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DISTRIBUTION

The Newsletter of the Distribution and Franchising Committee

American Bar Association Section of Antitrust Law
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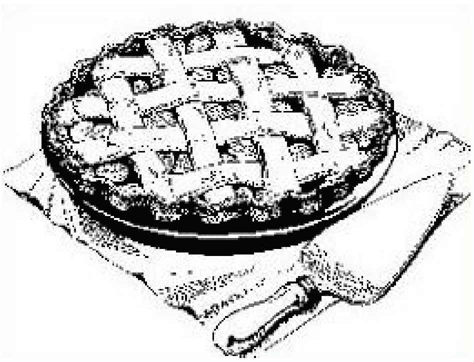
GREETINGS OF THE SEASON: MESSAGE FROM THE CHAIR



At this time of year, many Americans are gathering around their groaning tables for holiday meals with their friends and families. This issue of **DISTRIBUTION** likewise offers up a variety of food—for thought—about implications of two watershed moments in recent legal history.

In "Apple, eBooks and Publishing: Destruction is Not Always Positive Disruption," Distribution and Franchising Committee Vice Chair David Evans offers his take on the Apple *eBooks* decision, arising from a suit that began in 2012 and ended in March 2016, when the U.S. Supreme Court denied certiorari, leaving intact the Second Circuit's affirmance of the lower court's rulings against Apple. Readers will also appreciate Sarah Bartels's detailed summary of the Second Circuit's unanimous reversal, in September 2016, of the DOJ's win in its case challenging American Express's non-discrimination provisions in its agreements with merchants: "Competitive Effects: Balancing Interests in a Two-Sided Market."

As this issue of our newsletter goes to press, Distribution & Franchising Committee leaders have been busy working on two Spring Meeting programs and our bimonthly e-bulletin, *Up the Downstream*. In October, the Committee held a virtual book launch to celebrate the publication of the second edition of *Antitrust Law and Economics of Product Distribution*. In the course of a 90-minute telephonic presentation that I had the pleasure of moderating, co-editors Ted Banks, James Langenfeld, and Quentin Wittrock, as well as selected contributing authors, talked about the wealth of updated and new material contained in the second edition, including a new chapter on EU law and the impact of technology on product distribution. The book, which is available for purchase from ABA Publications, is an invaluable resource for lawyers and economists working with suppliers, wholesalers and resellers of consumer goods and other products.

DISTRIBUTION welcomes written submissions at any time. Please contact editors Celeste Saravia or Jeff White directly if you would like to contribute an article, book review, case analysis, interview, practice checklist, or other written piece.

Best wishes to all for a happy and peaceful holiday season,

Alicia L. Downey
Chair, Distribution & Franchising Committee

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Submission of Materials:
DISTRIBUTION welcomes submissions of articles, commentary, and case summaries involving significant or interesting decisions, trials, or developments in antitrust law affecting all types of distribution arrangements.

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Apple, eBooks and Publishing: Destruction is Not Always Positive Disruption

David H. Evans

In June, 2015, the United States Court of Appeals for the Second Circuit upheld[1] a lower court decision[2] finding that Apple, Inc. had orchestrated a conspiracy among publishers to raise the price of ebooks in violation of Section 1 of the Sherman Act. A year on, it is still a bad decision. It mischaracterizes the underlying behavior and chills the ability of manufacturers to decide the most efficient way to distribute their products, discipline inefficiencies and correct distortions.

Apple launched its ebook bookstore, iBookstore, in November 2009. Amazon had launched theirs in 2007. Amazon purchased ebooks at a variety of different prices from publishers but sold them uniformly at $9.99, sometimes below cost. Prior to the launch of iBookstore, Apple approached the major publishers and secured agreements to sell books on iBookstore. The publishers would have the authority to set the price of the books at whatever they wanted. And by virtue of the "cut" Apple took, the publishers would receive less profit per book than they did at Amazon. Two months after the iBookstore was announced, "every one of the [publishers] had taken control of pricing from Amazon and had raised the prices on many of their ebooks…"[3] The lower court found that the publishers had the opportunity to collude, that the increase in price of ebooks reflected an agreement to raise price, and that that agreement was both a per se and rule of reason violation of Section 1. The Second Circuit affirmed the decision.

Books are unique works of art that appeal to unique groups of people. Despite their uniqueness, however, demand for any given book usually follows a similar curve. For some consumers, a particular book is going to be highly desirable. Those consumers will purchase the book irrespective of price. These consumers are price insensitive. For other consumers, however, that particular book will not be as desirable. Those consumers will not acquire the book at the same price as a price insensitive consumer, but may if the price were lower. These consumers are price sensitive. Hardcovers are generally several times as expensive as paperbacks, and are released well before the paperback version.[4] Hardcovers are aimed at the price insensitive. Paperbacks are aimed at the price sensitive.

In the book industry, publishers will do some marketing and author development, but a good portion of it is done on the local level by bookstores. A typical bookstore, for example, will offer authors signing events, talks and release parties. The booksellers hire and develop staff who have particular expertise in various genres, and can offer consumers highly targeted recommendations. Bookstores also market through product placement, and their own reviews, newsletters and social media.[5] Margins on paperback books are typically low. Bookstores make a good deal of their profit on bestselling hardcover books, or at least they used to. These profits pay for the bookstores' promotional expenses over all their books—hardcover, paperback, bestsellers, frontlist, midlist and backlist. In essence, the publishers have outsourced the promotional activities that drive demand for books to the booksellers and finance that marketing by sharing some of the rents they are able to extract on the bestsellers.

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[1] United States v. Apple, Inc., 791 F.3d 290 (2d Cir., 2015)("Apple").
[2] United States v. Apple Inc., 952 F. Supp. 2d 638 (S.D.N.Y. 2013).
[3] *Apple*, 791 F.3d at 296.
[4] *Id.* at 298.
[5] Brief in *Amici Curiae* The Authors Guild, Inc., Authors United, American Booksellers Association, and Barnes & Noble, at 10-11, Apple, Inc. v. United States, No. 15-565 (December 2, 2015)("Amicus").

Amazon sells bestsellers at a considerable discount, perhaps even a loss.[6] For Amazon, the bestsellers are loss leaders designed to build its reputation and to bring customers to their "storefront" where they would purchase more profitable goods. Amazon's discounting disrupts the outsourced promotion model developed by the publishers. Customers could go into a bricks and mortar store, ask for advice on a new book, look at the products, perhaps meet the author at a talk, and then go to Amazon to buy the book at a discount. Amazon has even developed an app that will let a customer scan a product and buy it straight from Amazon over their phone there in the store. Amazon does not offer signing events, talks or release parties. They do not spend a lot of time developing knowledgeable staff. By discounting, Amazon is free-riding off the promotional activities of the bricks and mortar stores. And by depressing the price of bestsellers, they undermine the way in which publishers finance the development and promotion of books and authors.

Consumers are not necessarily better off either. The process by which a text is sold in hardcover first and then later released in paperback is a form of "windowing." Windowing is common in entertainment markets, like the markets for movies, for example. Movies are first released in theaters, then in DVD/BluRay/Streaming, then cable, then broadcast. The people who see the film in the movies want to see the movie very much. They are willing to pay the most. The person who waits for broadcast doesn't particularly want to see the movie that much. These windows are in effect temporal price discrimination markets. Once demand has been satisfied in a particular window, a new window is opened where the product is available at a lower price. Once that demand has been met, a further window is open. The slight differences in format reduce cost and maintain profitability as well as signal to consumers that a slightly-less-costly version of the underlying product is available for consumption. The hardcover and paperback book releases are similarly temporal price discrimination markets.[7] The people who value the book most pay the most for it. The people who value it less, receive a very similar product but at a lower cost and later time. Temporal price discrimination markets are allocatively efficient.

Amazon's below-cost pricing allows the price sensitive to acquire product quicker than they would otherwise. But those consumers do not desire the product enough to acquire it in hardcover, so the lower pricing does not satisfy demand that would otherwise go unmet. Amazon's below-cost pricing allows hardcover consumers to purchase the product at a discount, but their demand would have been satisfied at a higher price. A manufacturer in a similar situation would normally step in to correct the imbalance. It would eliminate the free riding, and either internalize the externalized promotional costs or compensate the parties to which it is outsourcing that promotion. And it would also seek to restore allocatively efficient windowing.

Enter ebooks. There is reason to think that for some ebooks there would be customers who want the ebook immediately and would be willing to pay more to get it. It may even be the case that there is a class of customer that would not buy a hardcover but would buy an ebook for more than a paperback.[8] By pricing all ebooks at the same price and releasing them at the same time, Amazon has effectively eliminated windowing for ebooks. It satisfies the demand of the price insensitive at suboptimal prices, and may very well over-charge a subset of price sensitive consumers and leave some demand within that group unmet, say a consumer that would buy an ebook in a $5.99 window.

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[6] Amicus at 15.

[7] *See* Richard J. Gilbert, *E-Books: A Tale of Digital Disruption*, 29(3) J. OF ECON. PERSP. 169 (2015) (discussing ebook cannibalization of hardcopy and paperback sales).

[8] *See id*.

When the publishers "took control" of pricing in ebooks, the publishers switched from a "sale" model to a "consignment" model. It is well established a manufacturer can sell product on a consignment basis through intermediaries and set the price.[9] The publishers retained the right to set the price of the ebook, and there was no evidence that the publishers agreed as to the price they charged their end-user customers. This is an important point. There was no agreement to fix price. The agreement, if any, was to deal with Amazon on a consignment basis. Had each individual publisher decided to deal with Amazon on a consignment basis independently, there would be no Section 1 violation. And the only reason why the court found such an agreement was plausible was because there was evidence that the publishers met and that prices went up. But prices didn't necessarily go up for all books, and the price increases were not uniform.[10] The price increases were equally consistent with independent rational behavior as they were with collusion—Amazon's pricing distorted investment in marketing and development and efficient pricing; these distortions needed to be corrected for the marketing and distribution system to work efficiently and effectively. Some prices went up because they were priced below their optimal level. Some prices went down because they were priced too high. It is not illegal to charge consumers more who are willing to pay more for something; higher prices don't necessarily mean there was a conspiracy.

Apple is not a price fixing case. It is not a refusal to deal. It is, at worst, a horizontal agreement to deal with a customer in a particular way. That is a rule of reason case; it's not per se. And while the court did find that the "agreement" violated the rule of reason, it did not consider the problem of the free riding and the inefficient allocation of costs. It also did not consider the legitimate concern a manufacturer would have regarding the allocative inefficiency of discounting to the price insensitive. The concern is the proper attribution of costs to revenues, branding, and profit maximization, concerns recognized for decades by the antitrust laws as legitimate.[11]

As such, *Apple* isn't just a simple price fixing case. It is an admonition to manufacturers who are considering how to structure a new market or to correct distortions in an existing market for its products. It limits the ability of manufacturers who have chosen widely disbursed distribution systems to control them, and to discipline free riding within their systems. The Internet makes it very easy for small, underfunded entities to enter a market, and with little to overhead, sell product at steep discounts. In the short run consumers benefit from the lower prices. But the discounting drives out the firms willing to invest and develop a brand. It is perfectly logical and efficient for manufacturers to deter this type of free riding. Antitrust should not condemn it.

David H. Evans is a partner in the antitrust group of Kelley Drye & Warren LLP. He serves as a vice chair of the Distribution Committee.

[9] United States v. GE, 272 U.S. 476 (1926); Ill. Corp. Travel v. Am. Airlines, 889 F.2d 751, 752-53 (7th Cir. 1989).

[10] Amicus at 16-17 (average ebook price fell from $7.97 to $7.34).

[11] Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36 (1977) (vertical nonprice restraints are evaluated on a rule of reason basis).

Competitive Effects: Balancing Interests in a Two-Sided Market

By Sarah Bartels

In February 2015, Judge Garaufis of the U.S. District Court for the Eastern District of New York issued a decision in *United States v. Am. Exp. Co.*, 88 F. Supp. 3d 143 (E.D.N.Y. Feb. 19, 2015), finding that the non-discrimination provisions ("NDPs") American Express ("Amex") included in its agreements with merchants constituted an unlawful restraint of trade in violation of Section 1 of the Sherman Act. The district court conducted a full "rule of reason" analysis before finding a Sherman Act violation.

One year and seven months later, on September 26, 2016, the Second Circuit of the U.S. Court of Appeals reversed the Eastern District's decision, determining that the district court's sole focus on the NDPs' effects on merchants, rather than also analyzing the NDPs' effects on cardholders in the two-sided credit card market, led to incorrect determinations regarding the definition of the relevant market, Amex's market power, and any actual adverse effects the NDPs have on competition.[1] The Second Circuit found that Amex's NDPs do not harm consumers as a whole, and therefore do not constitute a Section 1 violation.

I. Amex's Challenged Practices

The Second Circuit found that the credit card industry is comprised of a two-sided market that involves cardholders that use the credit card for purchases, and merchants that accept a particular card, and both sides are highly dependent on the other.[2] Credit card companies must balance the needs and costs to both cardholders and merchants in order to ensure widespread use and widespread acceptance of the credit card. Four credit card networks share the primary credit card transaction volume in the United States: "Visa (45%), American Express (26.4%), MasterCard (23.3%), and Discover (5.3%)."[3] Cardholders and merchants alike use and accept many different types of credit cards – a practice known as "multi-homing."

As described in the Second Circuit's opinion, Amex generally charges higher fees to merchants accepting its cards than Amex's two main competitors, Visa and MasterCard, due to differing business models.[4] While Visa and MasterCard derive the substantial portion of their revenues from interest payments by cardholders carrying unpaid balances ("lend-centric" model), Amex derives the majority of its revenue from fees paid by Amex accepting merchants ("spend-centric" model).

Amex operates its business in two distinct and important ways from its primary competitors: (1) deriving the primary source of its revenue from fees paid by merchants accepting Amex cards; and (2) utilizing a "closed-loop", rather than an "open-loop" system to decrease the number of parties to complete a transaction.

The open-loop system utilized by Visa and MasterCard can involve up to five parties to complete a transaction: (1) the network; (2) the cardholder; (3) the merchant; (4) the issuer; and (5) the acquirer.[5] In this model, the issuer and

[1] *United States v. Am. Exp. Co.*, No. 15-1672, 2016 WL 5349734 (2d Cir. Sept. 26, 2016).
[2] *Id.* at *2.
[3] *Id.* at *4.
[4] *Id.* at *5, 15.
[5] "When a cardholder uses his or her card to make a purchase, the transaction information is sent immediately to the acquirer, who discharges the cardholder's obligations by paying the merchant the funds owed on the transaction. As the price for handling this transaction, the acquirer charges the merchant a merchant-discount fee. The amount of the merchant-discount fee is determined in large part by the interchange fee, which is paid by the acquirer to the issuer as the price for handling its transactions with the cardholder." *Id.* at *5.

the acquirer are typically banks.[6] By contrast, Amex's closed-loop system allows Amex to serve the rolls of the issuer and acquirer, in addition to Amex acting as the credit card network. Using this model, Amex acts as the only intermediary between the cardholder and merchant, whereas the open-loop system utilizes three such intermediaries between the merchant and cardholder (acquirer, issuer, and Visa or MasterCard serving as the network).

Amex entered the credit card industry in the 1950s, and was a leader by the 1960s, focusing mainly on the travel and entertainment ("T&E") business.[7] As it expanded into "everyday" spending locations such as gas stations and supermarkets, its model allowed it to increase its offerings to both cardholders and merchants.[8] Exclusive membership-rewards programs attracted cardholders, while the technology offered by Amex's proprietary closed-loop model offered merchants the ability to track cardholder spending behavior to tailor marketing efforts.[9]

In the 1980s, Visa and MasterCard launched efforts to maintain market share in response to Amex expanding into the "everyday spend" space previously occupied only by Visa and MasterCard. One of the most notable initiatives included Visa and MasterCard requiring member institutions issuing their cards to adopt exclusionary rules that prohibited those institutions from issuing credit cards on the Amex or Discover networks.[10]

Amex's response came in the form of agreements with merchants that included "non-discriminatory provisions", or "NDPs". These provisions prevent a merchant from stating a preference for any credit card network over Amex, and are the subject of the Amex litigation.[11]

II. The Lower Court Decision

The U.S. Department of Justice and seventeen States (the "Government") challenged several allegedly restrictive NDPs used by American Express in contracts with merchants, including restrictions against merchants, which they contended violated Section 1 of the Sherman Act:

- Stating or implying that a merchant preferred a competing card to American Express;
- Trying to dissuade customers from using their American Express card, or encouraging them to use other methods of payment;
- Imposing any restrictions, conditions, or disadvantages on customers using an American Express card that are not imposed equally on all other cards; or
- Promoting other cards more actively than American Express cards.[12]

However, the Government did not challenge other restrictions preventing merchants from imposing surcharge fees on customers paying with Amex cards differentially from competing cards, nor did it challenge restrictions against mischaracterizing Amex cards or engaging in activities that harm Amex's business or brand.[13]

Following a seven-week bench trial and a complete analysis under the rule of reason, the district court found that the challenged NDPs violated Section 1 of the Sherman Act.

[6] *Id.* at *4.
[7] *Id.* at *2.
[8] *Id.* at *6.
[9] *Id.*
[10] The Second Circuit determined these exclusionary rules violated Section 1 of the Sherman Act in *United States v. Visa U.S.A., Inc.*, 344 F.3d 229 (2d Cir. 2003).
[11] *Id.* at *7.
[12] *United States v. Am. Exp. Co.*, 88 F. Supp. 3d 143, 162-63 (E.D.N.Y. Feb. 19, 2015).
[13] *Id.*

A. District Court Follows 2003 Decision for Market Definition and Disregards Rise in Debit Card Services

While recognizing that the two-sided platform for credit card services encompasses two distinct markets, one for card issuance and one for network services, the district court defined the relevant antitrust market as the market for general purpose credit and charge ("GPCC") card network services in the territorial United States.[14] This is the same market definition adopted by the Second Circuit in 2003, when it sided with the Government and found Visa and MasterCard prohibitions on their member banks issuing Amex or Discover cards to be illegal ("*Visa*").[15]

In the lower court decision, the court considered but ultimately rejected Amex's argument that debit card use has grown substantially since the time of the Second Circuit's decision in 2003, and that debit card network services should now be included within the relevant market definition. The court found that debit cards were not sufficiently interchangeable with GPCC cards to constitute the same relevant market, citing evidence that consumers and some merchants use GPCC and debit cards differently, that Amex does not consider debit card network service fees in setting prices for its GPCC card network services, and that GPCC merchant fees were not affected by recent declines in debit card network service fees.

The court also rejected the Government's argument that a submarket exists for GPCC card network services provided to T&E merchants. While evidence was considered that GPCC card network services pricing to T&E industry merchants differs from pricing to other types of merchants, the court found it insufficient to determine whether the reason for this differential pricing was due to the existence of a separate T&E submarket, or due to other factors such as cost differences in servicing the needs of T&E merchants.

B. District Court Determines Amex Possesses Market Power with a 26.4% Share

The lower court also found that Amex possessed market power within the relevant market. Just as it followed the Second Circuit's *Visa* market definition analysis, it also followed the market power analysis conducted in that decision. This required reviewing three categories of evidence: "(1) defendants' market shares and the structural characteristics of the market; (2) cardholder insistence; and (3) the networks' pricing practices and merchants' continued acceptance despite price increases."[16]

The four competitors in the relevant market were found to have market shares based upon card purchase volume as follows: Visa (45%), American Express (26.4%), MasterCard (23.3%), and Discover (5.3%). Noting that 26.4% is a relatively low market share at which to find market power, the court explained its supporting rationale for this finding, including that the Second Circuit previously found MasterCard to possess market power in the GPCC card network services market when it held only 26% of the market in 2003.

Recognizing that this market share alone likely was insufficient proof of market power absent other factors, the lower court considered the other two categories of evidence in its market power analysis: cardholder insistence and pricing practices. Due to Amex's loyal cardholder base, the lower court found "cardholder insistence" to amplify Amex's market position, resulting in market power.[17] The court found that a substantial segment of Amex's cardholder base insists on paying with their Amex cards and would shop elsewhere if a merchant stopped accepting Amex. This was found to be particularly true for T&E merchants

[14] *Id.* at 151.
[15] *Id.* at 173.
[16] *Id.* at 188 (internal citations omitted).
[17] *Id.* at 192.

that cater to the needs of business travelers, who most often use Amex corporate cards for their T&E expenses. As additional evidence of market power, the court also noted that Amex has raised its fees to merchants multiple times in recent years without suffering any significant defection to its competitors (this was particularly true as to larger merchants; smaller merchants were more likely to drop Amex). The court also noted that purported high barriers to entry, as evidenced by a lack of any meaningful entrants into the market since 1985, allows Amex to sustain this market power.[18]

C. District Court Finds NDPs Caused Actual Harm to Competition

The district court found that the NDPs caused actual harm to competition in the relevant market, resulting in higher prices for merchants and consumers. By preventing merchants from expressing any preference for different payment networks to consumers, the court found that the NDPs deprive merchants of any means of responding to differences in network pricing, other than the all-or-nothing decision of refusing to accept Amex cards (which the court found to insufficiently constrain pricing due to cardholder insistence). Consequently, the court found that the NDPs eliminate incentives to compete that Amex's competitors would otherwise have on the basis of offering lower swipe fees to merchants.[19]

The court further determined that the higher prices resulting from Amex's NDPs harm both merchants and cardholders: merchants pay the higher prices, and pass those higher prices on to customers—both Amex cardholders and non-cardholders.[20] The court indicated that Amex's NDPs prevent merchants from taking actions to respond to Amex's higher prices in a way that would typically be available in a competitive market because merchants cannot steer patrons to lower cost network service providers.[21] Due to the NDPs, merchants must either accept Amex and pay its higher fees, or not accept Amex and face the threat that Amex's cardholder base known for strong cardholder insistence may patronize competitor merchants that accept Amex.[22]

The court also considered whether Amex offered any procompetitive justification for its NDPs that could outweigh the anticompetitive harm caused. Amex argued that (1) NDPs help it to offer competitive differentiated products and services to consumers (enhanced rewards) and merchants (enhanced analytics and market reports); and (2) prevent freeriding on the services Amex offers.[23] The court rejected these arguments, reasoning that if Amex does in fact offer premium value to its merchants, the market will tolerate Amex charging premium prices even in the absence of NDPs.[24]

The court further noted that merchants generally cannot "free-ride" on Amex's data analytics because Amex charges a fee for these premium services in most circumstances.[25] The court recognized that there could be some freeriding on Amex's customer loyalty in circumstances where a consumer selects a merchant specifically because it does accept Amex, but is then persuaded by the merchant to use another payment form. However, the court was unpersuaded that this risk of harm to Amex outweighed the actual competitive harm caused to merchants and consumers by the NDPs.[26] In the absence of procompetitive justifications outweighing the anticompetitive harm, the court concluded that Amex's NDPs constitute an unlawful restraint of trade in violation of Section 1 of the Sherman Act.

[18] *Id.* at 195.
[19] *Id.* at 207.
[20] *Id.* at 208.
[21] *Id.* at 209.
[22] *Id.*
[23] *Id.* at 225.
[24] *Id.* at 233.
[25] *Id.* at 236.
[26] *Id.* at 235.

As a result, Amex was permanently enjoined from enforcing its NDPs for a period of ten years.

III. Second Circuit Reverses Lower Court's Decision

The Second Circuit expressed strong disagreement with the district court's approach of considering the NDPs' competitive effects only on merchants, which represent only half of a two-sided market for credit card network services. The Second Circuit's opinion also detailed the district court's misapplication of the three-step burden-shifting framework courts use to analyze potential restraints of trade in violation of Section 1 of the Sherman Act under the rule of reason.[27]

Under the rule of reason, the plaintiffs must first prove either that "the defendant's challenged behavior 'had an actual adverse effect on competition as a whole in the relevant market', or that the defendant has 'sufficient market power to cause an adverse effect on competition.'"[28] If the plaintiff satisfies this burden, the burden then shifts to the defendant to show procompetitive effects of the behavior at issue.[29] Upon the defendant's showing of such procompetitive effects, the burden then shifts back to the plaintiff "to prove that any legitimate competitive benefits offered by defendant[ ] could have been achieved through less restrictive means."[30]

The Second Circuit noted that the two-sided nature of the credit card market may lead to high barriers to entry.[31] A credit card network must have both a large amount of money in order to offer credit to cardholders, along with strong credit, so that merchants will accept it.[32]

A. Second Circuit's Market Definition Includes Both Sides of Two-Sided Market

Writing for the Second Circuit, Judge Wesley stated that the district court's definition of the relevant market was fatal to its determination that Amex violated Section 1 of the Sherman Act because it failed to include cardholders.[33] Because of the interdependence between cardholders and merchants, both sides of the two-sided market must be analyzed for competitive effects.

The court found that, in order to remain competitive, credit card companies must balance the benefits and costs of both cardholders and merchants. Increasing benefits to cardholders may result in increased costs to merchants to fund the increased cardholder benefits, especially in Amex's model that heavily relies on merchant fees for its revenue, unlike the Visa and MasterCard models that mainly rely on interest charged on outstanding balances for revenue. Credit card companies remain constrained by the interdependence of cardholders and merchants because merchants will leave the credit card's network if merchant fees are too high, and the network would lose cardholders due to an inability to use cards and gain rewards within a broad network of merchants.

This market definition departs from the market definition followed both by the lower court in its finding that Amex's NDPs violated Section 1 of the Sherman Act, as well as the market definition the Second Circuit used to determine that the Visa and MasterCard prohibitions on their member banks issuing Amex or Discover cards constituted a violation of Section 1 of the Sherman Act. Such a departure, the Second Circuit reasoned, is necessary, because the

[27] 2016 WL 5349734, at *10. All parties, the district court, and the Second Circuit agree that the NDPs are a vertical restraint, requiring analysis under the rule of reason. *Id.* at *11.
[28] *Id.* at *10 (internal citations omitted).
[29] *Id.* (internal citation omitted).
[30] *Id.* (internal citation omitted).
[31] *Id.* at *6.
[32] *Id.*
[33] *Id.* at *11-12.

potentially anticompetitive NDPs in this case are between Amex and its merchants, representing a vertical relationship, whereas the prohibitions in the case involving Visa and MasterCard represented a restraint of trade amongst competitors within the same level of the network services industry.[34]

B. Second Circuit Concludes that Amex Does Not Possess Market Power in Two-Sided Market

In addition to the flawed market definition, the Second Circuit found that the district court erred in its evaluation of Amex's market power. The district court had determined that the charge volume on Amex credit cards "accounted for 26.4% of [credit card] purchase volume in the United States . . . [and that Amex] is the second largest [credit] card network when measured by charge volume."[35] The district court also determined that the plaintiffs "successfully discharged their burden under the rule of reason indirectly by showing that Amex possesses sufficient market power to affect competition adversely in the relevant market."[36] Under the burden-shifting framework of the rule of reason, the burden would then shift to Amex to show sufficient procompetitive effects of the NDPs.

In analyzing Amex's market power, the district court had focused on Amex's Value Recapture program, which included price increases to merchants from 2005 to 2010 in targeted industry segments known to have high rates of cardholder insistence, determining that because these targeted rate increases were not met with any meaningful merchant attrition, Amex enjoyed meaningful market power in the network services market.[37]

However, as discussed in the market definition analysis above, the Second Circuit recognized that an increase in merchant fees typically results in increased cardholder benefits, and therefore cardholder use to capture these increased benefits increases at Amex-accepting merchants, providing a strong incentive for merchants to accept Amex cards. The district court determined that strong cardholder insistence by Amex's cardholder base amplified its market power because Amex cardholders would change where they shop so they could use their Amex cards and receive Amex's cardholder benefits.[38]

The Second Circuit concluded that such cardholder insistence resulted from competitive benefits Amex offers to its cardholders, rather than market power. The competitive benefits offered by Amex that result in its insistent cardholding base also benefit merchants that accept Amex, and strong cardholder insistence incentivizes merchants to accept Amex cards.[39]

Because Amex's market share is the direct result of cardholder satisfaction, the payment card industry is functioning competitively, and any disturbance to the current market state would likely increase market shares for Visa and MasterCard, decreasing overall competition in the market.[40] Additionally, Amex's ongoing efforts to offer attractive rewards to its cardholders illustrate an environment in which Amex does not have market power to increase prices in an anticompetitive way.[41] Further, merchants have the very viable option of choosing not to accept Amex cards – about one third of merchants that accept credit cards opt not to accept Amex.[42]

[34] *Id.* at *13.
[35] *Id.* at *15 (internal citation omitted).
[36] *Id.*
[37] *Id.* at *15-16.
[38] *Id.* at *16.
[39] *Id.* at *17-18.
[40] *Id.*
[41] *Id.* at *17.
[42] *Id.* at *6.

C. Second Circuit Finds that Amex's NDPs Are Procompetitive

The Second Circuit disagreed with the district court's conclusion that Amex's NDPs adversely affected competition in the market as a whole because the district court's market definition did not include the cardholder side of the market.[43] When cardholders are included in the market definition, the Second Circuit concluded that NDPs affect both cardholders and merchants, because the merchant fees provide revenue for the attractive benefits Amex offers to cardholders; any decrease in revenue from merchant fees would negatively affect cardholder benefits, and a decrease in cardholder benefits would also decrease competition on the cardholder side of the market.[44]

Attracting Amex's "marquee buyers" also presents a strong incentive for merchants to accept Amex cards.[45] Judge Wesley noted that Amex cardholders "tend not only to be more affluent than cardholders on competitor networks, but they also spend more on average per transaction than other cardholders and do so more often."[46] Merchants benefit from accepting Amex's standard NDPs because the NDPs attract Amex cardholders, who in turn are attractive to merchants.[47]

Because Amex's proprietary closed-loop system differentiates Amex from its competitors, the court noted, competition among credit card networks has increased rather than decreased competition.[48] Amex needs its NDPs to support the data capture services offered to Amex accepting merchants while offering its signature benefits to cardholders; any decrease in merchant fees would decrease the quality of Amex's value proposition to both cardholders and merchants, thereby decreasing competition in the credit card market.[49]

Because plaintiffs did not meet their initial burden of proving that Amex's NDPs resulted in actual adverse competition in the market, or that Amex had sufficient market power to adversely affect competition, the Second Circuit found that Amex did not violate Section 1 of the Sherman Act under a rule of reason analysis.

IV. Potential Implications of the Second Circuit's Ruling

The Second Circuit's decision may affect how courts analyze the competitive effects on two-sided markets, requiring a balancing of the interests of parties on both sides of a two-sided market. Although the appellate court found that Amex's NDPs may effectively require merchants to pay higher prices, it concluded that the NDPs fuel competition on both sides of the market for network services.

Further, the Second Circuit expressly stated that there was no requirement that Amex pass its gains from the higher merchant fees to cardholders in the form of cardholder rewards or benefits in order for the NDPs to have a net positive effect on competition in the market as a whole.[50] The Second Circuit thus appeared to recognize that, in a two-sided market, the effects on the market as a whole may be considered even if certain practices could lead to anticompetitive effects on one side of the market.

It is also notable that on November 10, 2016, the Government filed a petition for rehearing *en banc* in the Second Circuit, arguing that the Second Circuit's ruling in favor of Amex contradicted Second Circuit and Supreme Court precedent by (1) treating the two-sided market for network services as a single market, rather than as two distinct but interdependent markets;

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[43] *Id.* at *18.
[44] *Id.* at *18-19.
[45] *Id.* at *19.
[46] *Id.*
[47] *Id.*
[48] *Id.* at *20.
[49] *Id.*
[50] *Id.* at *19.

and (2) misapplying the burden-shifting analysis under the rule of reason, requiring plaintiffs to prove not only adverse effects on competition, but also "net harm" when accounting for procompetitive benefits.[51]

In its petition, the Government argues that merchants and cardholders should remain separate markets for network services, rather than analyzed as one two-sided market, because the services Amex provides to merchants and cardholders are not interchangeable, and therefore fail the Supreme Court's standard for determining relevant antitrust markets.[52] The government further argues that the Second Circuit departed from the proper burden-shifting framework by requiring plaintiffs to show that Amex's NDPs harm consumers on both sides of the platform (merchants and cardholders), rather than requiring only a showing that the NDPs adversely affected competition between network service providers to merchants.[53] It will be worth watching to see whether the Second Circuit's decision remains standing after the Government's latest petition or after any appeals run their course.

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[51] Petition of Plaintiffs, *United States v. Am. Exp. Co.*, No. 15-1672, 2016 WL 5349734, at 1-2 (2d Cir. Sept. 26, 2016).

[52] *Id.* at 6.

[53] *Id.* at 12-13.