

Antitrust Challenges to Most Favored Nation and Competitor Parity Clauses in the U.S. and Europe

Assessing MFNs and Parity Provisions for Antitrust

Vulnerabilities, Devising a Defensible Business Case for MFNs

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Milbank



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Agenda

- I. What Are Most Favored Nation Clauses?
- II. Traditional Antitrust View of MFNs
- III. How Has the Landscape Changed?
- IV. Economic Theories of Harm
- V. The European Landscape
- VI. Parity Provisions in the U.S.

Background on MFNs

What is a Most Favored Nation Clause?

- Most favored nation clauses, or MFNs, and parity provisions typically require parties to give buyers/suppliers the same or lower price (or same or better terms) offered to any rivals
- Spectrum of MFNs
 - MFN-equal clauses require matching, or the same terms
 - MFN-plus clauses require the seller to provide a buyer with lower prices/better terms than other buyers
 - Contemporaneous MFNs apply only to conditions at the time of purchase
 - Retroactive MFNs entitle the benefitting party to a refund based on previous purchases if the seller offers lower prices in the future

Wholesale vs. Retail MFNs

- MFNs can operate at the retail or wholesale level

Wholesale MFN

- The supplier commits to charge the same price to different retailers
- But retailers may be free to set their own retail prices

Retail MFN

- Generally involves the supplier selling direct to consumers or through agents
- Supplier commits not to sell/set a lower price for different sales channels

Conflicting Incentives of Retailer and Supplier to Use MFNs

Retailer

- Incentive to restrict price competition in order to increase margins (reduce intra-brand competition)

Supplier

- Generally has incentives to maximise retail competition and keep retail prices low
- Increases output, so earns a margin on more sales
- So why do suppliers agree to MFNs that reduce retail competition?

Supplier Incentives to Use MFNs

Anticompetitive incentives, e.g.:

- In differentiated product markets, may reduce pressure from retailers to reduce wholesale prices
- May facilitate collusion between suppliers
 - Allows suppliers to monitor competitors' prices

Efficiency incentives, e.g.:

- Avoid free riding
 - Retailers exploiting efforts of competing retailers while charging lower prices
- Prevents double marginalisation
 - Prevents retailers from exploiting market power by adding their own mark-up

Supplier Incentives to Use MFNs

- **Protecting yield management**
 - Airlines, hotels, railways, etc. use yield management to maximise revenues
 - Fixed capacity on a given flight
 - Sell seats to those who will pay the highest prices
 - This also maximises economic welfare
 - Limited number of seats are sold to those who value them most
 - Difficult to achieve if agent discounts prices
 - So airline may need to ensure that agents do not undercut its fares on other sales channels



Theories of Harm From MFNs

- Traditional concerns:
 - Exclusionary Conduct
 - MFNs used by **dominant** firms to exclude or disadvantage competitors more likely targets of antitrust scrutiny
 - Collusive Conduct
 - Competing firms can use MFNs to facilitate or maintain **agreements** on price or other competitive terms
- Required dominance or conspiracy
- New theory - vertical RPM

Treatment of MFNs Shifting in Europe and U.S.

- Why have antitrust regulators become more suspicious of MFNs/parity provisions?
 - MFNs may threaten innovation and new entry in certain industries (e.g., online platforms)
 - Increasing instances in which MFNs cover a material portion of market supply
 - E.g., online hotel booking cases in EU
 - MFNs can stifle price competition
 - E.g., United States v. Blue Cross Blue Shield of Michigan
 - Same economic impact as horizontal price fixing, but no need to establish conspiracy

Key Questions for the Analysis:

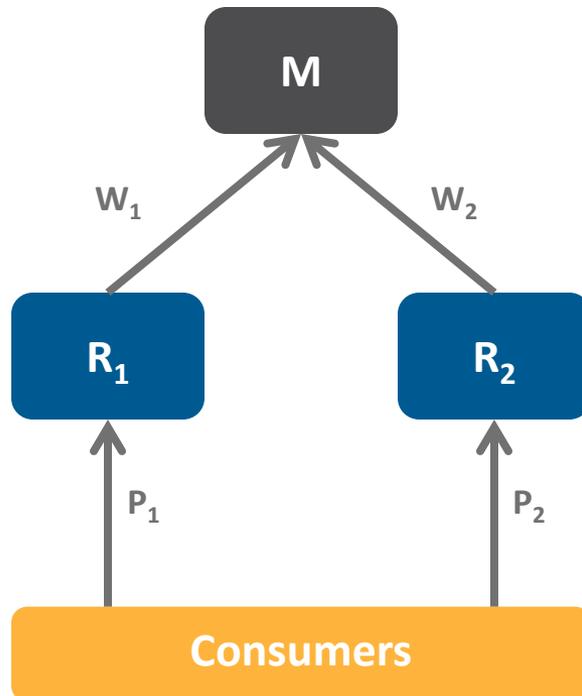
- **Market Structure**
 - How concentrated is the market?
- **Nature of the Product or Service**
 - E-commerce (especially in EU)
- **Reach of the Provision**
 - MFN-plus vs. equal
- **Asymmetric Information**
 - E.g., presence of two-sided markets
- **Consumer Pricing**
 - Pricing for end consumers or wholesale business?

Economic Considerations

Economic Considerations

- MFNs Can Restrict Competition
 - In merchant model: can restrict inter-brand competition or facilitate RPM (wholesale vs. retail)
 - In agency model: can be used to create RPM
- As with any vertical agreement, need to balance anticompetitive effects against efficiencies, e.g.
 - Avoiding free riding
 - Avoiding double marginalisation
 - Pricing efficiencies that maximise consumer welfare

Competition effects of a *wholesale* MFN (in a merchant model)



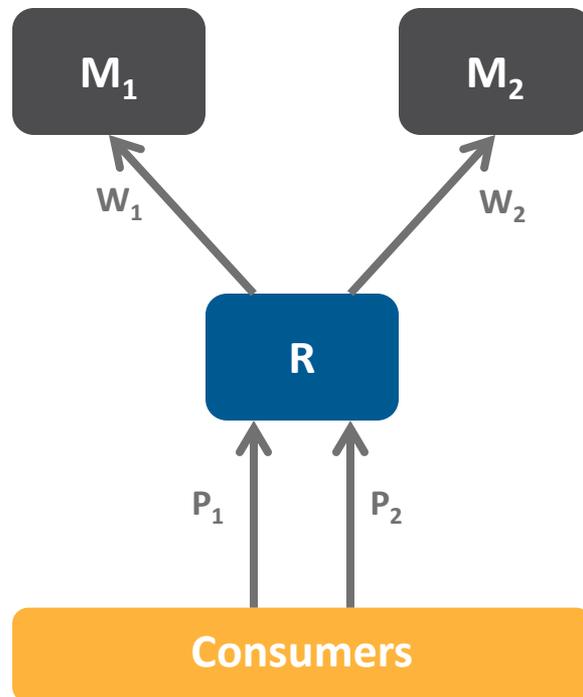
RPM: $P_1 = P_2$

- RPM eliminates *intra*-brand price competition between retailers
- Other dimensions of intra-brand competition, and inter-brand competition, may remain

MFN: $W_1 = W_2$

- MFN allows for price competition between retailers
- The MFN can support/facilitate RPM

Competition effects of a *retail* MFN (in a merchant model)



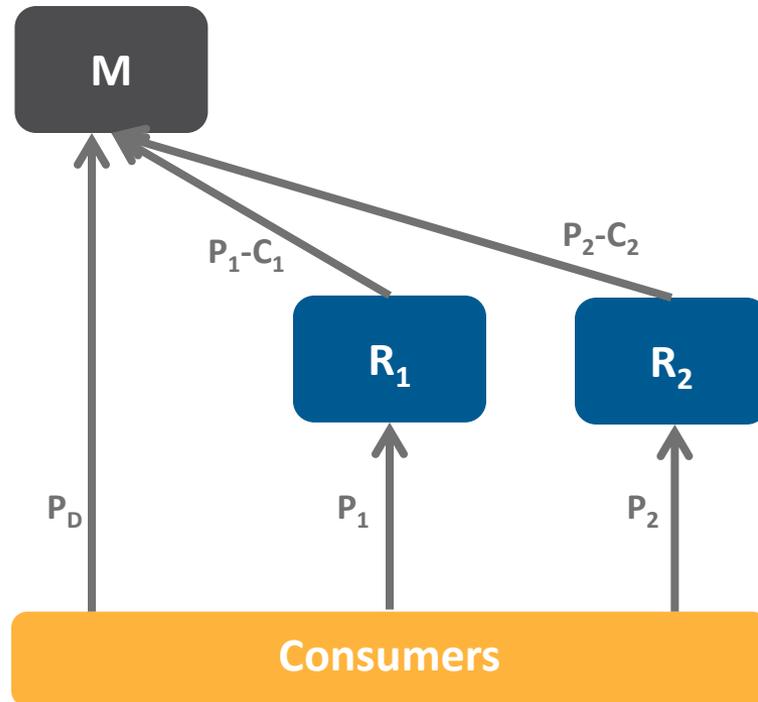
MFN: $P_1 = P_2$

- MFN eliminates *inter*-brand price competition between manufacturers through this sales channel
- Other dimensions of competition may remain
- Could also reduce *intra*-brand competition since retailers have less incentive to discount a particular product
- Anticompetitive effect greater if:
 - Applies across many retailers
 - Non-price competition is weak (undifferentiated/commodity product)

Broad v. Narrow MFNs (1)

- Some recent cases have involved products sold through agents (e.g. hotel rooms)
- The “manufacturer” (e.g. a hotel) sets the final price and agents compete on commission and non-price factors, such as quality of web-site and range of products/services
- Manufacturer may also sell direct (e.g. direct bookings on hotel’s own web-site)
- In this context, competition authorities sometimes distinguish between *broad* and narrow retail MFNs
 - *Broad*: MFN covers all distribution channels
 - *Narrow*: MFN applies only to the direct channel

Broad v. Narrow MFNs (2)



Broad: $P_D = P_1 = P_2$

- Covers all distribution channels and platforms
- Eliminates intra-brand price competition between platforms
- Other dimensions of intra-brand competition, and inter-brand competition, may remain

Narrow: $P_D \geq P_1$ and $P_D \geq P_2$

- Covers only the “direct” channel
- Manufacturer cannot undercut a competing channel
- But allows intra-brand competition between competing channels

Summary of Competitive Effects

- Wholesale v. Retail
 - Wholesale MFN in isolation allows for competition at retail level, but could be used to facilitate RPM
 - Retail MFN can restrict inter-brand competition
- Broad v. Narrow
 - Broad MFN can have similar effect to RPM: can restrict intra-brand competition
 - Narrow MFN allows for inter-brand and intra-brand competition (only restricts competition from the direct channel)
- Competition concerns often focus on use of MFN to impose or facilitate RPM

The European Landscape

MFN Cases in Europe

- While MFN cases are not a new phenomenon in Europe, regulators are ramping up scrutiny in this area:
 - 2002-2004: European pay-TV (European Commission, IP/04/1314)
 - 2005: Ruhrgas/Gazprom (European Commission, IP/05/710)
 - 2011: Digitization of European cinemas (European Commission, IP/11/257)
 - 2012: Universal Music Group/EMI (European Commission, COMP/M.6458)
 - 2011-2013: Apple e-books (European Commission, COMP/39.847)
 - 2012-2013: Amazon Marketplace (FCO and OFT/CMA, B6-46/12; CE/9692/12)
 - 2012-2015: Private Motor Insurances (OFT/CMA, CE/9388/10)
 - 2015: Amazon e-books (European Commission, IP/15/5166)

Approach of European Competition Authorities

- Historically, MFNs have not primarily been considered as vertical restraints themselves but rather as “supportive measures” in the context of wider anticompetitive practices.
 - MFNs as a means to facilitate a horizontal agreement or concerted practice (Apple e-books)
 - MFNs as a means to align prices and harmonize commercial terms (European pay-TV)
- Recent developments focus on e-commerce, in particular on platform markets:
 - E-books investigation
 - Amazon Marketplace investigation
 - Private motor insurance investigation
 - Online travel agencies (OTAs) investigation (see next slides)
- MFNs are increasingly scrutinized as vertical restraints themselves.

Legal and Political Framework in Europe

- Legal Framework

- Agreements with object or effect of restricting competition, Art. 101 TFEU
- Vertical Block Exemption Regulation (VBER)
 - Market share < 30%: block exemption (Art. 2(1), 3(1) VBER)
 - Market share > 30%: no block exemption, but individual exemption possible (Art. 101(3) TFEU)
- MFNs are not explicitly mentioned in primary/secondary EU law.
 - No hardcore restriction under the VBER
 - Guidelines on Vertical Restraints, para. 48

- Policy Framework

- Broad and ongoing e-commerce sector inquiry by the EC
- Coordination and cooperation among the European Commission and the NCAs under the European Competition Network (ECN)

OTAs Investigation – Theory of Harm

- OTAs (Booking.com, Expedia, HRS) act as intermediaries between hotels and consumers in return for a commission paid by hotels
- Contracts between OTAs and hotels often contained MFNs
 - Hotels were obliged to offer at least the same prices/other T&Cs as offered on other sales channels (particularly on competing OTAs and the hotels' direct booking channels)
- General theory of harm
 - Indirect price fixing of room rates (especially in case of market-wide use of MFNs)
 - Increase of barriers to entry for other OTAs/brokers/resellers
 - Reinforcement of incumbent's position (risk of market tipping)
 - Little incentive for OTAs to compete on commission rates

Booking.com



OTAs Investigation – NCAs Practice

- Since 2010, NCAs have distinguished between “broad” and “narrow” MFNs.
 - Broad MFNs apply to all internet listings, including those on competing platforms and the hotels’ direct booking channels
 - Narrow MFNs apply to the hotels’ direct booking channels only
- Most NCAs closed their investigations after OTAs removed the broad MFNs and switched to narrow MFNs instead (see overview next slide).
 - Narrow MFNs are not regarded as anticompetitive by object
 - Narrow MFNs – if at all – are regarded as restrictions by effect
 - Narrow MFNs may be justified to avoid hotels free riding on promotional efforts of OTAs

OTAs Investigation – Status Quo of EU Member States

Narrow MFNs accepted by NCA	Narrow MFNs accepted by NCA but prohibited by legislator	Narrow MFNs prohibited by NCA
 Austria  Denmark  Greece  Ireland  Italy  Poland  Sweden  Switzerland  UK	 France <i>(Art. L. 311-5-1 of the Tourism Code, enacted on 6 August 2015 as part of the „Macron Law“)</i>	 Germany <i>(see case study: next slide)</i>

Case Study: MFNs in Germany

- Overview of the German FCO's decisional practice
 - 20 December 2013: prohibition of HRS' **broad MFNs** (upheld by Higher Regional Court of Düsseldorf on 9 January 2015)
 - 22 December 2015: prohibition of Booking.com's **narrow MFNs**
- German FCO undertook an in-depth review of OTA and hotel markets
 - MFNs have the effect of restricting competition both between OTAs and between hotels
 - VBER not applicable (market shares of HRS/Booking.com > 30%)
 - OTAs could not prove the requirements of an individual exemption, Art. 101(3) TFEU
 - No efficiency gains (in particular, MFNs not apt to solve freeriding problem)
 - No fair share of the resulting benefits go to consumers
 - Restrictions not indispensable

Emerging EU Themes

- MFNs may be scrutinized even where benefitting parties are not dominant.
- FCO left it open whether MFNs may be exempted under the VBER if market share is < 30 %.
 - No per se illegality of MFNs under EU law
- MFNs and other parity provisions may be deemed anticompetitive without need to prove harm to ultimate consumers.
- High burden of proof on companies for an individual exemption under Art. 101(3) TFEU.

Parity Provisions in the U.S.

Historical Treatment of MFNs/Parity Provisions

- MFN clauses traditionally seen as procompetitive
 - Ensure buyers get best price
 - Create bargaining efficiencies between parties, e.g., minimizing need for ongoing price negotiations
- U.S. courts historically regarded MFNs as competitively benign or even procompetitive
 - *Blue Cross & Blue Shield United of Wisconsin v. Marshfield Clinic* (7th Cir. 1995) – MFNs 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 customers”
 - *Ocean State v. Blue Cross & Blue Shield of Rhode Island* (1st Cir. 1989) – “a policy of insisting on a supplier’s lowest price—assuming that the price is not ‘predatory’ or below the suppliers’ incremental cost—tends to further competition on the merits and, as a matter of law, is not exclusionary”

Enforcement Actions by US Antitrust Agencies

- MFNs used by **dominant** firms to exclude or disadvantage competitors more likely targets of antitrust scrutiny
 - E.g., United States v. Blue Cross Blue Shield of Michigan
 - BCBSM’s commercial health insurance policies covered more than 60% of Michigan’s commercially insured population
 - Contracts with “must-have” hospitals contained MFN-plus clauses
- Competing firms can use MFNs to facilitate or maintain **agreements** on price or other competitive terms
 - Potential for collusion: GrafTech/Seadrift (2010) – DOJ required graphite electrode producer to remove MFN pricing provision from supply agreement with ConocoPhillips in order to proceed with proposed acquisition of Conoco’s competitor

United States v. Apple

- Apple entered into e-book agency sales agreements with five of “Big Six” publishers
 - Prior to Apple’s entry, e-book industry operated under wholesale model
 - Amazon controlled 90% of e-book market and priced bestsellers at \$9.99 price point
- Apple’s agency agreements enabled publishers to control retail pricing and contained MFNs guaranteeing that Apple’s iBookstore would have lowest e-book retail price
 - MFNs facilitated horizontal conspiracy among publishers
 - Created price floor and enabled publishers to increase prices
- Second Circuit recognized MFNs are “surely proper in many contexts” but in this case “forc[ed] collective action by the publishers”



No Comparable Challenge to Online Platforms in U.S.

- To date, U.S. federal antitrust agencies have not announced any investigation of vertical agreements involving online platforms
- *In re Online Travel Co.* (N.D. Tex. 2014)
 - Private class action brought against OTAs and hotel brands alleging an “industry-wide conspiracy” to eliminate price competition in the online hotel bookings market
 - On a Motion to Dismiss, court found vertical agreements “made perfect economic sense” absent a conspiracy
 - Consistent with each hotel’s and OTA’s rational business interests
 - Hotels have right to control online pricing for their rooms
 - OTAs need assurances that others face similar prohibitions from discounting
 - No explicit evidence of conspiracy
 - Could not infer conspiracy where use of MFNs was consistent with competition

Uber – A New Platform Case?

- Private class action alleges conspiracy among Uber drivers to restrain prices and harm competition
 - Drivers cannot compete on price or “surge pricing” because Uber app dictates rates
 - In March 2016, Southern District of NY held plaintiff successfully alleged horizontal conspiracy between Uber’s CEO (a driver) and all other drivers (independent contractors)
- Smartphone technology can plausibly facilitate price agreement between hundreds of thousands of drivers across entire U.S.



Non-Price Parity Provisions



- DOJ challenged American Express’s non-discrimination provisions (NDPs) in its contracts with participating merchants
 - NDPs prevented merchants from steering customers to competing networks’ cards (e.g., by offering them a better price if they did so)
 - District court concluded the NDPs disrupted the “price-setting mechanism ordinarily present in competitive markets” by reducing incentives to offer lower merchant discount rates
 - Merchants could not negotiate lower discount rates with other credit card networks based on greater transaction volume
 - Similar effect to MFNs in online travel industry
 - Beneficiaries of parity provisions insulated from price competition
 - Discover Card’s inability to expand share analogous to EU concerns about MFNs impeding innovation and entry

Similar Themes to European Experience

- Finding of market power unnecessary due to direct evidence of adverse effects to competition in relevant market
 - American Express held 26.4% share, well below market leader
 - Market power nonetheless present due to market concentration, entry barriers and “cardholder insistence”
- Proof of harm to merchants (rather than ultimate consumers) “sufficient to discharge Plaintiffs’ burden”
 - Court relied principally on increases in merchant discount rates to show harm to competition
- Two-sided platforms
 - Asymmetry of information drives wedge between consumer demand and merchants/hotels responsible for paying discount/commission rates
- Consistent with full rule of reason analysis

Conclusions

Questions to Ask to Weigh Risks

- Who is asking for the MFN?
 - Supplier or retailer?
- What is the business reason for including (or rejecting) an MFN in your agreement?
- What type of MFN are you considering?
 - Greater risks with MFN-plus and retail-level MFNs
- How concentrated is the market in which you participate?
 - If highly concentrated, more likely to encounter scrutiny.
 - How prevalent are MFNs in the industry?
- What is the nature of your industry?
 - U.S. and EU targeting platform industries, two-sided markets
 - Significance of network effects
 - EU's focus on e-commerce