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"Success is the sum of the details." Harvey S. Firestone

I. INTRODUCTION

In her recent decision in the eBook price-fixing case U.S. District Court Judge Denise Cote identified the Most Favored Nation ("MFN") clause in Apple's contracts with book publishers as a component of the price-fixing conspiracy in which she found Apple and the publishers had engaged.[2] This was a significant moment in the history of the controversial agreements because, up until then, defenders of MFN agreements had been fond of observing that no court had ever found an MFN to be anticompetitive.[3] Now that the MFN has been implicated, we can expect that disputes over the competitive effects of MFN clauses will come up in more cases, and that the debate about them will continue among economists, attorneys, and antitrust practitioners.

II. BACKGROUND

As the name suggests, the term "Most-Favored-Nation" is borrowed from international trade, where the term was used to refer to trade rules that ensure that one trading partner trades on terms that are at least as favorable as any other trading partner. The use of the term has spread to other contexts and now refers, in practice, to any term that ensures that one party to an agreement gets terms at least as good as any other party in an analogous position. Some economists refer to MFNs as "most-favored-customer" clauses or "antidiscrimination" clauses, but, in practice, the original name, MFN, has stuck.

The MFNs that are the object of antitrust concern are those that ensure that a buyer, the beneficiary of the MFN—or group of buyers—will always receive a seller's most favorable (lowest) prices. MFNs come in two varieties, depending on which prices are compared with the beneficiaries' prices. A *retroactive* MFN requires a seller to rebate to the beneficiary the difference between a lower current price given to another buyer and a higher prior price paid by the beneficiary. Steven Salop offered the following example of a retroactive MFN in a generator sales contract:[4]

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[2] *See* p. 9 and note 23 below.

[3] Joe Palazzolo, *Apple Ruling Heaps Doubt on 'MFN' Clauses*, W.S.J. p. B1 (July 15, 2013), *available at* [online.wsj.com/article/SB10001424127887323664204578605880157245830.html#printMode, last visited 7/22/2013].

[4] Steven C. Salop, *Practices that (Credibly) Facilitate Oligopoly Co-ordination*, NEW DEVELOPMENTS IN THE ANALYSIS OF MARKET STRUCTURE, Ch. 9 (Joseph E. Stiglitz & G. Frank Mathewson eds. 1986). Hereafter this paper is referred as Salop (1986).

> If at any time before [buyer] takes delivery of said generator, [seller] offers a lower price for a generator of comparable size and quality to any other purchaser, [seller] will also offer that lower price to [buyer].

A *contemporaneous* MFN requires the seller to give the beneficiary the lowest price offered to any other buyer for purchasing the same good or service at the same time. Steven Salop also gave an example of a contemporaneous MFN:

> If [seller] should, during the term of this contract, offer or sell goods of equal quality and quantity to any other buyer at a price lower than that provided for herein, [buyer] shall receive the benefit of such lower price on all shipments made hereunder for which such lower price is effective.[5]

A contemporaneous MFN gives the seller greater flexibility to cut prices. A seller who has given a contemporaneous MFN can make general price cuts without penalty, but cannot give other buyers more favorable terms then the beneficiary receives in the same period. By contrast, a seller who has given a retroactive MFN will owe the beneficiary a compensating payment even for general price cuts that fall below the beneficiary's historic price.

III. THE ECONOMIC THEORY OF THE MFN

A. The MFN as a Device for Obtaining Low Prices

On its face, an MFN appears to be a device by which its beneficiary obtains lower prices than it might otherwise have to pay. A buyer might well have reason to be dubious that its suppliers would always give it the benefit of their lowest price. An MFN would ensure that the beneficiary always obtained the lowest price, and so would mimic, at least in part, the forces at work in competitive markets that ensure that the price to all buyers is driven down to its lowest possible level—namely marginal cost. If the effect of an MFN is lower prices, then, so long as those prices are not predatory, the MFN is pro-competitive. This was the traditional view of the MFN.

B. The MFN as a Device to Facilitate Collusion

Over time the traditional interpretation has come to face a more skeptical view. Some economists, such as Steven Salop, suspect that MFN clauses can be used strategically to sustain prices above the competitive level.[6] The essence of the argument is that an MFN increases the seller's cost of lowering prices. Normally a seller who contemplates a price cut must balance the additional revenue that would be gained from incremental sales (new sales induced by the lower price) against the loss of revenue on infra-marginal sales (sales already made) to which the price cut must be applied. If the seller has granted an MFN, then a price cut to some prospective buyer carries with it the cost of making the same price cut (either contemporaneously or retroactively) to the beneficiary of the MFN. Absent the MFN, it may not be necessary to extend the prospective price cut in that way. This increases the cost of the price cut.

Increasing the cost of making the price cut makes it less profitable to do so, and thereby inhibits the seller from cutting price. This feature of the MFN could be used to facilitate either

[5] *See* Salop (1986) *supra* note 4.

[6] *See* Salop (1986) *supra* note 4. Also *see* George A. Hay, *Oligopoly, Shared Monopoly, and Antitrust Law*, 67 CORNELL L. REV. 439-481 (1982).

tacit or explicit collusion. The argument with respect to explicit collusion is the simplest. Members of a cartel face the problem that any success they achieve in raising prices carries with it the seeds of the cartel's destruction. That's because the supra-competitive price gives each individual member of the cartel an incentive to undercut the cartel price just enough to gain increased market share. If the other members of the cartel don't respond, the price cutter can increase its own profit at the expense of other cartel members. This gives each of them the incentive to respond in kind, and can set off a process of successive price cutting whereby the cartel disintegrates. Therefore, the members of the cartel stand to gain from any mechanism by which they can credibly ensure one another that they won't cut prices. Granting wide-spread MFNs can serve that purpose, effectively acting as if the firms had posted a bond that would be forfeited if they were to cut price.

Indeed, if it is effective enough at discouraging price cutting, it could obviate the need for a (risky) explicit agreement at all. Thomas Cooper has shown that a firm may *unilaterally* offer an MFN that can induce a high price.[7] This can work because the firm that unilaterally offers MFN clauses (or sets a unilateral MFN policy) can set a price higher than the competitive level and, through the MFN, credibly commit not to reduce its price in the future. Knowing that the MFN firm will not lower the price, its competitors may find it in their unilateral interest to match the price increase (and possibly the MFN policy). As a result, the market equilibrium price is raised and sustained above the competitive level.

The history of General Electric and Westinghouse, two manufacturers of electric turbine generators, has been cited frequently as an illustration of Cooper's theory. In that case, General Electric adopted an MFN first and, in response, Westinghouse adopted the same MFN policy shortly thereafter.[8] This interpretation of the GE/Westinghouse case is not uncontroversial. William Neilson & Harold Winter have pointed out that for Cooper's model to produce an equilibrium in which both firms offer an MFN policy one must assume one firm's demand is more responsive to its *competitor's* price than it is to its *own* price, which is unlikely.[9] This critique does not invalidate Cooper's theory, though, since it is not necessary for *both* firms to offer an MFN to achieve a supra-competitive price. That may be accomplished if one firm unilaterally offers an MFN.

The MFNs analyzed by Cooper are retroactive. David Besanko & Thomas Lyon have shown that would-be colluders have less incentive to adopt contemporaneous MFNs, because unlike retroactive MFNs, contemporaneous MFNs do not allow a firm to commit to a minimum price over time. A firm that unilaterally adopts a contemporaneous MFN can (and may have to) lower its price to compete with other non-adopting firms, which makes the MFN less attractive as a facilitating device for (tacit) collusion.[10] This means that the contemporaneous MFN is limited (as a collusion facilitating device) to taking away firms' ability to make selective price cuts

[7] Thomas E Cooper, *Most-Favored-Customer Pricing and Tacit Collusion*, 17(3) RAND J. ECON. 377-388 (1986).

[8] *See* Footnote 1 of the paper written by David Besanko & Thomas P. Lyon, *Equilibrium incentives for most-favored customer clauses in an oligopolistic industry*, 11 Int'l J. Industrial Org. 347-367 (1993). Hereafter this paper is referred as Besanko & Lyon (1993).

[9] William S. Neilson & Harold Winter, *Bilateral Most-Favored-Customer Pricing and Collusion*, 12(1) RAND J. ECON. 147-155 (1993).

[10] Besanko & Lyon (1993), *supra* note 8.

to individual customers. In the presence of a contemporaneous MFN, a firm that wants to cut prices to undermine collusion will have to cut prices to all its customers.

There is a caveat to the argument that MFNs can facilitate collusion. If, in fact, MFNs do make it more costly for firms to cut prices, then they also make it more costly for a cartel to enforce discipline against a maverick that undercuts the cartel. Discipline, after all, generally takes the form of price cuts targeted at the maverick's customers.

C. The MFN as a Device to Economize on Transaction Costs

The strategic consequences of MFN clauses are not limited to facilitating collusion. MFN agreements have also been shown to enable firms to economize on some of the transaction costs that arise from opportunism and uncertainty, thereby serving a pro-competitive function.

1. Opportunism

Certain transactions require buyers and/or sellers to make costly investments that are only of value in the context of the anticipated relationship from the transactions. These are referred to as "relationship-specific investments."

Relationship-specific investments give rise to a problem. Once a relationship-specific investment is sunk, the other party to the transaction has the opportunity to exploit that fact by "holding up" the investing party. Thus, a seller who has a customer (a buyer) that has made relationship-specific investments in dealing with the seller can command a high price after the fact because the cost to the buyer of switching to an alternative seller would be as much as duplicating the original investment, if an alternative seller were even available. A rational buyer would anticipate this hold up behavior that would reduce the expected value of the investment, discouraging the buyer from making the investment.

An MFN can help overcome this problem. If the seller grants an MFN to the buyer, then the only way in which the seller can hold up the buyer is by raising the price to *all buyers*. If the seller's business model relies on a progression of new customers, *i.e.,* growth, it won't want to raise the price to all buyers and the MFN will protect the original buyer from the hold-up, thereby enhancing the expected value of the investment.

A closely related problem can arise if the buyer who makes the relationship-specific investment is in competition with others who might also purchase the good or service the seller provides. Here, the risk to the original buyer (a downstream firm) isn't limited to the possibility that the seller will increase the original buyer's price. The original buyer also has to be concerned that the seller will attract additional sales by offering subsequent buyers (competing downstream firms) a lower price, which would give them a competitive advantage. The risk to the original buyer is that its price relative to that charged to other buyers will be high. Again, an MFN can eliminate this risk by ensuring that the original buyer always gets a price at least as low as other buyers.[11]

There is more symmetry between the roles of buyer and seller in this context than the discussion thus far might suggest. The same issues can arise with the roles of the parties reversed.

[11] *See* Leslie M. Marx & Greg Shaffer, *Opportunism in Multilateral Vertical Contracting: Nondiscrimination, Exclusivity, and Uniformity: Comment*, 94(3) AMER. ECON. REV. 796-801 (2004).

If it is the seller who makes relationship-specific investments, then it is the seller who needs to be concerned about opportunism on the part of the buyer, and whose anxieties can be relieved by an MFN granted by the buyer. In this case, the MFN would ensure that the seller would always get the buyer's highest price.

2. Price Rigidity

An obvious alternative to the MFN in the presence of relationship-specific investments is long-term contracting. That is, a party to transactions that require transaction-specific investments could also protect itself against opportunism by negotiating a long-term contract at a fixed price. With a fixed price there is no risk that a seller (buyer) will opportunistically raise (lower) the price.

The disadvantage of a fixed price is that it deprives the transacting parties of the efficiency benefit of price flexibility. As market conditions (demand, cost, etc.) change over time, efficiency may require more or less volume of the good to be exchanged. Generally speaking, markets achieve that result through flexible prices. When costs rise or demand increases, price increases. This induces more supply from sellers and incentivizes buyers to carefully evaluate how much volume they wish to purchase. Competitive markets achieve efficient allocations through balancing these forces, but that mechanism is disrupted if the price is held rigid. By signing a long-term contract and demanding an MFN from a buyer, a seller can guarantee itself an efficient price and at the same time relieve the hold-up concern from the buyer.[12]

3. Demand Uncertainty

Many industries involve perishable production capacity. This is most often the case when the industry sells a time-specific service. Typical examples include hotel rooms, rental cars, and seats on airplanes, trains, or buses. These examples all involve industries that use fixed capital (*e.g.,* the planes, trains, and automobiles) to provide time-specific services. If time passes and the capital is not used to produce services at that time, the capacity represented by that time is lost—it has perished.

Sellers in these industries often face uncertain demand but need to decide production capacity in advance, so they must make investment decisions without knowing the state of demand. If, as the time for provision of the service approaches, demand appears to be low, a seller may slash its price to gain greater volume. Anticipating this possibility, a buyer—even one with a high willingness to pay—may want to delay purchasing if the buyer believes there is a chance that the price will be lower later.

This behavior extends the period of demand-uncertainty for the seller, making it harder to make efficient production and capacity decisions. To mitigate this inefficiency, a seller can

[12] 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. 297-322 (1994). Hereafter this paper is referred to as Crocker & Lyon (1994).

offer an MFN clause that guarantees to rebate the early customer if the seller cuts its price for later customers.[13]

IV. EMPIRICAL EVIDENCE

The empirical evidence on MFNs is mixed.

One example of a study that found MFNs had an anticompetitive effect was Fiona Scott Morton's analysis of pharmaceutical prices paid by Medicaid.[14] The Omnibus Budget Reconciliation Act of 1990 mandates an MFN clause that requires manufacturers to charge Medicaid the lowest price offered to any buyer. Professor Scott Morton found that the price of branded drugs increased on average by 4 percent after the adoption of the MFN, which is consistent with the theoretical prediction that MFN softens price competition.

By contrast, Jihui Chen & Qihong Liu found that the adoption of an MFN policy by BestBuy from 2003 to 2004 resulted in lower prices for electronics for both BestBuy *and its major competitors* such as Circuit City and CompUSA. They suspect that the fact that BestBuy's MFN rebate was not automatic played a role in this outcome.[15] Another example is research on natural gas prices by Keith Crocker & Thomas Lyon. They found evidence that an MFN clause in natural gas contracts between well owners and pipelines enhanced price flexibility and improved efficiency.[16]

V. CASES

A. Early Cases

Antitrust challenges to MFNs date back to the 1970s. During the 1960s and 70s, General Electric and Westinghouse used retroactive MFNs in their sales of turbine generators to utilities. They abandoned that practice after the Department of Justice ("DOJ") threatened antitrust prosecution in 1977.[17] In 1979, the Federal Trade Commission ("FTC") alleged that the Ethyl Corporation and three other makers of lead-based anti-knock gasoline additives violated antitrust law because of their use of contemporaneous MFNs. The case was dismissed on appeal.[18]

B. Healthcare Cases

In 1980s and 90s, there was a series of cases involving the use of MFNs in contracts between insurers and healthcare providers. Between 1986 and 1989, three related cases (*Madden v. California Dental Service, Kitsap Physicians Service v. Washington Dental Services, and Ocean State v. Blue Cross Rhode Island*) were resolved on terms that protected—or, at least, did not

[13] I.P.L. Png, *Most-Favored-Customer Protection versus Price Discrimination over Time*, 99(5) J. POL. ECON. 1010-1028 (1991).

[14] Fiona Scott Morton, *The Strategic Response by Pharmaceutical Firms to the Medicaid Most-Favored-Customer Rules*, 28 RAND. J. ECON. 269-290 (1997).

[15] Jihui Chen & Qihong Liu, *The Effect of Most-Favored Customer Clauses on Prices*, 59 (3) J. INDUS. ECON. 343-371 (2011).

[16] *See* Crocker & Lyon (1994), *supra* note 12.

[17] *See* Footnote 1 of Besanko & Lyon (1993), *supra* note 8.

[18] *See* George A. Hay, *Practices that Facilitate Cooperation: The Ethyl Case,* THE ANTITRUST REVOLUTION, 183-207 (John E. Kwoka, Jr. & Lawrence J. White, eds. 2008)

punish—the use of an MFN. In *Madden,* the court rejected a challenge to the California Dental Service's pricing policy that involved an MFN clause, saying "in balancing the procompetitive effects of assuring low prices and the anticompetitive effect of discouraging discounting, plaintiffs' offer of proof was limited to a theory about motivation and no evidence was offered to show a possible injury to members of the plaintiff class."[19]

In *Kitsap,* the court rejected monopolization allegations based on MFN clauses in dental plan contracts between insurers and dental practices, "because the policy was not 'predatory' or anticompetitive, but rather was justified by normal business purpose and not enforced arbitrarily; moreover, there was no dangerous probability of success because defendant had at most a 22% market share."[20] In *Ocean State,* both the trial judge and the First Circuit refused to label the MFN as monopolization.

In another case involving healthcare and insurance, *Blue Cross & Blue Shield United of Wis. v. Marshfield Clinic*, Judge Posner of the 7th Circuit wrote:

> Most favored nations' clauses are standard devices by which buyers try to bargain for low prices, by getting the seller to agree to treat them as favorably as any of their other customers. The Clinic did this to minimize the cost of these physicians to it, and that is the sort of conduct that the antitrust laws seek to encourage. It is not price-fixing. Perhaps, as the Department of Justice believes, these clauses are misused to anticompetitive ends in some cases; but there is not evidence of that in this case.[21]

As noted by Judge Posner, the DOJ and the FTC have generally held a negative view of MFNs and had been actively challenging MFN clauses in Healthcare contracts since the early 1990s. A string of five cases from 1995 to 1998 resulted in consent decrees that required insurers to remove MFN provisions.[22] The latest case (*U.S. v. Blue Cross & Blue Shield of Michigan*) was filed in 2010 and has been withdrawn because a law banning the use of MFNs has been passed in the State of Michigan. Before the case was withdrawn, in rejecting a motion to dismiss, the presiding judge had hinted that the DOJ may be able to prove its case against the MFN used by BCBS of Michigan.

C. The eBook Price-Fixing Case

Despite the DOJ's efforts, until the Apple eBook decision, there had never been a court decision finding an MFN anticompetitive. That changed on July 10, 2013.

The eBook case concerned agreements that Apple reached with five major book publishers just before releasing the iPad device. Under these agreements, Apple adopted the agency model for its online bookstore (the "iBook" store). The agency model allowed the publishers to set the retail price, from which Apple received a fixed share of 30 percent. The agreements also included an MFN clause that ensured that the retail prices on the iBook store set

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[19] *See* Footnote 42 of Jonathan B. Baker, *Vertical Restraints with Horizontal Consequences: Competitive Effect of 'Most-Favored-Customer' Clauses*, 64 ANTITRUST L.J. 517 (1995-1996).

[20] *Id.*

[21] 65 F.3d 1406 (7th Cir. 1995).

[22] FTC v RxCare of Tenn (1996), U.S. v. Delta Dental (AZ 1995; RI 1997); U.S. v. Vision Service (1995); U.S. v. Medical Mutual of OH (1998).

by publishers could not be higher than the prices of any other e-retailers. Apple argued that the purpose of MFN was to ensure that iBook store customers received the lowest possible price in the market.

Judge Cote, however, concluded that:

> Apple included the MFN • • • in its Agreements both to protect itself against any retail price competition and to ensure that it had no retail price competition. Apple fully understood and intended that the MFN would lead the Publisher Defendants inexorably to demand that Amazon switch to an agency relationship with each of them. • • • [T]his was no more than what the Publisher Defendants had already assured Apple that they wanted to, and would, do.[23]

Judge Cote also found that the consequence of this elimination of competition was to increase price, writing, "the MFN also forced the Publishers to convert all of their e-book distribution arrangements and *to raise e-book prices*."[24]

While Judge Cote's decision was harsh in its condemnation of Apple's particular MFN, she did not suggest that all MFNs are intrinsically anticompetitive:

> The Plaintiffs do not argue, and this Court has not found, that the agency model for distribution of content, or any one of the clauses included in the Agreements, or any of the identified negotiation tactics is inherently illegal. Indeed, entirely lawful contracts may include an MFN, price caps, or pricing tiers.[25]

Judge Cote found that Apple was liable because it served as a coordinator among five major publishers (horizontal competitors) by imposing the almost identical agency agreement with them, which, along with the MFN clause, left the publishers with no choice but to convert other e-retailers to an agency model so eBook prices could be raised, and so that Apple would not have to compete with Amazon.

VI. CONCLUSION

It seems fair to conclude that there is no simple antitrust consensus for or against MFNs. Theory offers mixed results; empirical results are mixed; and there is—as yet—insufficient precedent in the jurisprudence to state a clear rule for or against the MFN.

Here is a problem that for the foreseeable future will likely be the subject of case-by-case rule of reason analysis. If the courts in these cases follow the lead of Judge Cote, they will pay special attention to evidence of horizontal agreement on the terms of MFN contracts and to the question of how the particular MFN in any case does—or does not—promote cooperation or coordination among horizontal competitors in the particular circumstances of the market(s) in which the MFN operates.

Courts will also want to ask what other practices are present that could operate with the MFN to inhibit competition. The eBook case, for example, involved the interaction between the MFN and the agency model of retail sales. That is a pattern that courts hearing MFN cases may

[23] United States District Court, Southern District of New York, *United States of America v. Apple Inc. et. al.*, Opinion and Order, July 10, 2013, p. 116. (Hereafter, "Apple Decision").

[24] Apple Decision, *id.* p. 138, underlining in original, *italics* added.

[25] Apple Decision, *id.* p. 132.

want to look for, since recent research suggests that the combination of agency and MFN is likely to have anticompetitive effects.[26] Investigating the competitiveness of other combinations of institutional and contractual arrangements with MFNs may prove to be a fruitful area for additional research by economists.

[26] *See* Justin P. Johnson, *The Agency Model and MFN Clauses* (February 15, 2013). *Available at* SSRN: http://ssrn.com/abstract=2217849 or http://dx.doi.org/10.2139/ssrn.2217849. Johnson shows that the combination of agency MFN leads to higher prices, but that there is no such anticompetitive effect for MFNs under a wholesale model.