Assume that the buyers are the only two manufacturers of a particular product that uses the input, there are no reasonable substitutes for the input, and the input represents a large portion of the product's cost. In that case, an agency may consider whether the MFN enables price coordination in the output market by providing each buyer with significant information about its sole competitor's cost structure.

If the market power screen reveals that there is no plausible market in which the parties to the MFN, either individually or collectively, have market power, the antitrust risk of using MFNs is low.

Step 3: **Evaluate the Likelihood of Anticompetitive Effects**

Even if an MFN is requested by a large buyer or seller, or by one or more firms in a highly concentrated market, it may not have anticompetitive effects. The courts have recognized that "a policy of insisting on a supplier's lowest price—assuming that the price is not 'predatory' or below the supplier's incremental cost—tends to further competition on the merits."[8] Indeed, no court has found a company liable under the antitrust laws for employing MFNs.

The DOJ and FTC have brought approximately ten cases over the last two decades challenging MFNs. Most of these cases involved the health care industry and all were resolved by consent judgments.[9] The agencies' concern is that, in some market circumstances, MFNs may result in higher market prices because they deter sellers from offering price discounts that would either encourage entry by lower-priced firms or undermine collusive pricing behavior. The analysis of the potential effects of an MFN, therefore, should focus on the provision's impact on the incentives of buyers to seek, and of sellers to offer, lower prices.

Exclusionary Effects. The antitrust agencies' primary concern has been that MFNs may be used by a dominant firm to exclude competition. In the paradigmatic case, if a large buyer obtains MFNs from sellers that comprise a very large fraction of the market, the theory is that the MFNs may prevent the buyer's smaller rivals from entering or expanding their share by obtaining more favorable pricing. In *Delta Dental of Rhode Island*, for example, the DOJ alleged that Delta had MFN agreements with about 90 percent of the dentists actively practicing in Rhode Island, and that its plans covered about 35 to 45 percent of persons with dental insurance in the state.[10] The agency claimed that the MFNs lessened price competition from smaller insurers: "Because Delta represents such a large source of income for most Rhode Island dentists . . . Delta's MFN clause makes it unprofitable for a dentist to accept lower fees from non-Delta patients, even if the dentist would have otherwise been willing to accept those lower fees."[11]

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In the *Blue Cross Blue Shield of Michigan* (*BCBSM*) complaint, the DOJ alleges that Blue Cross's MFNs exacerbate these effects because some are MFN-plus arrangements, which require providers of health care services to charge Blue Cross Blue Shield patients prices that are as much as 40 percent lower than those charged any other patient.[12] The DOJ claims that Blue Cross's MFN-plus provisions not only discourage entry but "guarantee that Blue Cross' competitors cannot obtain hospital services at prices comparable to the prices Blue Cross pays, which limits other health insurers' ability to compete with Blue Cross."[13]

The DOJ's concerns in these cases would not arise, however, if a large buyer entered into MFNs with sellers comprising a small portion of the market. In that case, the competing buyers could negotiate more favorable prices with sellers not subject to the MFN. Likewise, the DOJ's concerns would not arise if buyers that comprise a small portion of the market entered into an MFN with a large seller. The MFNs would not materially alter the incentives of either the large seller or its competitors to offer more favorable pricing to other buyers. How large a percentage of sellers or buyers would have to be subject to MFNs in order to give rise to potential anticompetitive effects will vary by market, but it would be very unlikely that a share of less than 30 percent would have such effects.

Collusion Effects. The antitrust agencies have also expressed concern that MFNs may be used as a device to facilitate tacit or express collusion. The theory is that widespread use of MFNs in a concentrated industry diminishes the likelihood that sellers will cheat on a collusive arrangement because (i) the cost of cheating is higher, as any discount provided to one customer must be provided to others; (ii) buyers' incentives to negotiate hard are reduced, as any incremental benefit one buyer obtains automatically will be extended to its rivals; and (iii) cheating is easier to detect, as pricing becomes more transparent.[14] In *E.I. du Pont de Nemours & Co. v. FTC* (*Ethyl*), for example, the FTC alleged that two of the four producers of antiknock gasoline additives, which together controlled 71 percent of the market, used MFNs to reduce uncertainty about competitors' prices and incentives to discount, thereby "'facilitat[ing] the maintenance of substantial, uniform price levels and the reduction or elimination of price competition . . . .'"[15]

Even in cases in which there is widespread use of MFNs in a highly concentrated industry, however, closer analysis may reveal that there is little or no potential for anticompetitive effects. There are two key questions to consider in assessing whether MFNs are likely to be challenged under a collusion theory: first, are the MFNs a product of horizontal agreement, as opposed to purely vertical arrangements? In *Ethyl*, the court concluded the defendants' conduct did not violate Section 5 of the FTC Act in part because "the FTC concedes that the [producers] did not engage in the challenged practices by agreement or collusively. Each acted independently and unilaterally."[16] In *Starr v. Sony BMG Music Entertainment*, in contrast, the court denied a motion to dismiss a Section 1 claim, concluding that allegations that firms comprising 80 percent of sales in a market engaged in parallel pricing conduct—including charging the same "unreasonably high prices" and "us[ing] the MFNs to enforce a wholesale price floor"—were "sufficient to plausibly suggest that the parallel conduct alleged was the result of an agreement among the defendants."[17] As discussed below, however, there are circumstances in which MFNs implemented as part of an agreement among horizontal competitors have procompetitive effects.

Second, are the MFNs ubiquitous? If some participants in a concentrated market do not use MFNs, they may act as mavericks and effectively undermine any purported collusive scheme. In *Ethyl*, for example, the court observed that one of the two sellers that did not use MFNs provided price discounts on more than 80 percent of its sales, while the other did so on 33–58 percent of its sales.[18] The producers using MFNs responded in kind, and "effectively met the price discounts of the other two producers by providing competition in the form of extensive services which had the effect of retaining old customers or luring away new ones."[19] In highly concentrated markets in which not all firms use MFNs, it is important to consider whether market dynamics may prevent any potential anticompetitive effects.

Enforcement and Penalties. MFNs cannot have anticompetitive effects unless they are honored. Some commentators have observed that MFNs are often "underutilized, or even forgotten," and in any event infrequently enforced.[20] Where MFNs operate as little more than a statement of the parties' expectations, with little or no impact on the actual prices paid, the risk of antitrust investigation or enforcement is low.

On the other hand, if parties actively monitor and enforce MFNs in market circumstances where anticompetitive effects are possible, the risk is greater. Some MFNs include contractual mechanisms to enable the beneficiary of the MFN to confirm that no other party is receiving more favorable terms. In *BCBSM*, for example, the DOJ alleges that "[m]ost of Blue Cross' MFNs require the hospital to 'attest' or 'certify' annually to Blue Cross that the hospital is complying with the MFN, and they often give Blue Cross the right to audit compliance."[21] Although parties are entitled to the benefit of their bargain, the agencies may view active enforcement of MFNs in highly concentrated markets as one indicator of potential anticompetitive effects.

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A related consideration is whether MFN enforcement mechanisms give firms the ability to obtain detailed information about their competitors' prices, and thus could serve as a vehicle for anticompetitive information exchange. These are well-understood issues, and in circumstances where they give rise to a genuine antitrust concern may be addressed through standard safeguards. For example, parties to MFNs often use redacted contracts or third-party auditors to assess compliance, thereby ensuring the confidentiality of the information and protecting the parties from information exchange concerns. The absence of such safeguards in cases in which competitor access to competitively sensitive information is potentially problematic increases the likelihood that an agency may view the MFNs as a device to facilitate collusion.

Finally, it is important to consider the nature and severity of any damages for breaching the MFN. Precisely because MFNs may be difficult to monitor and enforce, penalties for breach may be an appropriate means of encouraging compliance. In circumstances in which MFNs might be used to exclude competition or facilitate collusion, however, the agencies may view penalties (beyond matching the lower price given to another buyer) as a means to punish discounting. This concern is likely to be more acute in the case of retroactive MFNs or MFN-plus clauses, as the addition of a penalty provision in these contexts may suggest that the enforcement mechanisms are designed to do more than ensure that the parties obtain the benefit of their bargain.

Step 4: Evaluate the Likelihood of Procompetitive Effects

If MFNs are used in market circumstances in which there is market power and anticompetitive effects are plausible, the next step is to consider whether the MFNs have potential procompetitive effects. Courts and commentators have identified several ways in which MFNs may promote competition. Since business people typically will say that the purpose of an MFN is to ensure that they get the best price, it is important for counselors to probe more deeply into the nature and scope of the efficiencies associated with a particular MFN.

It is generally agreed that MFNs can result in the following types of efficiencies:

Lower prices. Courts have found that MFNs can result in lower costs for buyers.[22] In markets in which prices are not transparent, or buyers have different levels of information about a seller's willingness to reduce price, buyers can use MFNs to combat price discrimination. Although there has been academic debate about how often MFNs succeed in lowering a buyer's costs,[23] courts have concluded that "'[m]ost favored nations' clauses are standard devices by which buyers try to bargain for low prices" and are "the sort of conduct that the antitrust laws seek to encourage."[24] The fact that a particular MFN may reduce price only in the short run, or may have no effect on price at all, does not mean that it is anticompetitive.

Given the antitrust agencies' focus on circumstances in which MFNs could lead to higher prices, however, it is important to ask more pointed questions about why the buyer wants the protection of the MFN. Does the buyer want to ensure that it pays the best price available because it has not been cost-competitive in the marketplace? If so, it is less likely the MFN will lead to higher prices. Or does the buyer just want to ensure that it pays the same price as its competitors, regardless of the price level? In this case, more careful consideration should be given to whether the MFN may lead to higher prices.

Reduced bargaining costs. There are many markets in which it may be difficult or expensive for buyers and sellers to reach agreement on price—e.g., markets in which supply and demand change rapidly, markets in which products are homogeneous and costs fall continuously, and markets in which long-term contracts are more efficient. For example, MFNs are commonly used in long-term contracts between natural gas pipelines and owners of natural gas wells because they enable the price paid to vary over time as the prices of natural gas and its substitutes change.[25] In these and other market circumstances, MFNs can reduce uncertainty, and the need to renegotiate frequently, by assuring parties they will obtain the benefit of future price changes.

Product investment and promotion. There are some markets in which buyers and sellers must contract in advance in order for a new product to be developed. In these circumstances, one side may be reluctant to make a contractual commitment unless it can be sure that the other side will not exploit its investment in the product's development. For example, if a manufacturer agrees with a supplier to jointly develop a new input, it may insist that the supplier sell that product to it at a price no higher (and perhaps lower) than other manufacturers pay. This issue is particularly acute in markets in which a seller has a strong incentive to sell the product at a discount to future buyers (e.g., because it has a low marginal cost of production). An MFN provides the initial buyer-investor the assurance that it will obtain the benefit of any future price decline.

There are also markets in which a product cannot be developed and promoted without multiple parties making simultaneous commitments to a common buyer or seller. In these circumstances, each party may require an assurance that its commitment will be on the same terms as the other parties to the transaction. For example, if a group of real estate brokers wish to pool their listings and make these available through a joint venture entity, each broker may require an assurance that it will pay no more than the other participating brokers for the new service. An MFN may thus serve not only to encourage investment in a joint enterprise, but also to maximize its value, by preventing one or more parties from free-riding on the investments of others.

Step 5: Balance the Competitive Effects to Assess the Antitrust Risk

Because MFNs are generally procompetitive, they are subject to rule of reason analysis. In assessing the antitrust risk of a particular MFN, therefore, its procompetitive benefits must be weighed against its potential anticompetitive effects. Although this calculus must be conducted on a case-by-case basis, it is unlikely that an MFN would be subject to antitrust investigation or challenge if (i) it relates to products in markets in which no firm has market power; (ii) it is requested by buyers or sellers that comprise a small portion of the market; (iii) it is a contemporaneous MFN with standard enforcement provisions; and (iv) it is likely to result in efficiencies, and its price effects are at worst uncertain.

On the other hand, an MFN should be considered with more caution if it has one or more of the following characteristics: (i) it relates to products in markets in which firms have market power; (ii) it is requested by buyers or sellers that comprise a large portion of the market, or the most likely price maverick; (iii) it has no plausible efficiency rationale, and could result in higher prices; or (iv) it may be the product of a horizontal agreement. Particular care should be taken in evaluating MFNs that are used in an industry that has been subject to prior enforcement actions (e.g., health insurance), or that have unusual terms and enforcement provisions (e.g., retroactive or MFN-plus provisions, stringent enforcement and audit provisions, penalty provisions).

The presence or absence of any single characteristic or even set of characteristics does not mean that an MFN is high-risk, but rather that closer analysis is required before reaching a final judgment. In *BCBSM*, for example, the DOJ alleges that the defendant has a market share of 60 percent and uses MFN-plus arrangements, which "effectively create[s] a large financial penalty for hospitals that do not accept them" and "discourages a hospital with a Blue Cross MFN from lowering prices to health insurers competing with Blue Cross."[26] As a result, the DOJ contends, "Blue Cross' MFNs have caused hospitals to raise prices charged to other commercial health insurers, rather than lower prices to Blue Cross."[27] In *Marshfield Clinic*, in contrast, the court rejected Blue Cross Blue Shield of Wisconsin's claim that the Marshfield Clinic used MFNs to conspire with its horizontal competitors "to put a floor underneath the[ir] physicians' prices, since if they cut prices to their other patients their reimbursement from the Clinic will decline automatically."[28] Terming this claim "ingenious but perverse," Chief Judge Posner concluded that the evidence showed that "[t]he Clinic did this to minimize the cost of these physicians to it."[29] In most market circumstances, careful evaluation will reveal that MFNs are unlikely to result in higher prices and therefore do not give rise to significant antitrust risk. ■

1 Complaint, United States v. Blue Cross Blue Shield of Mich., No. 2:10-cv-14155-DPH-MKM (E.D. Mich. Oct. 18, 2010) [hereinafter *BCBSM*]; Complaint, United States v. Apple Inc., No. 1:12-cv-02826-DLC (S.D.N.Y. Apr. 11, 2012).

2 Fiona Scott-Morton, Deputy Assistant Att'y Gen. Antitrust Div., U.S. Dep't of Justice, Contracts that Reference Rivals, Presented at Georgetown University Law Center Antitrust Seminar (Apr. 5, 2012), *available at* http://www.justice.gov/atr/public/speeches/281965.pdf; Sharis A. Pozen, *Antitrust Laws and Their Effects on Healthcare Providers, Insurers and Patients, Hearing Before the Subcomm. on Courts and Competition Policy of the H. Comm. on the Judiciary*, 111th Cong. 2d Sess. 41 (2010) (Statement of Sharis A. Pozen, Chief of Staff, Antitrust Division, U.S. Dep't of Justice), *available at* http://judiciary.house.gov/hearings/printers/111th/111-157_62658.PDF.

3 *See* U.S. Dep't of Justice, Public Workshop, Most-Favored-Nation Clauses and Antitrust Enforcement and Policy (Sept. 10, 2012), *available at* http://www.justice.gov/atr/public/workshops/mfn/index.html.

4 *E.g.*, Blue Cross & Blue Shield United of Wisc. v. Marshfield Clinic, 65 F.3d 1406, 1415 (7th Cir. 1995); Ocean State Physicians Health Plan, Inc. v. Blue Cross & Blue Shield of R.I., 883 F.2d 1101, 1110 (1st Cir. 1989); Mark Whitener, Sr. Gen. Counsel, Competition Law & Policy, Gen. Elec. Co, MFN Provisions and Antitrust Policy, DOJ/FTC Workshop (Sept. 10, 2012), *available at* http://www.justice.gov/atr/public/workshops/mfn/presentations/286769.pdf. *See also Interview with Howard Shelanski, Director, FTC Bureau of Econ.*, ANTITRUST SOURCE, Dec. 2012, at 5, http://www.americanbar.org/content/dam/aba/publishing/antitrust_source/dec12_shelanski_intrvw_12_20f.authcheckdam.pdf ("[I]f one were to ask me, have things fundamentally changed in terms of antitrust law's perspective on CRRs and MFNs, I would say the answer is no . . . .").

5 REPORT OF THE ATTORNEY GENERAL'S NATIONAL COMMITTEE TO STUDY THE ANTITRUST LAWS 181 (1955) (discussing the application of the Robinson-Patman Act's meeting competition defense).

6 There are other types of MFNs. For example, a seller may commit to accept the best price the buyer is offered by competing sellers. Or a buyer may commit to pay a seller the best price it pays other sellers. The antitrust principles and analytical tools applied to evaluate these different types of MFNs, however, are the same.

7 *Cf.* Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 45–46 (1984) (foreclosure of 30 percent of a market would not give rise to anticompetitive effects); Joseph Kattan & Scott A. Stempel, *Antitrust Enforcement and Most Favored Nation Clauses*, ANTITRUST, Summer 1996, at 24 ("In an earlier regime, the Justice Department indicated that antitrust concerns would arise only where the favored buyer accounted for at least 35 percent of the volume of sales in the market.").

8 *Ocean State*, 883 F.2d at 1110.

9 *See, e.g.*, United States v. Delta Dental of R.I., 943 F. Supp. 172, 176–80 (D.R.I. 1996) (denying defendant's motion to dismiss); United States v. Delta Dental of R.I., No. 96-113P, 1997 U.S. Dist. LEXIS 11239 (D.R.I. July 2, 1997) (consent judgment); RxCare of Tenn., 121 F.T.C. 762 (1996); United States v. Lykes Bros. S.S. Co., 60 Fed. Reg. 52,208 (Oct. 5, 1995) (consent judgment); United States v. Or. Dental Serv., No. C95 1211 FMS, 1995 WL 481363 (N.D. Cal. July 14, 1995) (consent judgment); United States v. Delta Dental Plan of Ariz., Inc., No. 94-1793 PHXPGR, 1995 WL 454769 (D. Ariz. May 19, 1995) (consent judgment); United States v. Classic Care Network, Inc., No. 94-5566, 1995 WL 367908 (E.D.N.Y. May 1, 1995) (consent judgment); United States v. Vision Serv. Plan, No. 1:94CV02693 TPJ (D.D.C. Nov. 1, 1995) (consent judgment), *available at* http://www.justice.gov/atr/cases/f0700/0766.htm.

10 Complaint ¶ 8, United States v. Delta Dental of R.I., No. CA 96 113, (D.R.I. Feb. 29, 1996), *available at* http://www.justice.gov/atr/cases/f0500/0594.htm.

11 *Id.* ¶ 17.

12 *BCBSM*, *supra* note 1, ¶ 4(A).

13 *Id.*

14 *E.g.*, *In re* Brand Name Prescription Drugs Antitrust Litig., 288 F.3d 1028, 1033 (7th Cir. 2002); Jonathan B. Baker, *Vertical Restraints with Horizontal Consequences: Competitive Effects of 'Most-Favored Customer' Clauses*, 64 ANTITRUST L.J. 517 (1996).

15 729 F.2d 128, 130, 133 (2d Cir. 1984) (citation omitted).

16 *Id*. at 140.

17 Starr v. Sony BMG Music Entm't, 592 F.3d 314, 323 (2d Cir. 2010), *cert. denied*, 131 S. Ct. 901 (2011).

18 729 F.2d at 140.

19 *Id.* at 141.

20 Deloitte, *Most Favored Nation Pricing: Are Your Suppliers Holding Up Their End of the Bargain?* 1 (2011), *available at* http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/AERS/us_aers_CRC_Most%20Favored%20Nation_120211.pdf.

21 *BCBSM*, *supra* note 1, ¶ 38.

22 *Marshfield Clinic*, 65 F.3d at 1415; *accord Ocean State*, 883 F.2d at 1110.

23 *Compare* Martha Samuelson, Nikita Piankov & Brian Ellman, Assessing the Effects of Most-Favored Nations Clauses, ABA Section of Antitrust Law Spring Meeting 2012, at 2 (Mar. 28, 2012), *with* Baker, *supra* note 14, at 531–33.

24 *Marshfield Clinic*, 65 F.3d at 1415.

25 Keith J. Crocker & Thomas P. Lyon, *What Do 'Facilitating Practices' Facilitate? An Empirical Investigation of Most-Favored-Nation Clauses in Natural Gas Contracts*, 37 J.L. & ECON. 297 (1994).

26 *BCBSM*, *supra* note 1, ¶ 45.

27 *Id.*

28 *Marshfield Clinic*, 65 F.3d at 1415.

29 *Id.*