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The Antitrust Agencies' Latest Favorite Target: MFN Clauses

Highlights from the Joint DOJ-FTC MFN Workshop

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On September 10, 2012, the Department of Justice (DOJ) and the Federal Trade Commission (FTC) hosted a public workshop exploring the uses of most-favored-nation clauses (MFNs) and their implications for antitrust enforcement policy. The workshop provided a forum for lawyers, economists, academics, and businesspeople to discuss the legal and economic analyses of MFNs, as well as an opportunity to help inform future treatment of MFNs by the antitrust agencies. Recent agency actions, speeches, and this workshop may signal a reinvigorated focus on MFN clauses by the DOJ and FTC. In fact, in a March 2012 speech, then-acting Assistant Attorney General for the DOJ's Antitrust Division, Sharis Pozen, stated that the DOJ has "combined [its] MFN expertise with the states' knowledge of local market conditions to open investigations of various MFN clauses in a number of markets."

MFN provisions, also referred to as "most favored customer" or "antidiscrimination" clauses, are most commonly included in contracts across a wide range of industries to guarantee a customer that it will receive prices that are at least as favorable as those provided to other customers of the same seller.

There are few, if any, cases fully litigated on the merits in which an MFN clause has been found to be anticompetitive. Until the mid-1990s, MFNs were generally viewed as procompetitive, or at least competitively neutral. Since that time, however, various private litigation and agency investigations have challenged the use of MFNs in different industries. Most recently, earlier this year the DOJ filed a lawsuit against Apple, Inc. and several large book publishers alleging a *per se* violation of Section 1 of the Sherman Act for conspiring to raise the retail price of e-books through various mechanisms, including MFN provisions.[1] The proposed final judgment with three of the publishers requires the termination of the existing MFNs. In another matter, from 2010, the DOJ sued Blue Cross Blue Shield of Michigan to prevent enforcement of MFN provisions by the region's dominant insurer, alleging that the clauses excluded competition.[2]

Economic Theories and Empirical Evidence of the Effects of MFNs

The workshop began with an examination of the economic theories concerning the potential pro- and anticompetitive effects of MFN provisions. For potential competitive benefits from the use of MFNs, the panelists focused primarily on efficiencies related to minimizing opportunism and transaction costs. The opportunism problem arises in certain transactions where the risk of exploitation by one party is high as the result of relationship-specific investments (such as site specificity, physical asset specificity, dedicated assets, or human capital specificity) required of the other party. MFN clauses may assure the party making the relationship-specific investment that the other party will not be able to take advantage of it. Transaction costs often include the costs associated with price discovery and negotiation. These costs can be eliminated for parties using MFNs, which may be a particularly important efficiency for smaller firms.

Three theories of harm to competition arising from the use of MFN clauses were also presented by the panelists. First, under a theory of collusive harm, the FTC has suggested that MFNs can facilitate coordination and dampen competition by creating fewer incentives for sellers to discount prices and for buyers to vigorously bargain.[3] Second, the DOJ has argued that MFNs may be exclusionary by raising costs for rivals and entrants.[4] Finally, the panelists also theorized that MFNs can increase a monopolist seller's bargaining power by eliminating the potential for future discounts, thus reassuring buyers that there is no benefit to delaying purchases in hopes of a lower price.

There are very few natural experiments available to examine whether the empirical evidence suggests that MFN clauses harm or benefit competition. However, the panelists pointed to the Omnibus Budget Reconciliation Act of 1990 (OBRA 90), which created a Medicaid prescription drug rebate program requiring pharmaceutical manufacturers to give "best price" rebates to states and the federal government. This "best price" requirement obligated pharmaceutical companies to lower the costs of prescription drugs to Medicaid customers when the price was lowered for non-Medicaid customers. This effectively increased the cost to pharmaceutical companies of providing discounts to non-Medicaid customers. The economic analysis of the overall impact of OBRA 90 on prescription drug prices showed a mixed pricing effect. For branded drugs without generic competition and for generic drugs, there was no price effect. However, for branded drugs with generic competition, there was a price increase. Economists have concluded, therefore, that greater price dispersion (as found with prescription drugs available in brand and generic form) increases the likelihood that an MFN will harm competition and result in increased prices.

Legal Treatment of MFNs

Despite the absence of fully litigated merits precedent on the competitive effects of MFN clauses, there is some antitrust dicta and case law regarding the treatment of MFNs. In addition to the cases discussed above, the panelist also discussed other cases that have touched upon MFN clauses. For example, in *Blue Cross & Blue Shield United of Wisconsin v. Marshfield Clinic*,[5] the Seventh Circuit approved an MFN clause, suggesting that it reduced costs. Conversely, in *Starr v. Sony BMG Music Entertainment,*[6] the Second Circuit vacated the dismissal of an antitrust suit brought against several record companies for their alleged conspiracy to fix online record prices. That court found that Plaintiffs had met the burden of alleging facts sufficient to overcome a motion to dismiss, including an allegation that Defendants had colluded to use MFNs to impose a common wholesale price and price-increase.

Based on case law and agency action, the panelists proposed a fact specific framework for analyzing the competitive effects of an MFN clause. First, identify the likely anticompetitive theory: exclusion or collusion. Second, refine the analysis by examining the mechanism of the anticompetitive effect. For exclusion, determine how the MFN clauses will impact rivals and competition. For collusion, assess how the MFN provision will make coordination more likely. Finally, evaluate any cognizable justifications, such as procompetitive effects from efficiencies.

MFNs in Practice

The panelists identified situations in which MFNs may be of concern in practice, but also of benefit. Several panelists remarked on the unique challenges faced by the health care industry when considering the legality of MFNs. One panelist noted that health care is different than any other industry because of the duality of the insurance and delivery markets. In the health care area, customers typically do not have price sensitivity because it is only the uninsured who pay retail. Most patients do not see the full cost of insurance. The lack of consumer price sensitivity means the pressure to control costs is on third party payors. Moreover, there are varying degrees of competitiveness in care/insurance markets, frequently geographic and reputational monopolies in hospital markets, and concentration in insurance markets varies widely across states. All of these elements may result in a system where insurers tend to be monopsonistic/monopolistic and able to obtain MFNs without actual contracts.

Another panelist commented on benefits of MFNs that are not immediately obvious in theory, but that reveal themselves in practice. She noted that not only are MFNs procompetitive in theory, but they also tend to facilitate negotiations that get deals done, serving as an important and "efficient" tool. Moreover, where there is uncertainty, as found in the "first mover" context that consists of initial dealings involving a new product or arrangement, MFNs may be useful. In the first mover context, one or both parties lack confidence in striking the initial price, and an MFN can provide commitment to adjust pricing as the market develops, reducing the risk to first movers.

However, the panelists did emphasize that regardless of some of these benefits, MFNs may be less beneficial for scenarios where a party has a large market share. In addition, they noted that even well-intentioned use of MFNs can occasionally result in anticompetitive effects over time, thus it is paramount to invest in ongoing monitoring of MFNs.

Future Treatment of MFNs

One panelist provided a brief history of MFNs to analyze how they have shifted from being viewed as procompetitive to sometimes anticompetitive. In 1989, the district court in *Ocean State* noted that MFNs tend to further competition and as a matter of law, are not exclusionary.[7] Then in 1995 came *Marshfield Clinic* where Judge Posner found that MFNs were per se legal. However, after receiving the government's amicus brief arguing that the court could not articulate a ruling finding a per se legal standard, Judge Posner modified the opinion, acknowledging that it was possible that MFNs could be used anticompetitively.[8] The panelist then characterized what followed as a "campaign" by the Department of Justice against MFNs, citing *Blue Cross Blue Shield of Ohio v. Bingaman,*[9] *United States v. Delta Dental of R.I.*,[10] and the recent Apple lawsuit.

The workshop's panelists seemed to hold a consensus that MFNs should not be treated as per se illegal. One panelist suggested weighing the more worrisome effects of an MFN against effects that cause less concern. The harmful effects side of the equation might include: 1) adoption of MFNs by large sellers with market power, 2) MFNs jointly adopted by horizontal agreement, and 3) "MFN plus" agreements (which require the seller to give the buyer better prices than other parties, while adding on a specific percentage increase). Characteristics of a less harmful MFN would include: 1) adoption of MFNs by smaller sellers that lack market power, 2) the existence of efficiencies from the deal, and 3) inclusion of MFNs in long-term contracts with locked-in assets.

The panelists also agreed that a structure for determining the legality of MFNs would be a positive step. They encouraged watching case development and expressed a need for guidelines from the antitrust agencies.

The FTC and DOJ are accepting comments regarding MFNs until October 10, 2012. Between the current pending litigation, particularly the Michigan Blue Cross case, and continued antitrust agency emphasis, this will be an area of great interest and attention.

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Endnotes

1 *United States v. Apple, Inc.*, No. 1:12-cv-2826 (S.D.N.Y. filed April 11, 2012).

2 *United States v. Blue Cross Blue Shield of Michigan*, No. 2:10-cv-15155 (E.D. Mich. Filed Oct. 18, 2010).

3 *See E.I Du Pont De Nemours & Co. v. FTC,* 729 F.2d 128, 139 (2d Cir. 1984) (holding, however, that the MFN clause did not violate Section 5 of the FTC Act).

4 *See United States v. Delta Dental, of R.I.,* 943 F. Supp. 172 (D.R.I. 1996) (denying motion to dismiss) (settled without a trial on the merits).

5 65 F.3d 1406 (7th Cir. 1995).

6 592 F.3d 314 (2d Cir. 2010).

7 *Ocean State Physicians Health Plan v. Blue Cross & Blue Shield*, 883 F.2d 1101, 1110-11 (Ist Cir. 1989).

8 *Blue Cross & Blue Shield United of Wisconsin v. Marshfield Clinic*, No. 95-1965, 1995 U.S. App. LEXIS 29056 at *2 (7th Cir. Oct. 13, 1995) ("Perhaps, as the DOJ believes, these clauses are misused to anticompetitive ends in some cases; but there is no evidence of that in this case.").

9 No. 94-2297, 1996 U.S. Dist. LEXIS 17091 (N.D. Ohio 1996).

10 943 F. Supp. 172 (D.R.I. 1996).

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