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Vertical Restraints with Horizontal Consequences: Competitive Effects of Most-Favored-Customer Clauses

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VERTICAL RESTRAINTS WITH HORIZONTAL CONSEQUENCES: COMPETITIVE EFFECTS OF "MOST-FAVORED-CUSTOMER" CLAUSES

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1. INTRODUCTION

George Orwell's novel Animal Farm recounts the course of a revolution against the discredited old order on Farmer Jones's Manor Farm. The victorious animals developed a carefully crafted and sensible set of rules to govern their own new order—the Seven Commandments. But the Seven Commandments were hard for most of the animals to remember. After much thought, one of the farm's leading intellectuals, a pig named Snowball, declared that the Seven Commandments could be reduced to a single maxim: "Four legs good, two legs bad." This seductive simplification was the beginning of the end for the animal revolution. In the name of this maxim, the pigs perverted each of the Seven Commandments, one after the other, to reestablish the old prerevolutionary order with themselves, rather than the farmer, on top.

Antitrust revolutions, too, can founder on oversimplification. The Chicago School revolution of the last twenty years uprooted and discarded old, oversimplified per se rules and rubrics because they discouraged efficient conduct. One theme of the Chicago revolutionaries was to focus antitrust attention on how collusion—that is, horizontal arrangements—can harm competition and consumers. Thus, they advocated reorienting enforcement to emphasize prosecuting price fixing and enjoining horizontal mergers that threaten to create monopolies or near monopolies.

Yet, the Chicago revolution also taught how vertical arrangements between sellers and buyers can achieve efficiencies. One of the most far-reaching doctrinal shifts attributable to the Chicago revolution was the Supreme Court's rejection of the per se prohibition against vertically
imposed territorial restraints in *GTE Sylvania.*\(^1\) By treating these restraints under the rule of reason, the Court permitted manufacturers to write contracts that induce dealer sales effort by discouraging dealer free riding on the promotional efforts of neighboring retailers. Other decisions have effectively relaxed old per se rules against other vertical arrangements, principally tying.\(^2\) Some enthusiastic commentators have advocated reversing all the old rules and treating vertical arrangements, including agreements setting resale prices, as per se legal.\(^3\) These developments could reduce to a deceptively simple maxim: "Vertical good, horizontal bad."\(^4\) If antitrust were to follow that maxim, it would give a free pass to all kinds of agreements between firms and their distributors or suppliers, while closely scrutinizing agreements among competitors.

Each side of the "vertical good, horizontal bad" maxim is an oversimplification. The "horizontal bad" half underplays the many important ways in which collaboration among competitors can achieve efficiencies. To be sure, another legacy of the Chicago revolution was a more nuanced treatment of horizontal restraints as well. Decisions like *BMI*\(^5\) and *Rothery*\(^6\) move away from per se treatment of some horizontal restraints expressly to permit efficiencies.\(^7\)

This article focuses on the "vertical good" half of the maxim. This slogan understates the competitive problems that can result from vertical restraints. Even believers in "vertical good, horizontal bad" should still pay attention to vertical restraints—not because "vertical" is by itself "bad," but because vertical restraints can impair horizontal competition.

This article describes three ways in which vertical restraints can harm competition by having horizontal effects, here termed "facilitating practices," "raising rivals' costs," and "dampening competition."\(^8\) Pointing

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7 Some commentators, recognizing this principle but then taking it to its extreme, might have restated the maxim as "vertical good, and horizontal good too." *See, e.g., Dominick T. Armentano, Antitrust Policy: The Case for Repeal* (1986).
8 These do not catalogue all the ways vertical restraints can harm competition. For example, this list excludes the way regulated firms can raise prices by evading regulatory
out the anticompetitive potential of vertical practices is not intended to minimize their efficiency benefits; it is instead merely intended to highlight the part of the story that has not been emphasized in recent years. The three kinds of anticompetitive effects will be illustrated with examples from antitrust cases involving one particular kind of vertical restraint, namely, most-favored-customer clauses.

II. MOST-FAVORED-CUSTOMER PROVISIONS

Analyzing vertical restraints is complicated by the variety of forms they take. The most-favored-customer clause is a good example because it is familiar and common and it has been frequently subject to antitrust attention.

A most-favored-customer clause, also called an “antidiscrimination” or a “most-favored-nations” clause, is a promise by one party, for example a supplier, to treat a buyer as well as the supplier treats its best, “most-favored” customer. If the supplier lowers price to someone else, then the buyer’s price will be lowered to match. The immediate effect of a most-favored-customer clause is uniformity in how one supplier treats different customers.

In applying rule of reason antitrust analysis to vertical restraints such as a most-favored-customer clause, the anticompetitive effects must be identified and compared with efficiencies. This article will describe three anticompetitive mechanisms by which a most-favored-customer clause in vertical contracts could harm competition, one corresponding to each of the general vertical theories previously noted: practices facilitating coordination, raising rivals’ costs, or dampening competition. This article’s broader purpose—of highlighting the many ways vertical practices can harm competition—is, in one respect, not well served by focusing constraints and the way vertical integration can facilitate anticompetitive price discrimination.

9 The most familiar vertical relationships are between manufacturers and retailers or between manufacturers and input suppliers. Designation of one level as “upstream” and the other level as “downstream” is convenient conceptually, but is arbitrary. For example, retailers are treated generally as “downstream” of manufacturers. But retailers could be treated equally as “upstream” suppliers to the manufacturers of a key input, namely, retailing services. In general, vertical relationships are those among sellers of goods or services that are complements to each other in demand, while horizontal relationships are those among sellers of substitutes in demand.

10 A most-favored-customer provision may appear expressly in a (vertical) supply contract. In other cases a seller will establish a most-favored-customer policy for all its buyers across-the-board. In the latter situation the vertical contract is implicit. If competing sellers agree that each will announce a most-favored-customer policy, they have reached a horizontal agreement to introduce a vertical practice. Most-favored-customer provisions can be retroactive or contemporaneous.
upon most-favored-customer provisions: the distinction between the facilitating practices and dampening competition theories could be made more apparent by choosing some other vertical practice for study. On the other hand, the goal of encouraging careful analysis of individual practices rather than careless application of slogans is well served: this article will explain why some, though not all, of the commonly supposed efficiency benefits of most-favored-customer provisions may not be persuasive.

III. FACILITATING HORIZONTAL COORDINATION

The first kind of competitive effect to be concerned about is the use of most-favored-customer provisions to facilitate anticompetitive horizontal coordination. Coordination works better if firms have little incentive to cheat to begin with. Most-favored-customer clauses can create that condition. A firm that has agreed to offer most-favored-customer treatment in its contracts has reduced its incentive to deviate from a coordinated horizontal arrangement because it cannot limit its discounts to a single customer.

The seller's reduced incentive to negotiate price cuts to individual buyers is complemented by a lessening of buyer efforts to drive a hard bargain. After all, a buyer likely has less incentive to invest in negotiating with a seller who will find it expensive to discount. Buyers' complementary disincentive to bargain hard can be exacerbated when many other buyers also have most-favored-customer provisions: a customer who resells further downstream may have less incentive to bargain aggressively.

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11 This article uses the term "facilitating practices" to refer to conduct that would permit firms to achieve higher prices in a noncooperative repeated game framework and the term "dampening competition" to refer to conduct that would lead to higher prices in a static setting. "Facilitating practices" may work by helping competitors, including the members of a horizontal cartel, monitor each others' behavior to detect whether they are cheating on each other; by increasing the punishment for cheating; or by making it easier for firms to reach a consensus on prices and outputs.


with the seller when doing so will not give it a competitive advantage over other buyers.\textsuperscript{14}

To facilitate horizontal coordination among sellers, it may be enough for a firm to offer most-favored-customer protection only to major customers, or even a single major customer—as the court recognized in the old polio vaccine case.\textsuperscript{15} The court refused to treat uniform high prices as evidence of criminal conspiracy where the largest purchaser, the government, insisted on most-favored-customer clauses.\textsuperscript{16} Industry witnesses pointed out that the most-favored-customer clauses set a price floor and they would be reluctant to cut price to any customer because they would then have to cut price to the federal government and to states with similar clauses in their contracts.\textsuperscript{17}

The Federal Trade Commission addressed the potential for most-favored-customer clauses to facilitate coordination in a recent consent settlement with RxCare, the leading pharmacy network in Tennessee.\textsuperscript{18} Pharmacies in a network contract with health plans to sell drugs to consumers are reimbursed by the pharmacy benefit management firms (PBMs) and managed care providers who sponsor the health plan with which the consumer is affiliated. RxCare fills prescriptions for patients covered by the state Blue Cross/Blue Shield plans and for consumers affiliated with several other managed care organizations.

RxCare required participating pharmacists, which accounted for more than 95 percent of all pharmacies in the state, to agree that if they accepted a lower reimbursement rate from a competing network, they would accept the same rate from RxCare. Because RxCare is owned by the largest pharmacists' organization in the state, the most-favored-customer clauses were effectively imposed by the pharmacists upon themselves.

\textsuperscript{14} Moreover, a buyer who knows that its own competitive position will not be undermined by rivals who get better prices from a key supplier may compete less strongly at the buyer level.

\textsuperscript{15} United States v. Eli Lilly & Co., 1959 Trade Cas. (CCH) \# 69,536 (D.N.J. 1959).

\textsuperscript{16} For a discussion of the problem of inferring an agreement to fix price in parallel pricing cases, see Baker, \textit{supra} note 12.

\textsuperscript{17} United States v. Eli Lilly & Co., 1959 Trade Cas. (CCH) \# 69,536, at 76,152 (D.N.J. 1959). The court cited, as further evidence of the price-floor effect, that when the practical impact of the clauses ended in late 1957, discounting broke out. \textit{Id.} at 76,152–53. \textit{But cf.} Blue Cross & Blue Shield United of Wis. v. Marshfield Clinic, 65 F.3d 1406, 1415 (7th Cir. 1995) (Posner, C. J.) (terming a price-floor theory similar to what was suggested in the polio case "an ingenious but perverse argument"), \textit{cert. denied}, 116 S. Ct. 1288 (1996).

\textsuperscript{18} RxCare of Tenn., Inc., File No. 951-0059 (consent order accepted for comment Jan. 19, 1996).
The FTC concluded that these contractual provisions tended to keep reimbursement rates high by discouraging selective discounting and the development of rival networks. According to the Commission, the clauses discouraged pharmacists from joining networks promising additional business but offering a lower reimbursement rate—that is, they discouraged pharmacists from cutting price to attract new business—even though RxCare was nominally nonexclusive. The reason: the pharmacists would then be required to cut price to the RxCare network, which is the largest source of third-party business for Tennessee pharmacies. Third-party payers could not plausibly avoid the high price implications of the most-favored-customer clause by assembling a rival network that excluded RxCare pharmacists because almost all of the state's pharmacists were RxCare members. And because RxCare was owned by a pharmacists' association, it had less incentive than would an independent network to bargain aggressively with its pharmacist members in order to offer low reimbursement rates to third-party payers. To the contrary, RxCare actually sought to persuade third-party payers to raise their reimbursement rates to the RxCare level. These anticompetitive incentives were significant: according to the complaint, reimbursement rates were higher in Tennessee than in other states.

The facilitating coordination effects of most-favored-customer clauses were also one object of the FTC's Ethyl litigation. The Commission challenged an industry-wide pattern of offering most-favored-customer protection as one of three practices that allegedly led to supracompetitive prices. The administrative law judge found that the clauses, used by the two largest firms in the industry, reduced those sellers' incentive to discount and increased each of these major sellers' confidence that the other would not discount. The Commission agreed that the disincentive to discount was obvious—it was reflected in the companies' own documents—and it rejected the respondents' claims that they would have set the same high prices even without the clauses. The court of appeals dismissed the complaint, however, principally because the Commission did not allege that the firms had used these practices to accomplish tacit collusion, but instead claimed that each firm had violated Section 5 of the FTC Act by adopting the practices unilaterally. The appellate opinion nevertheless acknowledged the anticompetitive potential of most-

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20 The other practices were delivered pricing and advance announcements of upcoming price changes.

21 For an argument questioning the appellate decision, see Baker, supra note 12, at 211–13.
favored-customer provisions, noting that the seller "voluntarily penalizes itself for price discounting."\footnote{E.I. du Pont de Nemours & Co. v. FTC, 729 F.2d 128, 140 n.10 (2d Cir. 1984).}

The Department of Justice’s consent order prohibiting anticompetitive practices in the electrical equipment industry was also concerned with the potential for most-favored-customer clauses to facilitate coordination.\footnote{United States v. General Elec. Co., 42 Fed. Reg. 17,005 (1977) (prohibiting the use of most-favored-customer price-protection clauses and advance price announcements). The firms had previously been convicted of price fixing. United States v. General Elec. Co., 1962 Trade Cas. (CCH) ¶ 70,503 (1962).}

IV. RAISING RIVALS' COSTS

The second kind of horizontal effect from vertical practices is exclusion, or, more generally, raising rivals’ costs. Vertical restraints can harm competition by creating conditions in which downstream firms must participate, or accede to, what we might call an involuntary or coerced cartel.\footnote{The possibility of such an involuntary anticompetitive arrangement is well established in the economics literature. Janusz A. Ordover et al., Equilibrium Vertical Foreclosure, 80 Am. Econ. Rev. 127 (1990); Steven Salop & David Scheffman, Cost-Raising Strategies, 36 J. Indus. Econ. 19 (1987); Oliver Williamson, Wage Rates as a Barrier to Entry: The Pennington Case in Perspective, 82 Q.J. Econ. 85 (1968); Richard Nelson, Increased Rents from Increased Costs: A Paradox of Value Theory, 65 J. Polit. Econ. 357 (1957).}

The restraints may increase the marginal costs of some downstream firms, inducing them to reduce output and raise price. Then, the remaining downstream firm or firms can reduce output to raise price without fear that these rivals will undermine the involuntary cartel by discounting.

To illustrate the way raising rivals' costs stories work, suppose that three firms, A, B, and C are the only horizontal competitors in a market protected from entry. For collusion to succeed, it may be assumed, all three firms must reduce output and raise price; collusion would fail if one firm, let us say firm C, refused to go along.\footnote{Firm C, the rival whose costs are increased, need not be an incumbent producer. It could instead be a firm whose potential entry constrains anticompetitive behavior. Then, the remaining downstream firms can reduce output to raise price without fear of new competition. In this case, the vertical restraints harm competition by increasing the costs of potential downstream entrants, removing a constraint on incumbent producers by discouraging entry.}

The other two firms, A and B, may nonetheless be able to achieve the anticompetitive result if they can raise C’s marginal costs. Higher costs would induce C to reduce output and raise price. With C forced to do the same thing that A and B want to do, namely, reduce output and raise price, A's and B's coordinated output reduction could succeed.\footnote{Of course, if firm C wanted to go along with collusion anyway, A and B would not need to take any action to raise its costs. But firm C may have different incentives than A.}
One way to raise C's marginal costs would be to foreclose C's access to inexpensive inputs or distribution. A and B might accomplish this by entering into contracts with input suppliers or distributors that contained terms effectively limiting C's access. Vertical merger between A or B and suppliers or distributors, used to foreclose access by the unintegrated firm C, may also have this effect.\(^{27}\)

For a vertical restraint to implement the involuntary cartel strategy successfully, three conditions must hold: the benefits of the strategy to the firms undertaking it must exceed their costs; those firms must not cheat on each other; and their target must be unable to avoid the strategy. None of these conditions is necessarily impossible to satisfy.

The first condition requires that the benefits to A and B exceed the costs they themselves incur in raising C's costs. It is not difficult to imagine settings in which this condition would be satisfied. Although it may be expensive for A and B to arrange for C's costs to rise, their prospective monopoly profits from successfully raising price may be great enough to make the expenditure worthwhile.\(^{28}\) Indeed, if A obtains a large fraction of the producer benefits from higher prices—if A's market share is large, for example—A may even find it worthwhile to pay all of those costs itself, without help from B.

The second condition requires that A and B avoid the temptation to cheat on their involuntary cartel. That is, deviation sufficient to undermine the involuntary cartel must be deterred.\(^{29}\) Determining whether this condition is met is a familiar inquiry for antitrust: A's and B's incentive and ability to deviate from the involuntary cartel they have imposed on C are unlikely to be greater than if C had agreed to join the scheme voluntarily.\(^{30}\) Indeed, if firm B faces capacity constraints or other barriers to expansion, or if the industry consists only of firms A and C, A need

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\(^{28}\) Cf. id. at 273–77 (the horizontal rivals that benefit from an involuntary cartel may find it necessary to share their monopoly profits with sophisticated suppliers).

\(^{29}\) The technical literature makes this point by asking whether A and B would be able to commit to the exclusionary policy. See David Reiffen, Equilibrium Vertical Foreclosure: Comment, 82 AM. ECON. REV. 694 (1992); Oliver Hart & Jean Tirole, Vertical Integration and Market Foreclosure, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY (MICROECONOMICS) 205, 257 (1990).

not coordinate with any rival in order to achieve higher prices by raising 
C’s costs.

The final condition instructs that for A’s and B’s involuntary cartel to 
succeed, C must be unable to avoid the cost increases by, for example, 
outbidding A or B for access to a key input or distribution channel. 
This condition, too, might plausibly be satisfied in many specific factual 
settings. For example, firm C may well be unable to offer as much as A 
or B. Firms A and B can offer to share some of the cartel profits with 
the input supplier. By contrast, C cannot offer to share cartel profits 
because if C avoids the foreclosure or cost increase, collusion fails and 
the competitive price will prevail. Moreover, even if firm C could bribe 
the input supplier not to be excluded, paying that bribe may itself raise 
C’s marginal costs and thus lead to the input reduction necessary to make 
the involuntary cartel successful (unless the bribe were to take the form 
of a lump-sum payment, unrelated to the level of C’s purchases from 
the input supplier). Although customers may have an incentive to help 
C avoid the foreclosure, they need not be able or willing to do so. 
Indeed, customers’ ability to assist C’s counterstrategy in an involuntary 
cartel setting is unlikely to be greater than their ability to undermine a 
voluntary cartel by sponsoring entry. In a market with many buyers, for 
example, no individual customer may have sufficient incentive to sponsor 
entry. Doing so would be costly, and each customer would recognize that 
most of the benefits of sponsoring entry would accrue to its rivals rather 
than itself.

Most-favored-customer clauses could be weapons in a strategy to im-
pose an involuntary cartel. Firms that demand and get most-favored-
customer treatment from important input suppliers are assured that new 
entrants and existing competitors will not be able to obtain lower costs 
by getting better prices from those suppliers. By reducing the ability of 
entrants or rivals to lower their costs, firms can achieve or maintain prices 
above competitive levels.

Antitrust cases have considered the threat of this kind of harm in 
the context of large health insurance plans demanding most-favored-
customer protection in contracts with hospitals or doctors. Two leading 

31 See Krattenmaker & Salop, supra note 27, at 268–72 (describing conditions under 
which rivals’ counterstrategies would not be successful).
32 Id.
34 In recognition of this difficulty, the foreclosure or raising rivals’ costs problem is 
sometimes described as reducing competition by requiring two-level entry.
cases point in opposite directions. In the *Reazin* case, Blue Cross had terminated its provider contract with the largest hospital in Wichita, Kansas, after that hospital affiliated with a major, for-profit chain and a sizable health maintenance organization. Blue Cross' standard provider contract included a most-favored-customer clause. Although *Reazin* did not address the legality of the most-favored-customer provision—the litigation mainly concerned the propriety of terminating the hospital's affiliation with Blue Cross, the jury relied on the effects of that clause—the way it discouraged price discounting and thus the entry of new competition—as evidence that Blue Cross had market power.

A similar scenario appeared in the *Ocean State* case, where the legality of the most-favored-customer provision was at issue, but the *Ocean State* outcome points in the opposite direction from *Reazin*. In *Ocean State* the Blue Cross plan demanded most-favored-customer terms from physicians who also affiliated with a new health maintenance organization.
(HMO). The HMO's payment schedule to physicians contemplated sharing profits, if any. If the HMO was not profitable, its effective payment rate to physicians was lower than what Blue Cross paid. Under the most-favored-customer contracts, the HMO's physicians would then also have to accept lower payment from Blue Cross. The implication was clear, as was the result: hundreds of doctors terminated their affiliation with the HMO after Blue Cross insisted on these terms. But both the trial judge and the First Circuit were reluctant to label as monopolization, in violation of Section 2 of the Sherman Act, a tactic that, on its face, looked like it was designed to ensure low prices.

Federal and state enforcers have been actively scrutinizing the use of most-favored-customer clauses in health care contracts to discourage entry by raising rivals' costs. In the Delta Dental of Arizona case, for

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40 Ocean State withheld 20% of its physician fees until the end of the year, paying them to affiliated doctors only if the HMO's revenues exceeded costs.

41 Two anticompetitive scenarios seemed possible on the record recounted in the opinion below, although neither was endorsed by the trial court, which entered a judgment in favor of the Blue Cross plan notwithstanding a jury verdict for the HMO. First, Blue Cross may have achieved or preserved market power in health insurance by forcing the HMO below efficient scale. (At a small scale, an HMO may be unprofitable. Without the ability to direct a significant number of patients to providers, it cannot negotiate discounts from hospitals and doctors. Yet without low input prices, it cannot keep premiums low enough to attract a significant number of patients.) Alternatively, if Blue Cross were controlled by doctors, it may have protected market power in physician services by making it uneconomic for doctors to lower their fees to those patients participating in the HMO. See generally Baker, supra note 35, at 166–69.

42 See also Blue Cross & Blue Shield United of Wis. v. Marshfield Clinic, 65 F.3d 1406, 1415 (7th Cir. 1995) (Posner, C. J.) (assuming without analysis that a most-favored-customer clause in a medical clinic's contract with affiliated physicians would help the clinic bargain with doctors for low prices), cert. denied, 116 S. Ct. 1288 (1996); Kitsap Physicians Serv. v. Washington Dental Serv., 671 F. Supp. 1267 (W.D. Wash. 1987) (monopolization challenge to most-favored-customer clause in dental plan contract rejected 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); Madden v. California Dental Serv., 1986-1 Trade Cas. (CCH) ¶ 67,176 (Cal. S. Ct., 1986) (Cartwright Act challenge to price policies of CDS, including a nondiscrimination clause, rejected after rule of reason analysis; 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); Willamette Dental Group v. Oregon Dental Serv. Corp., 882 P.2d 637 (Or. App. 1994) (court rejects argument that most-favored-customer clauses should be per se legal, but finds no evidence that defendants' enforcement of such a clause unreasonably excluded competition).

example, the Justice Department and the State of Arizona challenged the enforcement of a most-favored-customer requirement by a health plan that had signed up 85 percent of the dentists in the state. The Justice Department recently filed a Sherman Act Section 1 complaint challenging a similar contract provision in the agreements between Delta Dental of Rhode Island, Rhode Island's largest dental insurer, and 90 percent of the dentists actively practicing in that state.44

V. DAMPENING COMPETITION

Vertical restraints can harm horizontal competition through a third route: by dampening competition directly. A party to a vertical restraint may appear to be imposing a burden on itself, limiting its own range of competitive options.45 That burden can constitute a commitment to take strategic action that will encourage anticompetitive cooperation or discourage vigorous competition by its horizontal rivals. In particular, in some industries,46 a commitment to conduct that appears less aggressive will lead rivals to see that their best interest is allowing industry prices to rise.47 The practices generating the commitments could have greater power when they are adopted by most or all the firms in an industry.

The State of Pennsylvania also considered these issues a few years ago, when Blue Cross proposed to negotiate most-favored-customer protection from hospitals. The state insurance commissioner decided to limit the duration of the provision because of concerns that it would harm competition. The Department of Justice contributed to that decision, with a letter describing the possible competitive problems. Letter from Anne K. Bingaman, Assistant Attorney General, Antitrust Division, U.S. Department of Justice, to Hon. Cynthia M. Maleski, Insurance Commissioner, Commonwealth of Pennsylvania (Sept. 7, 1993) (on file with the author).

44 Complaint, United States v. Delta Dental of R.I., No. 96-113 ML (D.R.I. filed Feb. 29, 1996). The complaint was filed in the same district court that decided the Ocean State case.


46 In these industries, decision variables are termed "strategic complements" in the technical literature. Where the decision variables of rivals are instead "strategic substitutes," vertical practices that represent commitments threatening more, rather than less, aggressive competition can support supracompetitive prices if, for example, they deter entry. Yet, an investment that makes a firm become more competitive when decision variables are strategic substitutes may instead generate lower industry prices, even when rivals respond by lessening their own competitive efforts out of fear of provoking a strong response from the firm that has become more aggressive. See Chaim Fershtman & Kenneth L. Judd, *Equilibrium Incentives in Oligopoly*, 77 AM. ECON. REV. 927 (1987).

47 For example, in many branded consumer products industries in which manufacturers compete for retailers and retailers compete for customers on the basis of price, a manufacturer might make itself seem less aggressive by adopting a distributional strategy of greater product differentiation. See Michael L. Katz, *Vertical Contractual Relations*, in 1 HANDBOOK
Most-favored-customer clauses can dampen competition by making firms less aggressive in settings in which rivals will respond by becoming less aggressive as well. A firm that introduces a most-favored-customer clause commits to being less aggressive by obligating itself to pay a substantial penalty if it lowers price to any individual customer. The reason: if it lowers price to one, it must lower prices to all its customers. And if its rivals would respond by becoming less aggressive themselves, some firms will find it profitable to make this commitment. This dynamic may be most likely, and the resulting price increase may likely be the greatest, when the number of firms is small, when higher prices would not lead to new entry, and when exogenous shifts in cost or demand that would tend to lead to lower prices are unlikely.

Although the "dampening competition" and "facilitating practices" intuitions regarding the anticompetitive potential of most-favored-customer provisions are similar, they are not identical. For example, if buyers are similar, a commitment by a seller to treat buyers the same may not reduce seller incentives to discount in the static ("dampening competition") story. Yet, such a commitment could facilitate coordination in the repeated game ("facilitating practices") story when a retrospective most-favored-customer clause requires a discounting seller to give rebates to earlier buyers.

Yet, even if entry is easy, so that firms do not earn monopoly profits, the widespread adoption of most-favored-customer policies can lead to prices above the competitive level (and result in excessive entry). Aaron S. Edlin, Do Guaranteed-Low-Price Policies Guarantee High Prices? How Price Matching Challenges Antitrust (Sept. 8, 1995) (unpublished manuscript, on file with the author). The FTC has challenged trade association rules that generate high prices and inefficient entry, even though association members do not earn excessive profits. See generally James L. Langenfeld & Louis Silvia, Federal Trade Commission Horizontal Restraints Cases: An Economic Perspective, 61 ANTITRUST L.J. 653, 665–78 (1993) (raising own costs theory cases).

Cooper, supra note 49, at 386–87.
This effect may have been present in the industry situation of the FTC's Ethyl case, although that theory was not litigated. There were only four firms; the industry was declining, so entry was unlikely; and demand was reasonably predictable. Only the top two firms routinely relied on most-favored-customer clauses. The Commission found that unanimous use of these clauses was not necessary to produce an anticompetitive effect. While the court of appeals disagreed with the Commission's legal conclusion that unilateral adoption of the challenged practices would support a finding of liability, the court was not asked to consider the dampening competition theory.

The dampening competition theory represents something of a frontier for antitrust enforcement. The theory makes sense, but enforcers and courts have yet to confront the litigation challenges that will arise in demonstrating that a commitment to less-aggressive behavior has led, or will likely lead, rivals to act likewise. Indeed, to the extent that the "dampening competition" scenario is a story about unilateral conduct by a firm that is not a monopolist, issues about the reach of the antitrust laws may arise.

VI. EFFICIENCIES

The touchstone of the Chicago School's advice to treat vertical restraints leniently is the potential for creating procompetitive efficiencies. Two types of efficiencies are frequently cited for most-favored-customer


53 Experience may well lead business rivals to understand each others' likely reactions, but enforcers and courts may find the explanations harder to understand.

54 Sherman Act § 1 prohibits anticompetitive agreements and does not reach unilateral conduct. Sherman Act § 2, which addresses monopolization, does not easily reach unilateral conduct in an oligopoly setting. Cf. United States v. American Airlines, Inc., 743 F.2d 1114 (5th Cir. 1984) (attempted monopolization found when one firm expressly solicited a price increase from its only rival), cert. dismissed, 474 U.S. 1001 (1985). While FTC Act § 5 may extend beyond the Sherman Act, it may be a challenge to attack unilateral conduct by oligopolists under this statute as well. See E.I. du Pont de Nemours & Co. v. FTC, 729 F.2d 128 (2d Cir. 1984); see generally Baker, supra note 12, at 210–13.

55 There are many efficiencies potentially available from vertical practices that numerous court opinions have found significant. For example, vertical combinations can avoid the costs of successive marginalization in a chain of monopolies. Vertical contracts can align the incentives among sellers of complements, for example, by discouraging dealer free riding on the promotional incentives of the manufacturer or other dealers. Vertical combinations can avoid inefficient input substitution, for example, by downstream firms dealing with upstream firms exercising some market power. The use of vertical practices to discriminate in price is also potentially efficiency enhancing, although price discrimination could harm competition, too. And other efficiencies that are commonly cited are lowering buyers' search costs and avoiding opportunism, holdup, and agency problems.
treatment. Yet, the more common story of the two appears the less convincing upon careful analysis.

It seems obvious to many that a most-favored-customer provision helps a buyer lower its costs by purchasing inputs for less. In a recent decision Judge Posner described such contractual clauses as "standard devices by which buyers try to bargain for low prices" and dismissed the anticompetitive theory that a most-favored-customer clause could set a price floor for physician prices in the instant case as "an ingenious but perverse argument." The First Circuit found it "hard to disagree" with a district court's view that such clauses are "what competition should be all about." And former FTC Chairman James Miller III argued in Ethyl that most-favored-customer clauses must be procompetitive because buyers appear to want them.

What seems obvious at first glance can look different upon reflection, however. The greater the fraction of buyers who obtain most-favored-customer protection, and the larger their size, the less plausible it becomes that these contractual provisions will help buyers obtain inputs for less.

The best case for crediting this efficiency justification comes in a market with many buyers, in which it is costly for buyers to shop for a low price. In this setting uninformed buyers may pay more than the informed. An uninformed buyer able to bargain for most-favored-customer status might indeed expect to obtain the benefits of becoming informed without expensive search. If some other informed buyer can convince the seller to lower price to meet the competition, the most-favored-customer can free ride on that buyer's bargaining effort and so obtain a low price without price shopping itself. Thus, if a small buyer were to obtain most-favored-customer status, and if it expects to make multiple future purchases, its transactions costs of future search might be lowered a

Commentary also considers the possibility that a risk-averse buyer might seek a most-favored-customer clause as insurance protection against certain contingencies. The "significant limitations to the size of this benefit" are discussed in Salop, supra note 12, at 265, 284. Another story that appears unlikely to provide a legitimate business justification for most-favored-customer provisions is the suggestion that buyers may seek most-favored-customer status in order to ensure that rival firms do not obtain inputs for less. This is a peculiar efficiency justification, as it attempts to make a virtue out of the lessening of competition among buyers.

Blue Cross & Blue Shield United of Wis. v. Marshfield Clinic, 65 F.3d 1406, 1415 (7th Cir. 1995) (Posner, C. J.) (medical clinic's most-favored-customer clause in contracts with affiliated physicians found insufficient to support the inference of an anticompetitive vertical agreement absent further evidence), cert. denied, 116 S. Ct. 1288 (1996).


great deal with little offsetting harm to competition. Accordingly, it can reasonably expect to buy inputs for less, as this efficiency justification would have it.

But once one uninformed buyer discovers this way of shopping at low cost, other buyers seeking to minimize their own costs may be led by competition to seek most-favored-customer status as well. As Chairman Miller observed, the buyers will appear to want these contractual provisions. If only a few small buyers obtain most-favored-customer status, perhaps their input prices would fall without much of an increase in the prices paid by other customers and we might credit the efficiency justification. But if, through buyer competition or seller initiative, most-favored-customer provisions proliferate, these clauses may no longer help the formerly uninformed buyers obtain the product for less. The reason: prices to informed customers will tend to rise as sellers come to see more cost than benefit from discounting. Hence, despite the currency of the "vertical good" slogan, it is not surprising to find the Justice Department alleging, in its Delta Dental of Rhode Island litigation, that the most-favored-customer clauses at issue have "not generated any meaningful savings or other procompetitive benefits" when in widespread use.

There is nothing perverse, to use Judge Posner's colorful phrase, about the idea that buyer competition might reduce buyer benefits from some seller practice. Indeed, GTE Sylvania, a Chicago School landmark, teaches this. When buyers learn about a product's features from a full-service dealer and then make their purchase from a no-frills discounter, such buyer free riding may drive the full-service dealers out of business. If the buyers are firms that sell in turn to consumers, they may be led to free ride by competitive pressure to keep costs low, even if they know that they will be harmed in the long run by the disappearance of the

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60 A large buyer is more likely to be informed and thus less likely to have this cost-reducing motive for seeking most-favored-customer status.

61 Under such circumstances it is hard to see why buyers would want to bear the cost of becoming informed. But without informed buyers, sellers have little incentive to discount. This is another way of expressing an intuition behind the "dampening competition" story.

62 Complaint at ¶ 32, United States v. Delta Dental of R.I., No. 96-113 ML, (D.R.I. filed Feb. 29, 1996). The complaint further alleges that the defendant "has not considered the [most-favored-customer] clause a cost-savings device, has not sought to calculate any savings from its application, and has not factored any such savings into determining the premiums it charges its customers."

63 Blue Cross & Blue Shield United of Wis. v. Marshfield Clinic, 65 F.3d 1406, 1415 (7th Cir. 1995) (Posner, C. J.) (terming the theory that a most-favored-customer clause sought by buyers could harm buyers by putting a floor under seller prices "an ingenious but perverse argument"), cert. denied, 116 S. Ct. 1288 (1996).

full-service dealers. Similarly, buyer competition to obtain most-favored-customer protection, in the end, can cost buyers as a group. Nor is there anything perverse about the idea that buyers might compete to sign a contractual provision that ends up hurting them. When a monopolist asks its customers to agree not to deal with potential competitors in order to deter entry by keeping entrants below efficient scale, for example, buyers may compete to sign in order to ensure that they receive the monopolist's product—even when the buyers know that all would be better off if none were to agree. In short, when buyers desire something individually, one cannot assume, as these courts have done, that it is in the buyers' interest collectively to obtain it.

A second efficiency story is also frequently cited. This story applies when firms must write long-term contracts with their customers knowing that supply and demand conditions might change unpredictably. For example, natural gas pipelines must contract with well owners without knowing the future demand for gas. A long-term fixed-price contract is unattractive because it would not lead production to respond efficiently to changes in demand. Yet, the well owners would not be willing to agree to renegotiate the price every year because doing so puts them in a difficult bargaining position: once they drill, they would find themselves at the mercy of a single pipeline buyer in future years. One solution is to sign a long-term contract that contemplates annual price changes, but to constrain the pipeline's ability to exploit individual well owners with a most-favored-customer provision. This efficiency explanation would not apply to every use of a most-favored-customer clause, but, when plausible, it must be balanced against the harm to competition under the rule of reason.

VII. CONCLUSION

Unlike what happened in Animal Farm, we will not end up returning to the past. No one proposes making most-favored-customer clauses

Nor can one assume that a provision desired by buyers, who may exercise some market power in the resale market, is necessarily in the interest of the end-use consumers to whom the buyers sell in turn.
Moreover, well owners may also worry about the buyer's incentive to sign a contract with one seller, then take advantage of that fact by giving another seller more favorable terms. Under some circumstances, such opportunism would allow the buyer and second seller to appropriate rents that would otherwise go to the first seller.
In applying the rule of reason it is also necessary to ask whether the parties to the restraint could reasonably have achieved the efficiencies some other way, at less risk to
illegal per se. Indeed, enforcers seeking to address the anticompetitive potential of these contractual provisions must grapple with the hesitation of some judges to accept the economic teaching that a vertical relationship including a promise to reduce prices could have the overall effect of increasing them and with the often difficult task of untangling efficiencies from harm.\footnote{It is well established that in evaluating the reasonableness of any vertical practice, both its anticompetitive and efficiency-enhancing potential must be considered. If the “vertical good, horizontal bad” slogan carries with it a danger for antitrust’s future, it goes the other way—that antitrust might develop new per se rules of legality that ignore the possibility that vertical restraints can harm competition through their horizontal effects.\footnote{Cf. Easterbrook, supra note 3 (proposing a series of per se exemptions); Workable Antitrust Policy, 84 Mich. L. Rev. 1696 (1986) (contending that models based on analysis of strategic behavior are not useful for the law because they are too difficult).}

\footnote{Cf. Easterbrook, supra note 3 (proposing a series of per se exemptions); Workable Antitrust Policy, 84 Mich. L. Rev. 1696 (1986) (contending that models based on analysis of strategic behavior are not useful for the law because they are too difficult).}