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*To read the Second Circuit decision, please click here.*

# Report from Washington

## The Supreme Court Hears Oral Argument in American Express Case Raising Fundamental Questions Over Application of the Rule of Reason Test in Antitrust Cases

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### Introduction

*"[M]arket power is a gremlin that you are going to throw…into the gears of antitrust law as it has been under Section 1 across the country everywhere"*

*— Justice Breyer*

On February 26, 2018, the U.S. Supreme Court heard oral arguments in *Ohio v. American Express Co.* to decide if Amex's anti-steering provisions in its merchant agreements constitute an unlawful vertical restraint in violation of Section 1 of the Sherman Act. Specifically, the Court explored the application of well-known antitrust standards under the "Rule of Reason"—such as how to define the relevant product market, how to apply the Rule of Reason's burden-shifting framework, and the role of market power—in the context of a two-sided market (such as a credit card network). Two-sided markets are platforms that have two distinct user groups that provide each other with "network" benefits. That is, the addition of new users on one side of the platform benefits users on the other side of the platform. Thus, the success of the platform depends upon attracting sufficient supply and demand from both sides of the platform. Here, in the case of payment cards, the American Express Network depends on successfully incenting both the use of Amex cards by cardholders and acceptance of Amex cards by merchants. The Court appears poised to use this rare opportunity to modify the application of the Rule of Reason under the Sherman Act.

### Background

The Rule of Reason is the traditional framework that courts use to assess whether certain restraints of trade violate Section 1 of the Sherman Act.[1] In the first step of the rule of reason test, the plaintiff bears the initial burden to show that the challenged restraint is *prima facie* anticompetitive. If the plaintiff makes this showing, then the burden shifts to the defendant to establish a procompetitive justification for the restraint. If the defendant establishes a

[1] *See, e.g., California Dental Ass'n v. FTC*, 526 U.S. 756, 771 (1999).

procompetitive justification for the restraint, the burden shifts back to plaintiff to show that the anticompetitive effects of the restraint outweigh its procompetitive justifications.

Amex, like all major credit card networks, charges merchants a fee that is calculated as a percentage of the Amex cardholder's purchase amount at the point of sale with the merchant. Amex in particular uses the revenues from those fees to subsidize generous cardholder rewards programs in order to incentivize its customers to use their Amex card over a competitor's. To sustain these superior cardholder incentives, Amex charges materially higher fees to merchants than do other credit card companies. Because of these higher fees, merchants who accept Amex cards may be tempted to encourage or "steer" customers towards using other cards charging lower fees at the point of sale. To curb this behavior, Amex's standard merchant contracts contain anti-steering or nondiscriminatory provisions ("NDPs") that the company enforces actively.

In 2010, the three largest credit card networks—Visa, MasterCard, and Amex—all utilized merchant anti-steering provisions. The Department of Justice ("DOJ") and 17 States originally filed suit against all three networks, claiming that their anti-steering provisions unlawfully hindered price competition between credit card companies. Visa and MasterCard settled the suit and agreed to rescind their anti-steering provisions.

Following a seven-week bench trial in the summer of 2014, the United States District Court for the Eastern District of New York ruled that Amex's NDPs violate federal antitrust law. Although it is generally agreed among economists that payment-card networks are two-sided markets, the district court defined the relevant market exclusively as network services for merchants—*i.e.*, the market was defined to include only one side of the payment card network. The court also found that Amex possessed sufficient market power to harm competition in that market because: (1) Amex has significant market share of credit card transactions (26.4%), (2) the market is highly concentrated with substantial barriers to entry, and (3) Amex cardholders strongly insist on using their Amex cards. In turn, the district court held that Amex's anti-steering provisions unlawfully reduced price competition in the network services market by "removing the competitive 'reward' for networks offering merchants a lower price for acceptance services."

The Second Circuit reversed, finding that the district court erred by focusing its antitrust analysis exclusively on the merchant side of the network. Instead, reasoning that the cardholder and merchant sides of the platform were too interconnected to be considered separately, the Second Circuit held that the DOJ had to show a "net" anticompetitive effect, such that any restraint on merchants is not outweighed by potential procompetitive effects

for consumers. The Second Circuit held that the plaintiff failed to meet its *prima facie* Rule of Reason burden under Section 1 of the Sherman Act because it did not show that competition was harmed in the relevant market as a whole.

The Second Circuit also held that the district court's reliance on Amex cardholder insistence as evidence of Amex's market power was an error. According to the panel, cardholder insistence does not create market power but rather results from the competitive benefits on the cardholder side of the platform and the concomitant competitive benefits to merchants who choose to accept Amex cards.

The Supreme Court granted Ohio's petition for a writ of certiorari on October 16, 2017 to review the application of the Rule of Reason's burden-shifting framework to this two-sided market.

## Oral Argument Highlights

The Justices' questions over the course of oral argument show potential for a dramatic shift in how the Rule of Reason is applied, not just in context of two-sided markets but in all Section 1 cases. Indeed, the Justices' questioned almost all aspects of the Rule of Reason analysis, including how courts should grapple with defining the relevant product market, how courts should apply the shifting burdens of the Rule of Reason, and whether the market power is a necessary element in analyzing an allegedly unlawful vertical restraint on competition.

The Justices' questions also showcased potentially unusual divides among the Justices. For example, while Justices Breyer and Sotomayor appeared concerned by the Second Circuit's opinion on issues of market definition, Justices Gorsuch, Ginsburg and Kennedy all appeared to accept the benefits of the Second Circuit's approach to market definition in cases involving two-sided markets. Justices Breyer and Sotomayor also appeared to agree that the burden-shifting approach of the Rule of Reason analysis may require some unique application in cases involving two-sided markets, but questions from Justices Kagan and Kennedy suggested they disagree. All told, the shifting divisions among the Justices signal the potential for far-reaching changes in how different aspects of the Rule of Reason analysis are applied going forward.

### A Two-Sided Product Market or Two Separate, Complementary Product Markets?

The Court dedicated substantial time to investigating how trial courts should define the relevant product market. Justice Breyer raised concerns about the Second Circuit's

*"It's a two-sided market. I mean, I -- I -- I've never seen such jargon."*

*— Justice Breyer*

requirement that plaintiffs challenging conduct within a two-sided platform define the relevant market to include both sides of the market. Justice Breyer's questions suggested he is concerned that such a rule could be improperly invoked by defendants in antitrust suits to justify anticompetitive restraints on any two complementary products, including for example, nuts and bolts. Justice Sotomayor appeared to share those concerns, and probed how Amex could distinguish the Court's precedent in *Times-Picayune*,[2] which defined separate markets for newspaper subscribers and for newspaper advertisers despite their interdependence. Counsel for Amex argued that, unlike newspaper subscribers and advertisers, credit card transactions are so inextricably linked that neither "side" of the market can exist without the other side.

On the other hand, Justices Gorsuch, Ginsburg, and Kennedy seemed to give some merit to the Second Circuit's two-sided market definition as they probed plaintiffs on whether an antitrust analysis of a credit card transactions should account for both merchant- and cardholder-facing services.

### Application of the Rule of Reason

A related line of questioning centered on how to apply the Rule of Reason's burden-shifting framework to this two-sided payment platform. The states argued that NDPs alone were independently sufficient to satisfy a *prima facie* finding of anticompetitive behavior under step 1 of the Rule of Reason (where plaintiffs bear the burden of showing anticompetitive effects). And Justices Sotomayor and Breyer seemed to agree—they emphasized that NDPs created a substantial obstacle for low cost / low service payment platforms to compete at the point of sale, thereby showing an anticompetitive impact on the market. Justice Sotomayor explained her rationale for placing the burden on Defendants to show procompetitive justifications at step 2 (where the burden has traditionally rested with defendants): "[T]he government is never going to know that [whether higher merchant fees are passed through to cardholders]. It doesn't know your business model . . . if you want to argue procompetitive effects, you show it."

Justices Kagan and Kennedy focused instead on the wisdom—or lack thereof—of excluding cardholder benefits from step 1. Justice Kennedy warned that the failure to assess the corresponding increased value to Amex cardholders enabled by NDPs at step 1 was a "very dangerous step for this Court to take," implying that it could open the door to a flood of costly, protracted antitrust lawsuits.

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[2] *Times-Picayune Pub. Co. v. United States*, 345 U.S. 594, 610-12 (1953).

### The Gremlin, Market Power

The Justices also expressed very diverse views as they pushed both parties on the role of market power in assessing a potential Section 1 violation. Justice Gorsuch articulated his view that market power is a necessary precursor to ***every*** finding of an unlawful vertical restraint of trade and questioned whether Amex's 26% share was sufficient to establish market power. Justice Sotomayor emphasized that market power could be proven indirectly and suggested that it could be presumed in this case because Amex's competitors all raised their merchant fees to match Amex's pricing. Justice Breyer seemed to question the purpose of finding market power altogether. At one point, Justice Breyer asked counsel for Amex: "So where is this thing you have to prove in every Section 1 case, market power? I have not seen it . . . I don't think it's a universal requirement. And I think if you have an anticompetitive agreement which looks anticompetitive, seems anticompetitive, et cetera, why go into market power?" Amex responded that a showing of market power is a critical tool for enabling the trier of fact to assess whether a particular vertical restraint has an actual anticompetitive effect.

## Implications

The ruling in the *Amex* case could have a significant impact on core issues such as product market definition, burden shifting under the Rule of Reason, and market power that arise in almost all antitrust cases under Section 1 of the Sherman Act. The wide-ranging views intimated by various Justices on all three issues underscore the existing uncertainty in key aspects of federal antitrust law and the potential importance of this case as guidance to the lower courts.

Although the Court seems unlikely to depart from the basic structure of the Rule of Reason framework, the *Amex* case will force it to grapple with the specific issues presented by two-sided markets. While the 1953 decision in *Times-Picayune* underscores that two-sided markets are hardly new, technology-driven business models have led to an explosion of two-sided markets in recent years: electronic trading platforms like eBay, Craigslist, and StubHub; networking sites like LinkedIn, Match.com, and Monster.com; and electronic real estate services, just to name a few. Antitrust challenges to two-sided market participants' behavior abound, as exemplified by the numerous challenges to Visa, MasterCard, and Amex's credit card activities, as well as antitrust regulators' enforcement actions against Microsoft and Realcomp.

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