Do Low-Price Guarantees Guarantee Low Prices?

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In a competitive market, sellers set prices independently of each other, and often engage in price discrimination by charging different buyers different prices for the same item. However, sometimes sellers commit to pricing policies that, in effect, limit their pricing freedom by "linking" prices to some buyers to those charged to other buyers. An example of such a policy is a "price-guarantee" clause in a sales contract. While these provisions are known by acronyms such as most-favored-nation agreements (MFNs), most-favored-customer clauses (MFCs), and meeting-competition clauses (MCCs), they all have "price protection" as a common feature. This can be a promise by a seller to protect a buyer against the seller from lowering prices to other buyers or reducing prices in the future, or an assurance that the seller will match another seller's lower price.[1] Important to the "protected" buyer is the prospect that it benefits from any price reduction that the seller gives to other buyers (who often are rivals of the protected buyer), and the promise that it will receive terms at least as favorable as those provided to the seller's other customers. At face value, because such provisions seem to epitomize competition and represent a promise of lower prices, how can they be anticompetitive?

In general, there are two types of potential anticompetitive effects related to MFNs (and similar provisions) that cut against lower prices.[2] First, MFNs might facilitate higher prices or collusion by giving *sellers* a disincentive to offer price discounts. Such price-protection policies can reduce buyers' ability to negotiate for lower prices because the seller finds it expensive to offer discounts. This can apply to a single seller that commits to not lowering its future prices because otherwise it must retroactively reimburse buyers subject to the MFN for any price difference. Or, if a major seller offers a price-protection policy to its buyers by promising to match competitors' price cuts, competitor discounts become less profitable as they no longer expand sales to the extent they would absent the price-match guarantee. For a group of sellers, an MFN imposes a "punishment" for deviating from agreed upon prices due to the requirement to lower all protected customers' prices if lower prices are offered to other buyers. Because this built-in rebate mechanism creates a penalty for "cheating" on a collusive agreement (tacit or explicit), coordinated pricing has been shown to be more stable than if no MFN were used. The concern is that these types of MFNs raise the cost to sellers of offering selective price discounts and will result in higher prices or increased price rigidity.

Second, MFNs might be used by a dominant *buyer* to gain market power at the expense of rival buyers through exclusion or, more generally, by raising their rival buyers' costs. The concern is that such an MFN might disadvantage rivals to the dominant buyer who might otherwise negotiate lower prices than those of the dominant buyer. This is because it raises the cost to the seller(s) of giving lower prices to other buyers as the seller(s) must rebate any price difference to the dominant buyer. Because MFNs typically mandate that lower prices to one customer be made available to all parties to the MFN, price discounting may not occur to the extent it would absent the price protection. Moreover, if a dominant buyer has an MFN with many sellers in a given market that "penalizes" them from giving more favorable rates to other buyers, entry (or expansion) by rivals to a dominant buyer may be deterred.

MFNs have been highlighted recently for their potential to actually lead to higher, not lower, prices.[3] However, while the contractual obligations of MFNs might be clear, their economic rational and competitive effects are less so. This is because while the literature characterizes the conditions under which such policies can be procompetitive and efficiency enhancing (typically by reducing various transactions and negotiating costs), it also shows that they can be anticompetitive and used as mechanisms to sustain collusion and higher prices. The concern is that because MFNs raise the "cost" of price cutting, a discount that would be profitable when offered to a price-sensitive buyer may be unprofitable if the seller is obliged to offer the same discount to all "price-protected" buyers. For example, one provision that has received scrutiny from antitrust enforcers is the promise by a seller to a protected buyer that it will receive the "best" (lowest) price that the seller has given to any other buyer. Such a "contemporaneous" MFN effectively is a promise by the seller not to price discriminate.[4] The antitrust worry is that such a contractual obligation may dampen price competition because it raises the seller's cost of cutting prices to buyers not party to the MFN due to the "rebate" owed to the protected buyer(s).

The literature also describes strategic uses of MFNs to achieve higher prices when bargaining occurs between buyers and sellers. For example, consider the effect of an MFN on prices where a dominant seller negotiates sequentially with two buyers. Here, the seller negotiates over price first with "Buyer 1" and then with "Buyer 2." It has been shown that in certain circumstances, the seller can use an MFN with Buyer 1 to leverage more favorable terms such as higher prices from Buyer 2. This is because the seller could credibly claim that it cannot give Buyer 2 a "low price" because doing so would force the seller to also lower Buyer 1's price. Absent an MFN, the seller would not be able to make such a claim. Consequently, the seller's incentive to discount its price to Buyer 2 is diminished.

The view that MFNs are anticompetitive, with the specter of higher prices, has guided the DOJ's focus regarding Blue Cross Blue Shield (BCBS) contracts with healthcare providers as well as the Court's opinion in the recent *Apple* decision. In the Michigan BCBS matter, BCBS is a significant *buyer* of hospital services supplied by health care providers. The challenged conduct alleged BCBS entered into MFNs (and variants thereof) with a large number of hospitals to raise rival insurers' costs thereby reducing their ability to compete with offering health insurance. As the DOJ complained, "Blue Cross' use of MFNs has reduced competition in the sale of health insurance in markets throughout Michigan by inhibiting hospitals from negotiating competitive contracts with Blue Cross' competitors."[5] The DOJ further claimed, "Blue Cross sought to insulate itself from competition in health insurance markets throughout Michigan by entering into 'most favored nation' agreements ('MFNs') with more than 70 hospitals" with "dramatically higher prices resulting from the MFNs."[6] The DOJ claim is consistent with concerns that a dominant buyer (BCBS) may impose an MFN to disadvantage its rivals (competing health insurers). As stated by DOJ,

> A hospital that would otherwise contract with a competing insurer at lower prices than it charges Blue Cross would have to lower its prices to Blue Cross pursuant to the MFN if it sought to maintain or offer lower prices in contracts with other commercial insurers. The resulting financial penalty discourages a hospital with a Blue Cross MFN from lowering prices to health insurers competing with Blue Cross.[7]

The Court in *Apple*, which examined Apple's agreements with e-book publishers containing MFN provisions (in addition to examining the agency model for distributing e-books where publishers set the retail price and pay retailers a fixed commission), found that the MFN reduced retail price competition. The Court characterized the challenged pricing practice as follows, "The MFN guaranteed that the e-books in Apple's e-bookstore would be sold for the lowest retail price available in the marketplace," and that it "required publishers to match in Apple's iBookstore any lower retail price of a New Release offered by any other retailer."[8] The Court ultimately found, "the MFN protected Apple from retail price competition as it punished a Publisher if it failed to impose agency terms on other e-tailers."[9] Such a finding is consistent with MFNs being seen as a facilitating device used by sellers to credibly commit to imposing a penalty on themselves for offering a lower price to some customers, increasing the likelihood of higher prices overall. While the Court did not explicitly address whether MFNs in general ought to be *per se* illegal, it did determine that the circumstances surrounding them in *Apple* — notably Apple's participation in a horizontal price-fixing scheme — made for an unreasonable restraint of trade, and that Apple violated Section 1 of the Sherman Act by enabling a horizontal conspiracy among e-book publishers.[10]

Conclusion

While U.S. antitrust agencies recognize that MFNs may be procompetitive or anticompetitive depending on circumstances,[11] the literature has shown — and recent antitrust cases have emphasized — that such provisions may have significant anticompetitive effects. However, general conclusions about whether MFNs are procompetitive or anticompetitive are of little assistance in analyzing whether a particular MFN (or its variants) runs afoul of antitrust laws. Therefore, like any commercial practice analyzed under a "rule-of-reason" approach, there needs to be a careful balancing of the efficiency versus anticompetitive effects, with the outcome for any particular MFN dependent on the specific facts of the challenged conduct.

[1] MFCs and MFNs are guarantees by a seller to give a rebate to a customer if the seller offers lower prices to other customers. An MCC offers to match a lower price that a customer is given by another seller. A related price guarantee, known as a meet-or-release clause (MOR), is a commitment by a seller to release a buyer from a purchasing contract if a competing seller's price is not met.

[2] While prominent in the literature, these are not the only anticompetitive theories related to MFNs.

[3] See, e.g., "Apple Ruling Heaps Doubt on 'MFN' Clauses," Joe Palazzolo, *The Wall Street Journal*, July 14, 2013; and, "Justice Widens Blue Cross Probe Across Several States," Thomas Catan and Avery Johnson, *The Wall Street Journal*, March 26, 2011.

[4] A "retroactive" MFN might specify that a seller will offer a buyer a price reduction if future buyers receive a lower price for the same product, the reduction being a refund equal to the difference between the present and future price.

[5] US DOJ *Complaint* in the BCBS Michigan matter (joined by the Michigan AG's office), October 18, 2010, p. 1.

[6] *Plaintiff United States Of America's Memorandum In Opposition To Defendant Blue Cross Blue Shield Of Michigan's Motion To Dismiss The Complaint With Prejudice*, January 20, 2011, pp. 11, 29. On March 25, 2013, DOJ filed a motion to dismiss its antitrust lawsuit BCBS because Michigan passed a law that prohibits health insurers from using MFNs in contracts with health care providers (though private civil cases are still pending).

[7] DOJ *Complaint* in the BCBS Michigan matter (joined by the Michigan AG's office), October 18, 2010, p. 21.

[8] Opinion and Order, *United States of America v. Apple, Inc. et. al*, July 10, 2013, pp. 45, 52.

[9] *Id.*, p. 55.

[10] The Court stated, "While vertical restraints are subject to review under the rule of reason, Leegin, 551 U.S. at 907, Apple directly participated in a horizontal price-fixing conspiracy. As a result, its conduct is per se unlawful. The agreement between Apple and the Publisher Defendants is, 'at root, a horizontal price restraint' subject to per se analysis." Opinion and Order, *United States of America v. Apple, Inc. et. al*, July 10, 2013, p. 153.

[11] "Improving Health Care: A Dose of Competition," A Report by the Federal Trade Commission and the Department of Justice. July 2004, Chapter 6, p. 20.

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