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Developing an Administrable MFN Enforcement Policy

BY STEVEN C. SALOP AND FIONA SCOTT MORTON

AS DISCUSSED IN MORE DETAIL IN the companion article by Jonathan Baker and Judith Chevalier, most-favored-nation contractual provisions (MFNs) can lead to either procompetitive benefits or anticompetitive harms.¹ MFNs can be procompetitive by enabling new products and thereby enhancing competition. For instance, MFNs can be used to prevent opportunism in situations where one of the parties makes relationship-specific investments in order to create a new product or improve an existing product or service. MFNs also can be used by a firm to deter rent-seeking delays and hold out problems in instances where important market information such as demand, value, or costs would be discovered after some contracts are signed. In these circumstances, the MFN also may enable the parties to create or improve a product, where in its absence they would face too much risk and might choose not to.

MFNs are written in a form that promises buyers the potential for lower prices.² The paradigmatic MFN provision promises the covered buyer that it will be charged the lowest price offered by the seller to any other buyer. This sounds on its face like a provision that necessarily will lead to a lower price for the covered buyer. However, as explained in the Baker and Chevalier article, the provision creates a financial incentive for the seller not to offer such low prices, which often results in higher overall prices in the market. Thus, MFNs also can lead to anticompetitive concerns involving the potential that the MFNs actually will result in higher prices or less innovative entry.

The anticompetitive effects of MFNs can be either collusive or exclusionary. MFNs can facilitate coordination or dampen oligopoly competition by making it impossible to

offer selective discounts or prevent secret discounts. MFNs can soften price competition and thereby allow firms to charge higher prices than they otherwise would. These are harmful collusive effects. MFNs also can have exclusionary effects by raising the costs of rivals or entrants that attempt to compete by negotiating lower prices from suppliers of critical inputs, or by pioneering a different business model.

The goal of this article is to discuss how that analysis of harms and benefits can be factored into an administrable enforcement policy by the antitrust agencies and can aid antitrust counseling. We first review some classic cases. We then review some recent DOJ actions involving MFNs. Next, we discuss the type of evidence that is relevant to evaluating the likely competitive impact of MFNs. Finally, we provide some guidance regarding conditions in which MFNs are more or less likely to raise significant competitive concerns.³

Antitrust Enforcement of MFNs

There is a long history of antitrust attention to MFNs and similar contractual provisions dating back decades. The famous *Socony-Vacuum* price-fixing case involved concerted action by competitors to restrict supply.⁴ The driving force for the restraint was an MFN-like contractual provision. The wholesalers (jobbers) typically purchased gasoline from the large refiners under long term contracts that pegged the contractual price according to the “spot market” price, as published in the trade press. This contract price formula thus resembled an MFN, by relating the contract price to the price paid by wholesalers in the spot market.

The focus of the case was an agreement to manipulate the spot market price in order to raise the contract price, not the pricing formula itself. The spot price was depressed because independent refiners were selling large quantities of gasoline in the spot market. The major gasoline refiners conspired among themselves to purchase this gasoline on the spot market. This concerted action raised the spot price. As a result of the higher spot price, the majors increased the formula contract price they charged to the jobbers, which was the goal of the agreement. The Supreme Court treated the supply restriction agreement as per se illegal, though not the MFN-like contract price formula.

The role of an MFN was more central in the Department of Justice’s actions against GE and Westinghouse following

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their famous 1960s price-fixing conspiracy. After the conspiracy was revealed and the parties entered into a consent decree effectively ending the price-fixing arrangement, prices fell.⁵ At some point, GE and Westinghouse began adding MFNs to their contracts. The DOJ alleged that these MFNs had the effect and apparent goal of eliminating discounting and the consent decrees were modified to prohibit their usage.⁶

The Federal Trade Commission had similar concerns about the MFNs used by DuPont and Ethyl in the sale of antiknock compounds, along with advance notice of price increases and uniform delivered pricing. In that matter, the producers adopted their MFNs independently of one another. The FTC's case ultimately was reversed by the Second Circuit.⁷ The court focused only on the parties' advance notice of price increases and uniform delivered pricing, not the MFNs. Ironically, in the course of reversing the FTC, the court appeared to conclude that MFNs raised serious competitive concerns. Referring to the case against GE and Westinghouse, the court noted that an MFN could be a "plus factor" and referred to the anticompetitive impact of GE's MFN. As stated by the court, GE "adopted a 'price-protection' policy under which, if it offered a discount to a customer, it obligated itself to give the same discount retroactively to all other customers who had bought the product within the previous six months, *thus voluntarily penalizing itself for price-discounting.*"⁸

The competitive impact of MFNs often has been misunderstood by courts. The most superficial prediction is that an MFN would lead to lower prices, by promising the recipient that it would obtain any lower price the seller offers to other buyers. However, this interpretation has been shown in the economics literature to be erroneous in many circumstances, once the impact of the MFN on the seller's incentives is taken into account. A seller's promise to extend price discounts to other buyers with an MFN actually reduces the seller's incentive to offer price discounts.⁹ An MFN acts like a penalty on price discounts and so naturally can deter such discounts.

During the Clinton administration, the DOJ and FTC brought several cases involving MFNs. In *Delta Dental*, the MFNs allegedly had the purpose and effect of raising barriers to entry to small dental insurers.¹⁰ In denying a motion to dismiss, the district court distinguished the First Circuit's *Ocean State* decision and explained why the facts as alleged, if proven, established an antitrust violation.¹¹

The district court made the point that the DOJ alleged in *Delta Dental* that prices would rise, not fall, as was alleged by the plaintiff in *Ocean State*. This was partially because of the exclusionary impact the MFN can have on entrants. This impact is important because entry deterrence can lead to significant consumer welfare harm. In this case, the entrant insurer (Dental Blue PPO) had an innovative business model whereby it engaged in selective contracting with a subset of dentists and steered subscribers to them in exchange for lower

prices. Consumers who were willing to accept a more limited network in exchange for lower cost dental insurance would find such a plan attractive. The contracting dentists in turn would gain additional business in exchange for accepting lower prices. However, the dentists who agreed to participate in the Dental Blue PPO were bound by Delta's MFN to offer the same low prices to Delta Dental, which had a 35–45 percent market share.¹² This requirement served as a type of tax on the dentists who joined Dental Blue, approximately 90 percent of whom were part of the Delta Dental network.¹³ When the MFN was enforced by Delta, the dentists withdrew from the entrant's plan, causing it to fail. As summarized in the complaint, "By deterring low-cost plans' entry or expansion, Delta's MFN clause will deprive consumers of the benefits that such plans can offer: increased competition, lower premiums, and greater use of dental care."¹⁴

After an enforcement hiatus during the Bush administration, the DOJ in the Obama administration has brought several actions involving MFNs. The case most closely related to past actions is the complaint against Blue Cross Blue Shield (BCBS) of Michigan.¹⁵ Again, the incumbent health insurer had a high market share, 60 percent of the commercially insured population. As in *Delta Dental*, the MFNs were included in provider contracts and required hospitals to offer BCBS the lowest non-government rate for hospital services. For a group of hospitals comprising 45 percent of Michigan's tertiary care beds, BCBS included what the complaint calls an "MFN plus." This term required hospitals to charge BCBS's competitors *higher* prices than those charged to BCBS—up to 40 percent higher, according to the complaint. Because inpatient hospital services comprise a significant percentage of the cost of health insurance, the DOJ alleged that such contracts would cause BCBS's rivals to have higher costs than BCBS.

The DOJ also alleged that the MFN would lead to higher prices overall for hospital services in Michigan. If Michigan hospitals were aware of the competitive advantage they were bestowing on BCBS, they rationally would seek a share of the resulting profit. That is, a hospital reasoning along these lines could "sell" the MFN to the insurer in exchange for a higher price for hospital services. In this way, the protection from competition that the insurer obtains from the hospital would accrue to the benefit of the owners of the hospital as well as to BCBS. Because health insurance allegedly is inelastically demanded at the price levels in Michigan, such price increases would not result in significant reductions in demand. The complaint describes several instances of hospitals agreeing to MFN contracts for BCBS in exchange for BCBS agreeing to pay higher prices to the hospitals.

In addition to these short-run pricing harms, the complaint also alleges an adverse impact on entry because an entrant cannot pursue a different innovative business model. Like in *Delta Dental*, an insurer entrant attempting to build a narrow network plan offering hospitals low prices in exchange for incremental volume would be unable to attract

The agency and court will evaluate whether the MFNs led to higher or lower prices being paid by consumers. If the MFNs caused consumers to pay higher prices, and the higher prices were not offset by increases in quality or innovation, then consumers likely were harmed.

hospitals to its network. Hospitals would be required to give the same low prices to BCBS, and this financial penalty would prevent such entry.

The complaint against American Express contains similar economic issues.¹⁶ According to the complaint, the contract contains a contractual “merchant restraint” provision which “prevent[s] merchants from offering their customers a discount or benefit for using a network credit card that is less costly to the merchant.”¹⁷ Applied to Amex, this provision prevents the merchant from offering the shopper a different price or terms (e.g., a coupon for another visit or a free gift) for using one card brand rather than Amex. These merchant restraints impose the same type of symmetry on the marketplace as does an MFN on prices. The complaint alleges that price competition among cards thus would be restricted on the merchant side of the market.¹⁸ Entry similarly could be restricted because a merchant cannot direct its business, even if the new card entrant is more efficient.

The DOJ e-books case involves the use of an MFN in the context of an alleged horizontal as well as vertical combination. The MFN required that the publishers mandate retail margins for Amazon and others such that Apple’s margins would not be lower than any other retailer’s. A fixed high retail margin advantages the firm with high-quality position and business model (e.g., high-quality customer service), relative to competitors with lower quality. Thus, an MFN of this type can prevent a firm from pursuing a low-price/low-quality service that would be desired by some consumers.¹⁹ In the case of Amazon, its business strategy appears to be to charge low book prices and earn additional revenue from the sale of devices or other products. This strategy also would be precluded by the MFN.²⁰ As stated in the complaint:

Apple saw a way to turn the agency scheme into a highly profitable model for itself. Apple determined to give the Publisher Defendants what they wanted while shielding itself from retail price competition and realizing margins far in excess of what e-book retailers then averaged on each newly released or bestselling e-book sold.²¹

Evaluating MFNs Under the Rule of Reason

Unless they are adopted by an agreement among competitors, MFNs normally are evaluated in antitrust under the rule of

reason. This evaluation can involve direct and indirect evidence of likely harms and benefits from the MFNs. This evidence can involve the upstream market in which the inputs are sold to buyers and the downstream market in which consumers participate. By analyzing the circumstances under which the MFNs were adopted, their motivation and likely effects also might be better discerned. For example, if the MFN leads to entrants being deterred or smaller rivals shrinking or exiting from the market, competition is more likely to have been reduced and consumer harm is more likely. All this evidence can aid a fact finder in evaluating whether the pro-competitive or anticompetitive theory is more plausible. It also can be used to evaluate the likely overall effects on consumers.

Where reliable measurement is possible, evidence of likely effects often will focus on prices. The agency and court will evaluate whether the MFNs led to higher or lower prices being paid by consumers. If the MFNs caused consumers to pay higher prices, and the higher prices were not offset by increases in quality or innovation, then consumers likely were harmed. To make this evaluation, prices before and after the MFNs were adopted might be compared. Or, prices in similar markets may be compared, but where some of the markets have MFNs and others do not. Evidence of reduced or deterred innovation also would be relevant to a competitive evaluation.

In the upstream market, price and cost are relevant. One key type of evidence of harm is the impact of the MFNs on the prices and costs of the input purchased by buyers that do not have MFN protection. If those costs are higher than they would be absent the MFN, that suggests a greater likelihood of consumer harm. Evidence of the effect on the input prices of buyers that have MFNs also is relevant. If those input costs also rise, despite the MFN protection, there is more likely to be consumer harm.

In contrast, pricing evidence can also indicate MFN benefits. This would include evidence of lower prices, either input prices or output prices. Direct evidence that the MFN led to the recipients obtaining strictly lower prices (as opposed to non-recipients paying higher prices) would be relevant to this determination.

Competitive benefits are also indicated where the MFNs lead to higher output or additional products or consumer choices, where it is possible to measure these reliably. Evidence that the MFNs eliminated bargaining delays that were slowing or preventing innovation also would suggest benefits. Direct evidence of increased investment or new product innovation flowing from the adoption of the MFNs also would be relevant. Again, this evidence might involve comparisons across markets or over time.

Counseling on MFNs

The type of evidence outlined in the previous section can be very useful to the antitrust agencies and courts in evaluating the impact of MFNs. However, attorneys counseling clients

contemplating the adoption of MFNs might benefit from having a simpler checklist of situations where MFNs are more or less likely to raise significant concerns. While such a checklist necessarily is oversimplified and clearly is not a substitute for a fuller competitive effects analysis, it can provide useful guidance for counseling and a starting point for further analysis.

In this regard, the following conditions suggest that MFNs are less likely to raise antitrust concerns:

- *Received only by smaller buyers:* MFNs received only by small buyers comprising a small share of the market are likely to cause a smaller increase in seller price levels, perhaps additionally because the largest buyers may have sufficient bargaining power to prevent such price increases.
- *Provided to buyers (all of which are small) by smaller sellers that lack market power:* MFNs offered by such sellers are unlikely to cause an increase in bargaining power or raise barriers to entry that would lead to consumer harm. Exceptions to this condition occur when a power buyer obtains MFNs from numerous small sellers or where the MFNs facilitate coordination among the small sellers.
- *Unconcentrated markets:* Where neither the input market nor the output market are concentrated, coordination is less likely to be concern, even if there are MFNs. However, where only one of the markets is unconcentrated, the MFNs can raise barriers to entry or can facilitate coordination.
- *Input with close substitutes:* Where inputs subject to MFNs have close substitutes, non-recipients can avoid being placed at a significant competitive disadvantage by purchasing a substitute input instead.
- *As part of long-term contract with locked-in or sunk assets:* In this situation, MFNs may be a device for allocating cost and demand risk or for avoiding the potential for expropriation of efficient investment.
- *In exchange for significant investment, particularly by initial customer or technology sponsor:* Providing an MFN can avoid delays and facilitate the launch of network effects by ensuring that an initial sponsoring buyer will not suffer a price disadvantage relative to other buyers that wait.
- *Input has uncertain value for innovative new product, with resulting potential for delays and holdout problems:* Similar benefits of MFNs can occur when the value of the input is unclear and early buyers fear being locked into long-term contracts at prices that do not reflect market values.
- *As part of the settlement of one in a series a number of law suits brought against the provider:* An MFN can be used to avoid holding out by plaintiffs hoping for a better settlement if they wait.

In contrast, the following conditions suggest that MFNs are more likely to raise competitive concerns, *ceteris paribus*. We do not intend these conditions to comprise irrebuttable presumptions. These concerns could well be offset by bene-

ficial effects. Instead, these conditions suggest the need for further analysis of benefits and harms by counsel and the antitrust agencies:

- *Jointly adopted by horizontal agreement:* Antitrust is generally suspicious of horizontal agreements involving price because they are more likely to have anticompetitive effects and are presumed less likely to be efficiency enhancing.
- *Provided by large sellers with market power:* If a seller has market power, there is a greater concern that its MFN could have an anticompetitive purpose and effect.
- *Received by largest buyers:* Similarly, if MFNs are received by the largest buyers, they are more likely to lead to higher prices paid by rivals than they are to generate lower prices paid by the buyers who receive the MFNs.
- *Multiple MFNs with high market coverage:* The broader the coverage of MFNs, the more likely they are to have price effects downstream. This conclusion comes with caveat, however, that highly efficient MFNs are more likely to gain large coverage.
- *Highly significant input:* An MFN for an input that comprises just a trivial share of the buyers' cost is unlikely to generate substantial cost effects, whereas an MFN for a highly significant input can have that effect. Significant cost effects can both affect prices and impact entry and innovation.
- *Airtight MFN with audit rights and penalties for non-compliance:* If an MFN is easily evaded by the seller granting it, it is less likely to constrain the seller's prices to other buyer and, therefore, less likely to have anticompetitive effects.
- *Retroactive MFN, perhaps with penalties:* Retroactive MFNs can create larger disincentives for price discounts, particularly where there are penalties in addition to having to match the discounted price, thereby making price competition less likely.
- *MFN-plus provisions:* MFN-plus provisions promise the recipient a strictly lower price than what is paid by rivals. As a result, even if the recipient pays a higher input price, the profits earned from its resulting cost-advantage may more than offset the adverse impact of the higher input price. This term is more likely lead to consumer harm.
- *Obtained by a leading buyer in response to new entry by a low cost, innovative competitor:* This timing raises concerns that the purpose and likely effect of the MFN is to raise the cost and reduce the procompetitive impact of the new entrant.
- *Obtained by a leading buyer in exchange for an agreement by that buyer to deal exclusively with a leading seller:* This timing and connection to an exclusive dealing agreement raises concerns that the MFN and exclusive dealing have the purpose and likely effect of raising barriers to competition at both levels of the market.
- *Only claimed rationale is that the buyer is more concerned about the price it pays relative to other competitors, not the absolute level of the price paid:* A firm's compet-

itive advantage and profits often are related more to the relative price it pays for inputs than the absolute price level. Where this occurs, a buyer may be willing to pay a higher input price in exchange for retaining a cost advantage, a condition that is more likely to lead to less price competition and consumer harm. Thus, it raises suspicions of anticompetitive purpose.

- *Only claimed rationale is that the largest buyer “deserves” the lowest price:* The largest buyer sometimes (but not always) has the bargaining power to negotiate the lowest input price. But, entrants or smaller buyers sometimes have the ability to negotiate lower prices, and when they do, consumers may benefit from the increased competition.²² Where it occurs, the largest buyer’s possibly greater bargaining power does not necessarily translate into consumer benefits or create an antitrust “right.” Indeed, if the largest buyer would get the lowest price anyway, it does not need an MFN. This rationale might well be considered “non-cognizable” justification under the Sherman Act.

As noted above, this checklist is not intended to be a substitute for a full competitive effects analysis. That analysis would evaluate the likely benefits and harms from the implementation of MFNs in the particular market in order to predict the likely net effect on consumers. The impacts on price, quality, and innovation are the ultimate determinants of benefits and harms. However, this checklist can be useful for counseling purposes and as part of that full competitive effects analysis. What is clear that MFNs are neither always anticompetitive, nor always procompetitive. Their effects depend on the particular facts of the market. □

available at <http://www.justice.gov/atr/public/speeches/281965.pdf>). For a recent survey, see Jonathan M. Jacobson & Daniel P. Weick, *Contracts that Reference Rivals as an Antitrust Category*, ANTITRUST SOURCE, Apr. 2012, at 1, http://www.americanbar.org/content/dam/aba/publishing/antitrust_source/apr12_jacobson_4_26f.authcheckdam.pdf.

- 4 See *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150 (1940).
- 5 *United States v. Gen. Elec. Co.*, No. 28228, 1977 WL 1474, at*1 (E.D. Pa. Sept. 16, 1977).
- 6 *Id.* at *3.
- 7 See *E.I. du Pont De Nemours & Co. v. FTC*, 729 F.2d 128 (2d Cir. 1984).
- 8 *Id.* at 139 n.10 (emphasis added).
- 9 Even Judge Posner was slow to accept this point. *Blue Cross & Blue Shield United of Wis. v. Marshfield Clinic*, 65 F.3d 1406, 1415 (7th Cir. 1995) (Posner, C.J.).
- 10 See *United States v. Delta Dental of R.I.*, 943 F. Supp. 172 (D.R.I. 1996).
- 11 *Ocean State Physicians Health Plan, Inc. v. Blue Cross & Blue Shield of R.I.*, 883 F.2d 1101 (1st Cir. 1989).
- 12 Complaint ¶ 8, *United States v. Delta Dental of R.I.*, 943 F. Supp. 172 (D.R.I. 1996) (No. 96-cv-113), available at <http://www.justice.gov/atr/cases/f0500/0594.htm>.
- 13 *Id.*
- 14 *Id.* ¶ 31.
- 15 See Complaint ¶ 3, *United States v. Blue Cross Blue Shield of Mich.*, 809 F. Supp. 2d 665 (E.D. Mich. 2011) (No. 2:10-cv-15155), available at <http://www.justice.gov/atr/cases/f263200/263235.pdf>.
- 16 The analogous complaints against Visa and MasterCard were settled. Press Release, U.S. Dep’t of Justice, Justice Department Sues American Express, MasterCard and Visa to Eliminate Rules Restricting Price Competition; Reaches Settlement with Visa and MasterCard (Oct. 4, 2010), available at http://www.justice.gov/atr/public/press_releases/2010/262867.pdf.
- 17 Amended Complaint ¶ 3, *United States v. American Express Co.*, No. 1:10-cv-4496 (E.D.N.Y. Dec. 21, 2010), available at <http://www.justice.gov/atr/cases/f265400/265401.pdf>.
- 18 Price competition on the consumer side of the market regarding annual fees, points, and other attributes of the card were not restrained.
- 19 Resale price maintenance can have similar effects. As noted by the Court in *Leegin*, “A dominant retailer, for example, might request resale price maintenance to forestall innovation in distribution that decreases costs.” *Leegin Creative Leather Prods., Inc. v. PSKS, Inc.*, 551 U.S. 877, 893 (2007).
- 20 Anticompetitive MFNs also have been alleged with respect to GDS airline booking services and online hotel room booking service. See Complaint ¶ 64, *Turik v. Expedia, Inc.*, No. 3:12-cv-04365 (N.D. Cal. Aug. 20, 2012); Amended Complaint ¶ 51, *American Airlines, Inc. v. Sabre, Inc.*, No. 4:11-cv-00244 (N.D. Tex. June 1, 2011).
- 21 Complaint ¶ 56, *United States v. Apple, Inc.*, No. 1:12-cv-02826 (S.D.N.Y. Apr. 11, 2012), available at <http://www.justice.gov/atr/cases/f282100/282135.pdf>.
- 22 For an insightful analysis of this often misunderstood point, see Alexander Raskovich, *Pivotal Buyers and Bargaining Position*, 51 J. INDUS. ECON. 405 (2003). There is also evidence that the largest insurers do not necessarily obtain the lowest hospital prices; rather, the most elastic ones do. See Alan T. Sorensen, *Insurer-Hospital Bargaining: Negotiated Discounts in Post-Deregulation Connecticut*, 51 J. INDUS. ECON. 469 (2003).

¹ See Jonathan B. Baker & Judith A. Chevalier, *The Competitive Consequences of Most-Favored-Nation Provisions*, ANTITRUST, Spring 2013, at 20.

² The analysis in this article focuses on “seller-side” MFNs, that is, contractual provisions granted by a seller that promise to a recipient buyer that it will be charged the lowest price. However, there also are “buyer-side” MFNs, that is, contractual provisions granted by a buyer to a recipient seller that it will be paid the highest price. These buyer-side MFNs also can have procompetitive or anticompetitive effects.

³ There is now a substantial legal and economic literature on MFNs. For example, see Steven C. Salop, *Practices that (Credibly) Facilitate Oligopoly Co-ordination*, in NEW DEVELOPMENTS IN THE ANALYSIS OF MARKET STRUCTURE 265 (Joseph E. Stiglitz & G. Frank Mathewson eds., 1986); Fiona Scott Morton, Deputy Assistant Att’y Gen., Antitrust Div., U.S. Dep’t of Justice, Keynote Address at Northwestern Univ. School of Law 4th Annual Conference on Antitrust Economics and Competition Policy: *Contracts that Reference Rivals: Economic Theory and Implications for Antitrust Enforcement* (Sept. 23, 2011) (a published version of Ms. Scott Morton’s address is



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