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ATTORNEY GENERAL OPINION NO. 89-74

Winston Barton, Secretary
Social and Rehabilitation Services
Docking State Office Bldg., 6th Floor
Topeka, Kansas 66612

RE: Commerce and Trade -- Monopolies and Combinations in Restraint of Trade -- Discrimination in Price; Discrimination; State Drug Bidding Program; Participation by Other States

Monopolies and Unfair Trade -- Restraint of Trade; General Provisions -- Unfair Trade

Synopsis: Although the proposed drug bid program raises serious antitrust questions, it is our opinion that it does not represent a per se violation of antitrust laws. Under a rule of reason analysis the proposed bid program may survive an antitrust challenge. The proposed program should be conducted in a manner that renders the market more, rather than less, competitive and does not allow one manufacturer to unlawfully possess market power to the exclusion of its competitors. Cited herein: 15 U.S.C. § 1-27.

* * *

Dear Secretary Barton:

You request our opinion concerning a proposed pharmaceutical bid program and extension of that bid program to other states

wishing to participate. You specifically ask whether the bid process and the extension of the process to other states violates antitrust laws.

Pursuant to conversations with and correspondence from the Department of Social and Rehabilitation Services (SRS) and its legal staff, we understand that the bid process works as follows: SRS solicits and accepts separate bids on each of certain specific drugs from any and all manufacturers of that drug; each drug is separately bid; bids will be accepted on the generic equivalent as well as the therapeutic version of each drug; the manufacturer who submits the winning bid on each drug will become the only manufacturer of that drug that SRS will reimburse (when that manufacturer's brand of the drug is used by Medicaid/ MediKan recipients); only one manufacturer for each type of drug will be so designated and SRS will not reimburse for brands of the same drug manufactured by unsuccessful bidders; when a participating provider-pharmacist dispenses the designated drug to a Medicaid/MediKan recipient, that Medicaid/MediKan recipient must pay a flat co-payment fee to the pharmacist; the provider-pharmacist then submits a claim to SRS; SRS reimburses the participating provider-pharmacist for the costs of the designated drug that the co-payment fee did not cover; SRS then takes all the claims it has received from participating provider-pharmacists and submits those claims and amounts to the bid winner for each drug; the winning drug manufacturer then gives a rebate to SRS for the difference between the amount SRS paid to the provider-pharmacist and the amount of the winning bid price.

For example: (1) the winning bid is accepted from a manufacturer at $1.00 per unit for drug Z; (2) drug Z is sold by the manufacturer to a participating provider-pharmacist for $2.50 per unit; (3) a Medicaid/MediKan recipient buys drug Z from that participating provider-pharmacist, who charges a retail price for the drug of $5.00 per unit; (4) the Medicaid/MediKan patient pays the required flat fee co-payment of .50 cents per unit; (5) the participating provider-pharmacist submits a claim for the unpaid cost of the drug, $4.50 or $2.00 (dependent upon whether SRS reimburses wholesale or retail costs); (6) SRS submits a claim to the winning manufacturer for the difference between the provider-pharmacist claim ($4.50 or $2.00) and the winning bid ($1.00), $3.50 or $1.00. The amount paid from the winning manufacturer to the state is characterized as a rebate. The rebate paid to SRS from the winning bid manufacturer will be paid to the state general fund.

SRS believes this bid program will result in cost containment for the state and has used this drug bid procedure for almost two years. Approximately 95% of all Kansas pharmacies participate in supplying drugs to Medicaid/MediKan recipients.

Certain unavailable information may have a significant impact upon the permissibility of the proposed bid program: details concerning geographic market; the relevant market share and market power; the intentions of the participating states or other entities; the exact nature of the interstate cooperation agreement; each participating state's enabling legislation; and the length of time the bid and the interstate agreement will be in effect. As we do not have specific information concerning these and other possible fact issues, this opinion is general in nature and is limited to a discussion of antitrust principles as they apply to the facts currently before us. It is hoped that the discussion contained herein will provide guidance and allow SRS to conduct the bid program procedure in accordance with and mindful of antitrust principles.

You state that the details and terms of a multi-state program have not been established. Because many states are interested in participating and because the successful bid winner's brand could become the only brand that states will reimburse Medicaid recipients for, the successful bid winner could significantly increase or assure itself of a large market for each drug. The geographic market, market share and relevant market for each successful bidder cannot be ascertained at this point. Nevertheless, it is obvious that should a significant number of states participate nonsuccessful bidders could potentially lose or be precluded from obtaining a significant amount of business. Nonsuccessful bidders would be able to sell their product to pharmacies wishing to stock their brands and pharmacists remain able to sell any brand of drug to the general public or to state and federal aid recipients, but any Medicaid recipient wishing to have the state pay drug costs will have to purchase the approved brand. Thus, pharmacists have a strong incentive to stock adequate quantities of that brand and Medicaid recipients are extremely likely to request that brand.

The general purpose of antitrust laws is the subject of much discussion between legal authority and economists. Broadly and generally stated, antitrust laws seek to promote, encourage and maintain competition and to prevent harmful

monopolies. See generally City of Chanute, Kansas v. Williams Natural Gas Company, 678 F.Supp. 1517 (Kan. 1988); 54 Am.Jur.2d Monopolies § 1 (1971); 58 C.J.S. Monopolies § 15 (1948).

The Sherman Act, 15 U.S.C. §§ 1-7, forbids monopolizing trade in broad and general terms. Violation requires the possession of monopoly power in a relevant market and the knowing intentional acquisition of that power by two or more conspirators. McKenzie v. Mercy Hospital of Independence, Kansas, 854 F.2d 365, 367 (10th Cir. 1988). The Clayton Act, 15 U.S.C. §§ 12-27, prohibits specific anticompetitive behavior outside the broad scope of the Sherman Act. See generally 54 Am.Jur.2d Monopolies § 111 (1971). The Clayton Act seeks to promote competition through protection of viable, small and locally owned businesses. Ford Motor Company v. United States, 405 U.S. 562, 92 S.Ct. 1142, 31 L.Ed.2d 492 (1972). The Robinson-Patman Act was enacted to strengthen sections of the Clayton Act and seeks to protect small businesses unable to purchase in quantity. See FTC v. Morton Salt, 334 U.S. 37, 68 S.Ct. 822, 92 L.Ed. 1196 (1948). State antitrust laws vary in scope and application and each participating state must examine its own antitrust laws.

In order to determine whether a particular action violates antitrust laws it becomes necessary to characterize the questioned or challenged activity. Antitrust principles look at two types of anticompetitive relationships, horizontal and vertical. Horizontal restraints are arrangements between entities operating on the same level; manufacturers, suppliers or buyers. The proposed interstate drug bidding arrangement could be characterized as a horizontal arrangement between two entities operating on the same level, i.e. states as buyers or insurers. Practices that may result in a prohibited horizontal restraint include price fixing, boycotts of a product, manufacturer or customer, and mergers resulting in a monopoly. See Vakerics "Antitrust Basics", pp. 6-1 through 6-49 (1988). Vertical restraints are conditions or restrictions agreed to, imposed or directed at entities operating at different levels. Vertical relationships which may exist in the proposed drug bidding program include the relationship between the states and the drug manufacturers, the states and the provider-pharmacists, the states and the general public, and the states and the benefit recipients. Vertical restraints include dictating resale prices, Arizona v. Maricopa County Medical Society, 457 U.S. 332, 102 S.Ct. 2466, 73 L.Ed.2d 48 (1982), or non-price restraints such as

territorial or customer restrictions, price discrimination, exclusive dealing or requirement contracts, and tie-ins. Antitrust restraints that may be implicated by the proposed bid program include price fixing, boycott, price discrimination, and requirement contract considerations.

Price fixing restraints are traditionally considered per se illegal, while non-price restraints are more often subject to the rule of reason. Courts currently evidence a reluctance to impose a per se rule unless there is clear evidence of intent to monopolize or otherwise hinder helpful competition. Rather, courts now frequently use a rule of reason analysis to determine antitrust violations. Under the "rule of reason" the legality of restraints on trade is determined by weighing all the factors in a case, such as the history of the restraint, the evil believed to exist, the reason for adopting the particular remedy and the purpose or ends thought to be attained. Blacks Law Dictionary 1196 (5th ed. 1979).

Generally, price fixing is any combination formed for the purpose and effect of raising, depressing, pegging, or stabilizing the price of a commodity. United States v. Socony Vacuum Oil Company, 310 U.S. 150, 223, 60 S.Ct. 811, 84 L.Ed. 1129 (1940). Sharing information on prices may also result in improper price fixing. See United States v. Container Corporation of America, 393 U.S. 333, 89 S.Ct. 510, 21 L.Ed.2d 526 (1969). However, where third parties are not affected by the price fixing scheme, a rule of reason will usually be applied. Medical Arts Pharmacy v. Blue Cross and Blue Shield, 675 F.2d 502 (2d Cir. 1982). See generally Hjelmfelt, "Antitrust and Regulated Industries", pp. 42-45 (1985).

The proposed bid program does not appear to be a vertical or horizontal price fixing scheme. The states are a large buyer or buyers seeking the lowest price on a commodity. If the states were considered competitors there could be a possible horizontal price fixing charge against them. However, the proposed drug bid program does not dictate and will not automatically affect the price charged to and paid by participating provider-pharmacists to the drug manufacturer. Moreover, the resale price to the general public or benefit recipients is not dictated by the drug bidding program. The bid reflects the price at which each manufacturer independently agrees to ultimately provide the drugs to the state or states. The states ask that each manufacturer fix its own individual price, and the states remain free to either accept or reject each bid. Thus, the price is fixed by the

manufacturer not by the states, and it is therefore unlikely that a price fixing claim would succeed.

Another possible antitrust principle that may be involved concerns boycotts. A boycott is "a method of pressuring a party . . . by withholding or enlisting others to withhold patronage or services." St. Paul Fire and Marine Insurance Company v. Barry, 438 U.S. 531, 541, 98 S.Ct. 2923, 57 L.Ed.2d 932 (1978). A boycott may be illegal if it impermissibly increases market strength through concerted efforts.

The Fifth Circuit held that a per se rule would be applied to boycotts only when there was evidence of an anticompetitive motive, a commercial purpose rather an industry self-regulation, and coercive economic pressure. St. Bernard General Hospital v. Hospital Service Association, 712 F.2d 978 (5th Cir. 1983). When there is no evidence of exclusionary anticompetitive purpose, intent or conduct, a rule of reason generally applies. American Medical Association v. United States, 130 F.2d 233 (D.C. Cir. 1942), affd. 317 U.S. 519, 63 S.Ct. 326, 89 L.Ed. 434 (1943).

In the proposed drug bid program there is no obvious evidence that the states or the provider-pharmacists are getting together and refusing to deal with certain drug manufacturers for an anticompetitive purpose. The articulated reason for encouraging use of the successful bidder's brand by the states is to keep costs paid for these drugs at a minimum. The intent to contain costs is not a refusal to deal but rather an intent to obtain the most competitive price and thus to promote and encourage competition among suppliers.

Using the rule of reason analysis, cost containment represents a valid competitive purpose. Reasonable contract terms and free and open access to the bidding process will lessen the possibility of a successful boycott claim against the states. However, the fact that only one manufacturer will be approved for each drug, even if more than one drug manufacturer submits the same low bid, undermines this cost containment argument and purpose. Rather, the purpose of accepting only one manufacturer appears to be either administrative ease or an effort to increase the bargaining power of the states. We strongly suggest that price containment purposes remain the rationale and primary focus of the drug bidding program. Each and every manufacturer of a required drug should be given an equal opportunity and be encouraged to compete for this

business. No intent to exercise exclusionary anticompetitive pressure should be evidenced or contemplated by participating states. If the states are satisfied that the bid price of more than one brand is the lowest price they can expect or get, it may be advisable to award the business to more than one manufacturer.

The proposed drug bid program also resembles a requirement contract, which is defined as "[a contract in which] one agrees to buy, for sufficient consideration, all the merchandise of a designated type which the buyer may require for use . . . one in which a party agrees to supply a specific good which another party may need during a certain period for an agreed price." Blacks Law Dictionary 1172 (5th ed. 1979). In the proposed bid program, the state agrees to ultimately pay the price of any drug used by a benefit recipient if that recipient uses the brand of a successful bidder. Thus, the insurer-state agrees to purchase all drugs of a particular type that it requires from one manufacturer. Requirement contracts are examples of non-price vertical restraints. The risk of antitrust problems increase in relation to the relative market power created by a requirements contract. Vakerics, "Antitrust Principles" § 7.1 (1988).

A requirement contract may violate antitrust law if an arrangement substantially lessens interbrand competition and competitors are seriously hindered or foreclosed from an available market for a significant period of time. See Tampa Electric Company v. Nashville Coal Company, 365 U.S. 320, 81 S.Ct. 623, 5 L.Ed.2d 580 (1961); Standard Oil Company of California v. United States, 337 U.S. 293, 69 S.Ct. 1051, 93 L.Ed. 1371 (1949). Several federal courts have examined the concept of exclusive dealing or requirement contracts in the health care field. These cases evidence a willingness to permit these arrangements if competition is not substantially lessened or a relevant market monopolized. See DosSantos v. Columbus-Cuneo-Cabrini Medical Center, 684 F.2d 1346 (7th Cir. 1982); White and White, Inc. v. American Hospital Supply Corp., 540 F.Supp. 951 (Mich. 1982), rev'd on other grnds, 723 F.2d 495 (6th Cir. 1983).

In Medical Arts Pharmacy of Stanford, Inc. v. Blue Cross & Blue Shield of Conn., Inc., 518 F.Supp. 1100 (D. Conn. 1981), aff'd per curiam, 675 F.2d 502 (2d Cir. 1982), the district court found that the defendant insurer was the purchaser even though the insureds actually used and obtained the drug. The second circuit court seems to imply that if

market share is large enough there may be sufficient monopsony power exercised by one large buyer to sustain a competitive seller's claim that a pharmaceutical purchasing agreement obtained without collusion could be anticompetitive and a violation of the Sherman Act. See also Sutliff, Inc. v. Donovan Cos., 727 F.2d 648, 655 (7th Cir. 1984); Pan-Islamic Trade Corp. v. Exxon Corp., 632 F.2d 539, 547 (5th Cir. 1980); Quality Auto Body, Inc. v. Allstate Ins. Co., 660 F.2d 1195 (7th Cir. 1981) cert. den. 455 U.S. 1020 (1982). (Monopsony; "a condition of the market in which there is but one buyer for a particular commodity." Blacks Law Dictionary 908 (5th ed. 1979).)

Most joint buying arrangements have potential efficiencies which remove them from per se violation of antitrust laws. Under the rule of reason, agreements or combinations may be prohibited if they prejudice the public interest by unduly restricting competition or obstructing the course of trade. Reazin v. Blue Cross and Blue Shield of Kansas, Inc., 635 F.Supp. 1287 (Kan. 1986). In a 1987 paper presented to the National Health Lawyers Association Conference on Antitrust Law in the Health Care Field, Michael L. Denger stated that the Federal Trade Commission considers government insurance programs to be purchasers of health care services, thus making such programs part of a relevant market. However, Mr. Denger noted that membership in a prepaid prescription drug organization making up less than 30 percent of the retail pharmaceutical sales in a geographic market will probably not be challenged by the Justice Department. Other authorities believe obtaining more than 17 to 20 percent of a relevant or geographic market will result in an antitrust law violation. It therefore becomes necessary to determine the geographic market for each drug and of each manufacturer in the bid program and what percentage of the relevant market will be given to the winning manufacturer as a result of the proposed bid program. This requires detailed factual information concerning the amount of a particular type of drug sold nationally, and in each participating state or area, and what percentage of those sales could, pursuant to this bid program, be given exclusively to the winning manufacturer. When the market share does not confer market power, anticompetitive claims become less plausible. However, antitrust laws may prohibit the proposed bid program if it allows one manufacturer to obtain an unusually large share of a relevant market, thus essentially reducing or precluding all helpful competition. The length of time that the agreement will allow the winning manufacturer to obtain this market share will also be relevant.

Unless a substantial share of a relevant market is foreclosed for a significant period of time, or unless there is an anticompetitive purpose or intent, an exclusive dealing or requirements contract will generally not present antitrust problems under a rule of reason analysis. Vakerics at § 7.09. We therefore suggest that any agreement entered into between the states or between an individual state and a pharmaceutical manufacturer be for a limited time period and initially allow every manufacturer equal access to this particular market. Once the proposed bid program and the degree of state participation is determined, an analysis of the pertinent market data can be made. It is our opinion that, under the rule of reason, unless there is an anticompetitive intent or a large percentage of the entire market for each particular drug will be foreclosed to other manufacturers for a significant period of time, the proposed drug bid program does not represent impermissible large scale buying or a prohibited requirement contract.

15 U.S.C. § 13(a) discusses price discrimination. Most recent price discrimination cases do not involve governmental prosecution, but rather, are brought by parties allegedly harmed by the behavior. Illegal price discrimination may be alleged by nonparticipating states, pharmaceutical companies who lose business, or members of the public or provider-pharmacists who do not receive the same price. Without specific information we cannot discuss the merits or standing of such challenges. Generally, any unwarranted price favoritism shown by suppliers to larger purchases not based on permissible justifications or defenses may be a violation of antitrust laws. See Gianelli Distributing Company v. Beck and Company, 172 Cal.App.3rd 120, 219 Cal. Rptr. 230 (1985); Jefferson County Pharmaceutical Association Inc. v. Abbbott Laboratories, 460 U.S. 150, 103 S.Ct. 1011, 74 L.Ed.2d 882 (1983); Portland Retail Drug Association v. Kaiser Foundation Health Plan, 662 F.2d 641 (9th Cir. 1981).

The price paid by the pharmacist and the patient-purchaser for each particular drug is not necessarily altered by the drug bid program. Rather, the drug bid program establishes the ultimate price that the state insurer will pay for the drug. The same drug (with the same shipping, manufacturing and other associated costs) will ultimately be made available to the state at a potentially different and lower price than the price paid by others. The provider-pharmacist will not necessarily be charged less for the drugs used by

Medicaid/MediKan recipients. Ultimately, however, others may pay more for the same drug.

15 U.S.C. § 13b permits rebates from a cooperative association to its members, producers, or consumers, but rebates may not be used to violate price discrimination laws. See Bargain Car Wash, Inc. v. Standard Oil Company, 466 F.2d 1163 (7th Cir. 1972). The fact that the states are paying a potentially lower price for the same drugs may not represent price discrimination if a valid defense can be claimed. The defendant (often the supplier) in an antitrust case can rebut a claim of illegal price discrimination by showing that there are lower costs in serving this particular purchaser, changing conditions allow a change in price, or competition is met and justifies the lower price. See Hansen, "Robinson-Patman Law", LI Fordham L. Rev. 113 (1983).

Prices set or obtained by governmental entities may not represent price discrimination if the activity is of a governmental nature. Generally, the Robinson-Patman Act does not apply to sales made to the government. See Gaslight Company of Columbus v. Georgia Power Company, 313 F.Supp. 860, 440 F.2d 1135, cert. den., 404 U.S. 1062, 92 S.Ct. 732, 30 L.Ed.2d 750 reh. den., 405 U.S. 969, 92 S.Ct. 1162, 31 L.Ed.2d 244 (1970). However, governmental immunity is not extended to every act or every price set by a governmental entity. See Jefferson County Pharmaceutical Association, Inc. v. Abbott Laboratories, 460 U.S. 150, 103 S.Ct. 1011, 74 L.Ed.2d 882 (1983). Immunity from antitrust laws exists for a governmental entity if (1) the challenged restraint is one clearly articulated and affirmatively expressed by state policy and (2) the policy itself is actively supervised by the state. See Russell v. City of Kansas City, Kansas, 690 F.Supp. 947 (Kan. 1988).

Using the analysis articulated in Russell, SRS and other state agencies may be able to make a legitimate argument that involvement in drug bidding programs is immune from antitrust laws. Most social welfare agencies are given authority to administer the state's medical programs and thus the argument can be made that the legislature's authorization of that administration either contemplated the resulting anticompetitive effects or such activities were a reasonably foreseeable consequence of the authorization. However, those challenging this activity may argue that the legislature allows SRS (and other equivalent agencies) to provide medical care, not to set prices in violation of antitrust laws. Jefferson County, 460 U.S. 150, 103 S.Ct. 1011, 74

L.Ed.2d 882 (1983), involved the sale of pharmaceutical products to state and local government hospitals in competition with private pharmacies. The Court, in a five to four decision, held that these actions were not exempt from the Robinson-Patman Act. However, the opinion noted that "we are not concerned with . . . state purchases for use in traditional governmental functions . . . [nevertheless] we conclude that the exemption does not apply where a state has chosen to compete in the private retail market." Id. at 153-154. In footnote seven the court acknowledged that it was not addressing whether sales by the state to indigents were in competition with private enterprises. Thus, this remains an unresolved issue.

Kansas legislators have given SRS broad authority in the area of medical care benefits for qualified persons. This delegation has allowed SRS much regulatory and discretionary authority concerning implementation of the benefits program. If SRS authorities exercise this delegated authority by participating in the drug bid program and the legislature does not act to limit this authority, it is our opinion that, even if an antitrust law would otherwise be violated, governmental immunity may allow SRS to take part in this program. Agencies from other states who wish to participate in the proposed drug bid program must individually examine whether their state's policies and enabling acts authorize participating in such a program and whether the state actively supervises its implementation.

In conclusion, although the proposed bid program raises serious antitrust questions, we believe it does not represent a per se violation of antitrust laws. Under a rule of reason analysis, the proposed drug bid program may survive an antitrust challenge. The drug bid program should be conducted so as to provide that (1) each manufacturer is given an equal and meaningful opportunity to compete for this business, with no voice in determining which manufacturer is selected, (2) the participant states should not be competing purchasers who conspire to fix a buying price, (3) objective bidding criteria should be maintained, (4) each participant pharmacist, benefit recipient and purchaser should remain free to select any and all pharmaceutical providers with which they wish to contract, (5) the winning manufacturer should not be allowed to possess a market power that unreasonably excludes or eliminates all competition, and (6) the terms of the agreement should be for a reasonable and limited time period. If, under the rule of reason analysis, a potential antitrust violation remains a possibility, governmental immunity may nevertheless allow the

activity if: (1) each participating state agency has authority to enter into such an arrangement; (2) the state actively supervises the program; and (3) the anticompetitive results are expected or foreseeable. Specific legislative enactment allowing each aspect of the program could effectively negate most claims that the participating states violated antitrust laws.

Very truly yours,

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