MAYER • BROWN

Bulletin
October 2010

Insurance Industry Group:
Global Corporate Insurance & Regulatory Bulletin

US - US Department of Justice challenges use by Blue Cross of most favored nation contracts

The Antitrust Division of the US Department of Justice (**"DOJ"**) has challenged the use of "most favored nation" clauses by an alleged dominant health insurer, contending that contracts guaranteeing a buyer the lowest price may exclude competition.

Most favored nation (**"MFN"**) contracts require a seller to give a buyer the seller's lowest price. They are a common tool for negotiating lower prices and, as such, are generally considered procompetitive and lawful under the antitrust laws.

However, when a powerful buyer uses MFN contracts with most or all of the sellers in a given market, the result, at least theoretically, can be less price competition and higher prices. If that buyer asks these sellers to agree that they will charge competing buyers more, the resulting "MFN Plus" contracts may exclude the buyer's competitors and reduce competition. In that extreme case, regulators have argued that MFNs violate state and federal antitrust laws.

The Antitrust Division and the Michigan Attorney General are employing this theory in their lawsuit challenging the use of MFN and MFN Plus agreements by Blue Cross Blue Shield of Michigan (**"Blue Cross"**). The key allegations of the complaint are that:

- Blue Cross is the largest seller of commercial health insurance in Michigan (with 60 - 80 percent of commercially insured lives in some parts of the state), and is the largest non-governmental purchaser of hospital services in Michigan;
- Blue Cross has MFN agreements with at least 70 of Michigan's 131 general acute care hospitals, which operate more than 40 percent of Michigan's acute care hospital beds;
- Blue Cross has MFN Plus agreements with 22 hospitals and 45 percent of Michigan's tertiary care hospital beds. They require some hospitals to charge Blue Cross' competitors 40 percent more than they charge Blue Cross;
- Blue Cross pays hospitals higher prices in exchange for MFNs. Therefore, MFNs result in higher prices to both Blue Cross and its competitors;
- By forcing hospitals to charge Blue Cross' competitors higher prices, MFNs have prevented entry or expansion by those competitors, which helps Blue Cross to maintain its market power;
- By increasing hospital prices and reducing health insurance competition, MFNs led to higher health insurance prices and injured consumers; and
- Blue Cross' MFNs have no procompetitive benefits that would outweigh these anticompetitive effects. According to the complaint, *"[t]he MFNs have not led, and likely will not lead, to lower hospital prices for Blue Cross or other insurers. On no occasion has a Blue Cross MFN resulted in Blue Cross' paying less for hospital services."*

The complaint also charges that Blue Cross' MFNs are unreasonable restraints of trade. MFNs are commonly used in many industries and they are usually legal, because they often result in lower prices by requiring sellers to expand their discounting. The question is, when do MFNs cross the line? The DOJ's lawsuit suggests that MFNs are anticompetitive and illegal when buyers are so large and the demanded discount is so steep that the MFNs effectively prevent sellers from lowering their prices or selling to non-dominant buyers.

Even under the DOJ's theory, most MFNs will be legal because most buyers are not large enough to be able to exercise excessive control in the marketplace. For very large players, however, the DOJ's lawsuit serves to remind buyers with high market shares of the antitrust risks of MFNs.

Mitchell D. Raup and Robert E. Bloch

UK – Solvency II update

All of a sudden Solvency II does not appear too far off. True, the London Olympics will have come and gone before the 1 January 2013 deadline for implementation into EU Member States of the Solvency II Directive has been reached. However, now that many firms are busy responding to the Quantitive Impact Study 5, the final such impact study organised by CEIOPS, Solvency II seems that much more real and imminent.

To the extent they have not already focussed on these issues, (re)insurers are now fully taking on board the implications for them of Solvency II, including, amongst other matters, the impact for them given the corporate structure of their groups, their capital structures, the products they underwrite, and their corporate governance structure. Of particular interest to some (re)insurers is the extent to which hybrid and contingent capital will classify as tier 1 capital for the purposes of the new solvency capital regime to be introduced by Solvency II, tier 1 being the highest quality capital.

For those (re)insurers based outside the EU, but which have EU subsidiaries or which are part of a EU group, the equivalence assessments to be organised by CEIOPS will be keenly watched. Bermuda and Switzerland have made it provisionally into the first wave, as has (perhaps rather surprisingly) the US, but only with regard to group solvency and reinsurance. If a (re)insurer is based in a jurisdiction which is ultimately deemed to have an equivalent solvency regime to Solvency II, then all well and good. For those (re)insurers which do not, it is unclear what the potential implications might be but include the EU based member(s) of the group being required to post higher capital.

Solvency II will no doubt herald challenges for many firms. However, with any challenges there are also opportunities. There is a sense that many firms are now starting to strategically position themselves to take advantage of such opportunities.

Martin Mankabady

UK – Speech by the FSA on the future approach to the regulation of mutuals

On 19 October 2010, Ken Hogg, the director of the FSA's insurance sector, delivered a speech to the Association of Financial Mutuals regarding a strategic assessment of the FSA's future approach to the regulation of mutuals.

The speech set out to discuss the evolving environment that mutuals need to respond to and how mutuals can continue to operate in the best interests of their members. Ken Hogg noted most insurance mutuals had successfully navigated the recent wider financial challenges to the financial sector and that they appear to have grown relative to their peers.

Ken Hogg stated that *"I believe in the mutual proposition – existing solely to benefit customers, rather than shareholders, theoretically offers an in-built advantage. The absence of dividend payments to external parties allows you to concentrate on running the business in a way that best meets the needs of your members."* However, the speech then highlighted the following specific challenges faced by insurance mutuals:

1. **With-profits mutuals** – the history of the recent FSA consultation on this issue was set out and how the FSA is in the process of writing to firms on their individual positions. As part of this process, the FSA is setting out its expectations for distributing surplus in a with-profits mutual and treating with-profits policyholders fairly. Ken Hogg stressed that it was not an attempt to regulate the mutual sector away;
2. **With-profits** – it was noted that treating with-profits policyholders fairly is arguably the key conduct issue facing not just mutuals but the life sector today. The FSA released its finding of its review into the with-profits regime in June and noted that a significant number of firms are *"not adequately demonstrating the practices we expect from a well-run with profits business."* The speech went on to discuss what is expected of firms and the steps the FSA is exploring to strengthen rules in this area;
3. **Solvency II** – the speech highlighted that Solvency II will affect all insurers, including smaller firms, and that the FSA has formed a specialist Smaller Insurers Team to aid firms find the right approach to implement the regime. Ken Hogg then discussed the Quantitive Impact Study Number 5 (**"QIS5"**) and noted that the QIS5 exercise submissions are due at the end of the month for solo entities, while group submissions are due by 15 November. The importance of this feedback in determining the successful negotiation of the regime as a whole was stressed and firms were encouraged to participate on a full and realistic basis; and
4. **Retail Distribution Review** (**"RDR"**) – significant changes regarding conduct, charging and professionalism will be introduced by the new rules on the RDR in 2012. The FSA takes the view that all investments (with very limited exemptions) should be subject to the RDR rules. All insurers will need to consider the impact of these changes on their business models.

Lastly, recognising that the FSA will be replaced by a new subsidiary of the Bank of England and a new Consumer Protection and Markets Authority in 2012, it was stated that the FSA *"aims to begin phasing into a shadow structure during quarter one next year, but the FSA's objectives will continue as they stand today until the new regulatory bodies take over. Which means you still have the same responsibilities to the FSA, and you should carry on dealing with your current contacts until otherwise notified."*

To view the full text of Ken Hogg's speech, please click here.

Ian Slingsby

If you have any query in connection with anything in this Bulletin, please do not hesitate to get in touch with your usual Mayer Brown contact or one of the contacts referred to below.

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October 2010