BakerHostetler

Supreme Court to Decide First Antitrust Case in Two Years

By Carl W. Hittinger and Tyson Y. Herrold

November 6, 2017

On Oct. 16, the U.S. Supreme Court granted *certiorari* in *United States v. American Express*, the court's first antitrust case of the 2017 term and the first antitrust case they have reviewed since 2015. The American Express case presents complex questions about the legality of anti-steering provisions in agreements between credit card companies and the merchants that agree to accept their cards. It also presents the Supreme Court with an opportunity to provide real guidance for the first time on the combination … or conspiracy in restraint of trade" under the Sherman Act. This case will also be the first antitrust case which antitrust expert Justice Neil Gorsuch will join.

The Credit Card Business Model

The success of a credit card companies depends on their ability to attract a critical mass of merchants and cardholders. "That is, cardholders benefit from holding a card only if that card is accepted by a wide range of merchants, and merchants benefit from accepting a card only if a sufficient number of cardholders use it." This market structure is often referred to as a "two-sided market" because credit card companies must serve two different customer groups to be successful. Because cardholders are empirically more sensitive to credit card fees than merchants, as a practical matter credit card companies charge most of their fees to, and therefore derive most of their revenue from, merchants, usually calculated as a fixed fee per transaction and/or as a variable fee calculated as a percentage of the price of the good or served purchased.

Accordingly, credit card companies face divergent and often contradictory economic interests in marketing their cards to merchants and cardholders. Merchants prefer low fees while cardholders prefer the "better services, benefits, and rewards that are ultimately funded by those fees." Credit card companies attempt to balance these competing interests by charging merchant fees and offering cardholder benefits that are satisfactory (or at least acceptable) to both groups. This equilibrium can be tricky: decrease merchant fees too much and the company cannot offer enough services, benefits, and rewards to maintain a critical mass of cardholders; increase services, benefits, and rewards too much and the merchant fees necessary to support those services may drive away merchants.

In an effort to balance these competing economic interests and in response to competition from rival credit card companies, Amex added nondiscriminatory provisions (NDPs) to its contracts with merchants. These NDPs prohibit merchants from "offering customers any discounts or nonmonetary incentives to use credits cards less costly for merchants to accept," "expressing preferences for any card," and "disclosing information about the costs of different cards to [the] merchants who accept them." The upshot of these NDPs is that they can prevent the free flow of pricing information between merchants and cardholders.

The Second Circuit Reverses the American Express Verdict

In 2010, the U.S. Department of Justice and 17 states sued Amex, claiming that the company's NDPs violated Section 1 of the Sherman Act, which prohibits "contracts, combinations … and conspiracies in restraint of trade." After full discovery and a seven-week bench trial, Judge Nicholas Garaufis of the U.S. District Court

for the Eastern District of New York ruled that Amex's NDPs violated the Sherman Act by restricting merchants' ability to steer cardholders to other credit card companies and therefore allowed the company to charge "inflated prices for their services."

On appeal, the Second Circuit reversed the district court's verdict, fundamentally finding that it committed legal error by failing to consider both sides of the credit card industry's two-sided market: the cardholder side and the merchant side.

First, the Second Circuit concluded that the district court incorrectly defined the relevant market by considering the merchant side of the market in isolation and "excluding the market for cardholders from its relevant market definition." As the Second Circuit explained, this "ignores the two markets' interdependence." Instead, the Second Circuit explained, the district court "must consider the feedback effects inherent on the credit card platform by accounting for the reduction in cardholders' demand for cards (or card transactions) that would accompany any degree of merchant attrition" that would result from Amex increasing its merchant fees.

Second, the Second Circuit concluded that the district court similarly erred in its application of the rule of reason because it failed to assess in its ruling after trial the procompetitive effects of Amex's NPDs on the cardholder side of the market. The district court reasoned that the NDPs were anticompetitive because they facilitated Amex's campaign to raise merchant fees. However, this one-sided analysis failed, according to the Second Circuit, to assess the extent to which the increase in merchant fees were (or would be) used to fund cardholder benefits. To the extent Amex chose to offset the increase in merchant fees with an increase in cardholder benefits, that increase in benefits could attract further and more affluent Amex cardholders. Therefore, Amex's increase in merchant fees could actually benefit merchants by giving them access to more consumer spending. As the Second Circuit held: "Because the NDPs affect competition for cardholders as well as merchants, the Plaintiffs' initial burden [at trial] was to show that the NDPs made all Amex consumers on both sides of the platform–i.e., both merchants and cardholders –worse off overall."

The Significance of the Supreme Court's Grant of Certiorari

The Supreme Court's decision to grant certiorari in the American Express case is significant for two reasons. First, it gives the court the opportunity to explore the application of the Sherman Act to so-called "two-sided markets," where businesses market their services to two or more distinct customer groups, each of which may respond to different incentives but each of which is nonetheless essential to the service being offered. Other industries that often operate under similar market structures are the software industry (which connects computer users and application developers) and the real estate listing industry (which connects home buyers and sellers). Even the health care market (which we discussed in our November and December 2016 articles) has features reminiscent of a two-sided market. As the Seventh Circuit explained in FTC v. Advocate Health Care Network, "insurance … splits hospital competition into two stages: one in which hospitals compete to be included in insurers' networks, and a second in which hospitals compete to attract patients. Insured patients are usually not sensitive to retail hospital prices, while insurers respond to both prices and patient preferences."

Second, the *American Express* case provides an opportunity for the Supreme Court finally to offer some further needed guidance to the lower courts on the correct application of the rule of reason. Although the rule of reason has been around (in one form or another) for more than a century, the Supreme Court has never provided much insight into how courts should balance the procompetitive and anticompetitive aspects of a restraint on trade (not all of which are unlawful). Past Court decisions have instead limited their focus to identifying the circumstances under which the rule of reason (as opposed to the per se rule) should apply.

For example, in the Court's 2008 seminal decision in *Leegin Creative Leather Products v. PSKS*, Justice Anthony Kennedy, writing for the court, considered whether the rule of reason should apply to "vertical" restraints. In *Leegin Leather*, the vertical restraint at issue was a manufacturer's minimum resale price agreements with retailers selling the manufacturer's product. Although the court concluded that rule of reason also

applies to resale price maintenance agreements, it remanded the case for further proceedings and therefore elected not to engage itself in the rule of reason analysis on appeal. By contrast, in the American Express case, the parties and the lower courts agree that the rule of reason applies, so the Supreme Court may take the opportunity to address the application of the rule itself for the first time.

Justice Gorsuch's First Supreme Court Antitrust Case

The *American Express* case will be Justice Gorsuch's first antitrust case since he was appointed to the Supreme Court on April 7. As we discussed in our February and March articles, Justice Gorsuch is a well-known antitrust expert. In his early years in private practice at Kellogg Huber Hansen Todd Evans & Figel, Gorsuch defended Baby Bell corporations from antitrust claims brought by the Department of Justice and competitors. He also successfully represented snuff tobacco manufacturer Conwood Co. against rival U.S. Tobacco Co. in the classic predatory practices case of *Conwood v. United States Tobacco* case, in which the Conwood Co. was awarded what is widely considered to be one of the largest antitrust jury verdicts ever awarded to a private litigant: $350 million (subsequently trebled under the Sherman Act to $1.05 billion).

As a Judge on the U.S. Court of Appeals for the Tenth Circuit, Justice Gorsuch authored three important antitrust opinions. In *Four Corners Nephrology v. Mercy Medical Center of Durango* and *Novell v. Microsoft*, Gorsuch examined the extent to which the Sherman Act imposes an obligation on businesses to deal with their competitors. In *Kay Electric Cooperative v. Newkirk*, Gorsuch evaluated the application of state action immunity in the context of municipal utility companies acting as private market participants.

During his short tenure on the Supreme Court, Justice Gorsuch has been an active and vocal member of the court, including even at oral argument as the most junior justice. Of the 16 cases in which Gorsuch participated in the 2016 term, he authored one majority opinion (not including possible per curiam opinions, which do not identify the authoring justice(s)), three dissents, and one concurrence. He also joined in a number of other concurrences and dissents. The *American Express* may provide further insight into Gorsuch's still evolving antitrust jurisprudence, especially if he chooses to write his own concurrence or dissent (or maybe even be selected to write the court's majority opinion). Stay tuned.

Carl W. Hittinger is a senior partner in Baker & Hostetler's antitrust group and the litigation group coordinator for the firm's Philadelphia office. He concentrates his practice on complex commercial and civil rights trial and appellate litigation, with a particular emphasis on antitrust and unfair competition matters. He can be reached at 215-564-2898 or chittinger@bakerlaw.com.

Tyson Y. Herrold is an associate in the firm's Philadelphia office in its litigation group. His practice focuses on complex commercial and antitrust litigation matters. His experience also includes judicial clerkships for U.S. District Judge Malachy E. Mannion of the Middle District of Pennsylvania, Judge C. Darnell Jones II of the Eastern District of Pennsylvania and Judge Dolores K. Sloviter of the U.S. Court of Appeals for the Third Circuit. He can be reached at 215-568-3439 or therrold@bakerlaw.com.