OPINION: The 2nd Circ.'s Misguided Approach To Antitrust

David Balto

Law360, New York (October 21, 2016, 5:23 PM EDT) -- Joni Mitchell's 1967 ballad "Both Sides Now" is an elegiac view of the path we take through the life and the different perspective we journey through along the way. As we grow and change, the things that enchanted us can come to let us down. Clouds that once graced the sky as "feather castles" now "simply block the sun."

That's a powerful and illuminating way of looking at life's changes — but it's a deeply misguided way to enforce the law. Yet it encapsulates the errors in a landmark federal court antitrust ruling that got so lost in Mitchell's ultimately relativistic call to look at "both sides" that it failed to see either of them clearly.

The issue in United States v. American Express Company[1] were AmEx rules that prevented merchants from steering consumers to lower cost credit cards.

There are two sides in credit card markets — merchants and consumers. And although there was clear evidence that one side of the credit card market — merchants — was plainly harmed by American Express' restrictions, the court got caught up in Joni Mitchell's "both sides now" perspective and held that this harm could be "offset" by supposed competitive effects on the other side of the market.

While Mitchell's wisdom is great poetry, it obscures the purpose of the antitrust laws, is inconsistent with decades of antitrust jurisprudence and will handicap the ability of the antitrust agencies and courts to challenge anti-competitive conduct in dozens of markets, including the critical consumer markets that today's economy relies upon and may create new classes of antitrust immunity in so-called two-sided markets.

To be sure, American Express' rule that prevents merchants from "steering" consumers to lower cost forms of payment results in economic harm to the merchants. Consumers may think that all credit cards look alike and cost the same, but to merchants it is a much different story. American Express charges merchants a hefty fee for accepting their cards — far higher than that charged by Discover or even Visa or MasterCard. Outside of the credit-card context, merchants already "steer" consumers to lower cost products every day simply by posting a price and allowing consumers to choose the best product for them in light of the price. But anti-steering contract provisions prevent retailers from doing the same with their credit cards, which means merchants can't incent consumers to use the most efficient form of payment. Merchants also can't discount cheaper forms of payment or use steering to lower the price and thereby benefit all shoppers.

The result is a tremendous tax on merchants and ultimately consumers, which pay these fees in the form of higher costs for their products. This is especially pernicious for cash-paying customers (about 25 percent of all Americans), who pay inflated prices of card acceptance that merchants pass on to them. But unlike card-payment customers, who at least arguably benefit from the rewards that American Express and its competitors fund with merchant fees, cash-paying customers receive no benefit for the higher prices. Because cash-paying customers tend to be less affluent than card-paying customers, this tax on the economy is highly regressive.

The district court, after a seven-week bench trial condemned the rule concluding that the restrictions "create[d] an environment in which there is nothing to offset credit card networks' incentives — including American Express's incentive — to charge merchants inflated prices for their services." The court found that the relevant market was for network services, that American Express had market power in the market both in terms of market share and demonstrated ability to raise prices, and that American Express used that power to "remov[e] the competitive 'reward' for networks offering merchants a lower price for acceptance services."

The Second Circuit reversed by redefining the issues and tossing out the district court's factual findings, relying on one sided economic literature to create a new quagmire in an area of law that was largely settled — that of two sided markets.

A two-sided market means that there are different types of entities brought together by a platform to make a transaction — in this case merchants and consumers. These platforms

rely on two distinct but interdependent classes of customers. Additionally, consumers derive more utility from multisided platforms as their size increases on both sides. These may sound unusual but antitrust enforcement has successfully dealt with these markets through traditional antitrust tools in cases such as United States v. First Data Corp.,[2] United States v. Visa,[3] and United States v. Microsoft[4] and United States v Comcast.[5]

That has always been the law, but the Second Circuit charts a new uncertain course that creates a clear cut intracircuit conflict with United States v. Visa. This uncertainty creates a huge enforcement loophole so that a company can exercise market power to force one side of a two-sided market to pay higher fees if there is some chance that the company will pass some of those fees off to their customers, on the other side of the market even if the higher fees result in higher prices for all consumers. Under this scenario, the conduct may be excusable and antitrust enforcers must look at the entire universe of potential economic effects on both sides of two-sided markets to prove a violation.

Requiring consideration of both sides of a two-sided market may be an interesting tool, but it's like viewing clouds like "rows and flows of angel hair." That's not what clouds are made of and that's not what antitrust law is about. Not surprisingly, the panel relies almost entirely on one side of a debate in economic literature rather than case law because the decision is unquestionably inconsistent with decades of antitrust jurisprudence. Indeed, antitrust merger law and the precedent set by Illinois Brick Co. v. Illinois[6] does not permit those types of tradeoffs. For example, for over 50 years since the decision in United States v. Philadelphia National Bank it is a fundamental tenet that a merger that is harmful in one market can not be permitted even if the merger would benefit another market.[7] Moreover, years later, the U.S. Supreme Court in Illinois Brick held that courts could only consider the harm to the initial purchaser of a good in assessing damages.

And antitrust enforcement has to have limits to the analysis. For example, only direct purchasers can recover damages because the complexity of allocating damages among secondary purchasers is too complex. The Supreme Court in Illinois Brick stated: "However appealing this attempt to allocate the overcharge might seem in theory, it would add whole new dimensions of complexity to treble-damages suits and seriously undermine their effectiveness."[8] Without sound limits to the antitrust inquiry, defendants can prevail simply by claiming that the economic analysis needs to be expanded.

Given that the antitrust laws are already complex, antitrust enforcers and courts need clear

limits and standards to the analysis. As Judge William Howard Taft famously said:

[T]he courts ... have set sail on a sea of doubt, and have assumed the power to say ... how much restraint of competition is in the public interest, and how much is not. The manifest danger in the administration of justice according to so shifting, vague, and indeterminate a standard would seem to be a strong reason against adopting it.[9]

Effectively the panel's decision compels a vastly more complex analysis than is required by the law and sound antitrust policy. It is a quagmire. How do you balance effects in one side of the market against effects in the other side of the market? Antitrust analysis is already difficult but going down this path of balancing will result in haphazard results and outcomes. Venturing into the two-sided quagmire will lead to the same confusion and uncertainty.

This is why multisided platforms are traditionally examined under familiar rules of antitrust law. As current Acting Assistant Attorney General Renata Hesse explained in a 2007 article, "Two-Sided Platform Markets and the Application of the Traditional Antitrust Analytical Framework," harm in a single market is sufficient to demonstrate an antitrust violation.[10] The reasons for this can be illustrated through a simple example. Imagine that a powerful manufacturer with must-have products tells retailers that they are not permitted to sell competing products at lower prices, even if their wholesale prices are lower. This harmful conduct would be illegal, and yet that is just what American Express did through its anti-steering rules. Holding that American Express' anti-steering rules are different is what happens when antitrust law falls victim to obfuscation.

The Second Circuit's rewriting of multisided platform antitrust law was influenced by two erroneous lines of thinking. First, the decision's analysis started by prejudging vertical conduct as largely pro-competitive. This is a misstatement of antitrust jurisprudence[11] that builds upon dangerous assumptions, especially when trying to compare unrelated areas of antitrust law that operate under different economic principles.

The court's unconditional blessing of vertical arrangements was also problematic in that it diverted the court's attention away from the horizontal impact of the restraints that the district court found. American Express's restrictions had a direct and pernicious effect on horizontal competition. The district court stated that "[i]n undermining the competitive process and price-setting mechanism in the market …, the challenged restraints impede a critical form of horizontal, Interbrand competition."[12] Because of these restrictions the card

networks did not have to compete for merchant loyalty by reducing merchant acceptance fees.

Second, the decision repeatedly uses customer rewards to excuse evidence of anti-competitive effects. This produces an unusual result, permitting a wide range of anti-competitive behavior so long as any profits obtained are split with the bad actor's consumers. However, this short-sighted analysis completely ignores harm to non-American Express customers who pay higher prices.

Decision Dismantles Three Antitrust Tools

The Second Circuit's decision systematically dismantled three traditional antitrust tools needed to enforce anti-competitive vertical multiplatform market conduct — market definition, market power and adverse effects on competition — essentially creating an enforcement carve-out for a wide range of vertical behavior in multisided platforms.

Market Definition

The court found that the market definition test applied in United States v. Visa was inappropriate in this case. Visa involved the U.S. Department of Justice's successful challenge to Visa and MasterCard rules that prevented banks from issuing rival cards. The Visa court considered the multisided credit card market and found that the relevant market was for general purpose card network services, in which Visa, MasterCard, American Express and Discover compete to sell network services to merchants.[13] The court dismissed the Visa court's test for two reasons: (1) the court believed it was significant to the Visa case's market definition that the anti-competitive effects occurred on both sides of the market whereas in this case American Express customers received a benefit in the form of a rewards program; and (2) the court believed that there is a significant difference between horizontal and vertical cases when defining a market. This reasoning does not make any economic sense. Market definition is part of an antitrust tool that is only used to measure market power through the proxy of market share. Anti-competitive effects are measured in another, separate, step of proving an antitrust claim. By conflating the two steps the court incorrectly defined the market. Also, the Visa court dealt with the issue of defining markets in a multisided platform. There is no reason why this analysis should be swept away because this case concerns a vertical rather than horizontal restraint.

In this case the Second Circuit held that antitrust enforcers must use a test that considers the “feedback effects inherent” in multisided platforms, meaning the DOJ must account “for the reduction in cardholders’ demand for cards (or card transactions) that would accompany any degree of merchant attrition.” However, there is no discussion on what a test might look like that satisfies the court. The Second Circuit’s ruling condemns antitrust enforcers to go down a rabbit hole of complex economics when much simpler and easier to apply solutions have already been used and accepted by courts.

Market Power

Market share, as measured in an appropriately defined market, is only a proxy to determine market power. But market power can be shown directly. The DOJ presented substantial evidence of market power by demonstrating high barriers to entry, cardholders insisting on using American Express at the register, and actual cases of American Express raising prices to merchants without any meaningful merchant attrition. There are numerous cases holding that the fact that a firm can raise prices is direct evidence of market power. The Second Circuit waved away this substantial evidence because it perceived there was increased demand from cardholders due to the rewards that came from these price increases. Cardholder insistence is written off as not due to market power, but instead from the result of competitive benefits due to cardholder rewards and services. Once again, the Second Circuit seems to be working in a competitive effects judgment into an assessment of market power.

Adverse Effects on Competition

The Second Circuit faults the district court for elevating the interests of merchants above American Express cardholders. However, nowhere in the Second Circuit’s assessment of adverse effects is there a discussion on how merchant price increases in response to high American Express fees harms non-American Express customers. Merchants cannot allocate the higher costs to the customers creating those higher costs, nor can they reward customers who save merchants money. Merchants can only respond by raising prices. Therefore, recognizing the harm to merchants is the appropriate and necessary proxy for identifying harm that flows to all customers, and therefore competition, because of the high fees that lead to higher prices.

The panel’s myopic focus on potential benefits to American Express cardholders obscures

the real question — how are all consumers effected? The Second Circuit must account for the higher prices that result to all consumers. These higher prices have a net impact on all customers, one that may even exceed the value American Express customers are getting in the form of rewards. The Second Circuit has rejected the district court's measure of adverse effects, which was easy to apply and included derivative consumer harms, and replaced it with a measure that is harder to apply and fails to account for consumer harm. Doing so inherently elevated the interests of American Express cardholders over merchants and consumers generally without any evidence that would justify this and without any basis in jurisprudence.

The Greater Problems Posed by the Decision

The harm of the Second Circuit's decision alone in the credit card market is tremendous. Merchants pay billions in fees to American Express and these are clearly inflated by the anti-steering rule. The evidence at trial was clear cut that but for the anti-steering rule, competition from Discover, Visa and MasterCard would force down these merchant fees. In addition, the anti-steering rule dooms all customers to higher prices and removes the transparency necessary to drive competition.

But the spill-over effects may be even more substantial. By requiring consideration and balancing of both sides of the market, the decision effectively forces the courts, as then Justice Taft observed to "set sail on a sea of doubt." How does a court balance conflicting interests and effects on different market participants? What tools can be used? Antitrust cases are already extraordinarily complex, costly and time-consuming. This decision will raise these problems exponentially.

The impact on other types of critical antitrust enforcement may lead to even greater harm. Take the Federal Communications Commission and the DOJ challenge to the Comcast-Time Warner merger. That was premised on harm to video content providers who would have been paid less by the merged firm. But under the American Express decision that would have had to be balanced against any benefits to consumers from supposed lower "input" costs and that could have been an obstacle to enforcement. Or the Anthem/Cigna merger where the DOJ has alleged harm to health care providers. If that harm led to lower input costs enforcement could be forestalled.

Just look at the effects this decision would have had against past decisions in technology

markets. First, the decision in United States v. Apple Inc.,[14] in which Apple organized a conspiracy among book publishers to raise e-book prices would have come out much differently. The case presented a two-sided market where higher prices to consumers led to higher revenues to authors. If the Second Circuit's opinion was in effect at the time the case was decided, then the DOJ may have had to look at both sides of the market in defining the market and accounted for the benefits to the authors of the price-fixing scheme when analyzing competitive effects. Second, the American Express decision likely also would have thwarted merger enforcement that led to a consent decree in the merger of First Data Corp. and Concord EFS.[15] There parties argued that increases in interchange fees for merchants are largely due to intense competition for issuers.[16] Renata Hesse said that these arguments came from "confus[ing] vigorous competition for one set of customers for the exercise of market power against the other."[17] However, under the Second Circuit's ruling these arguments would have been valid.

The Second Circuit's decision could also harm enforcement in a current case involving an alleged dominant hospitals rules that prevent insurers from guiding consumers to the lowest cost providers.[18] In Carolinas Healthcare System the DOJ challenged an anti-steering provision that prevented insurers from steering their members to other, lower cost hospitals, which could result in overall lower costs to consumers. The defendant, relying on the American Express decision, now challenges the DOJ's claim stating the Second Circuit found such anti-steering provisions are not anti-competitive.

Antitrust enforcement is critically important in new technology and high-tech markets, including those involving multimarket platforms. The Second Circuit's decision is inconsistent with decades of mainstream antitrust law and unless reversed will impede enforcement in these critical markets.

If the decision stands, it's easy to see future antitrust enforcers explaining that abusive market behavior is lawful because it has some indirect or "second side" benefit. Or throwing up their hands at the very idea of antitrust enforcement because it is too difficult to assess the different impacts on the different sides of these market. Clever corporate lawyers will no doubt argue that it's not just "both sides" that must be considered — and construct Rube Goldberg "multisided markets" that hamstring enforcers even more. Perhaps they can try to justify their inaction and adapt Joni Mitchell's observation that "so many things I would have done, but clouds got in my way," but for antitrust abusers it would be more like "Take A Walk on the Wild Side."

“Both sides now,” is terrific poetry but misguided antitrust jurisprudence. The DOJ should appeal this voyage on the sea of doubt or lose the ability to bring enforcement in critical industries on which the economy and consumers vitally depend.

—By David Balto, Law Offices of David Balto

David Balto is a former policy director of the Federal Trade Commission Bureau of Competition and a former antitrust lawyer at the U.S. Department of Justice. He is also general counsel for the Independent Specialty Pharmacy Coalition.

[1] Case 15-1672 (2d Cir. Sept. 26, 2016), available at http://ij.org/wp-content/uploads/2016/09/15-1672_opn.pdf.

[2] Case No. 03-cv-02169 (D.D.C. 2003).

[3] 344 F.3d 229 (2d Cir. 2003).

[4] 253 F.3d 34 (D.C. Cir. 2001).

[5] Case No. 11-cv-0106 (D.D.C. 2013).

[6] 431 US 720 (1977).

[7] United States v. Philadelphia National Bank, 374 US 321, 370 (1963).

[8] Illinois Brick Co. v. Illinois, 431 US 720, 737 (1977).

[9] United States v. Addyston Pipe & Steel Co., 85 F. 271, 283-84 (6th Cir. 1898).

[10] Renata B. Hesse, Two-Sided Platform Markets and the Application of the Traditional

Antitrust Analytical Framework, Competition Policy International, Vol. 3, No. 1, Spring 2007, available athttps://www.competitionpolicyinternational.com/assets/0d358061e11f2708ad9d62634c6c40ad/Hesse.pdf.

[11] See, e.g., Leegin Creative Leather Products v. PSKS, Inc., 127 S. Ct. 2705, 2716-17 (2007) (discussing anticompetitive effects of vertical agreements).

[12] United States v. American Express, Case 10-4496 at 107 (E.D.N.Y. Feb. 19, 2015), available at https://www.justice.gov/atr/case-document/file/485746/download.

[13] The Visa court determined that "general purpose card network services…constitute a product market because merchant consumers exhibit little price sensitivity and the networks provide core services that cannot be reasonably replace by other sources." United States v. Visa, 163 F. Supp. 2d, 338-39.

[14] Case 13-3741 (2d Cir. June 30, 2015).

[15] United States v. First Data Corp., 03 Civ. 02169 (D.D.C. 2003).

[16] See Transcript of Hearing (Dec. 5, 2003) at 97:12 to 98:12, United States v. First Data Corp., 03 Civ. 02169 (D.D.C. 2003) (testimony of Professor Michael Katz, expert for the defendants), available at http://www.usdoj.gov/atr/cases/f201900/201902a.htm.

[17] See Renata Hesse, supra note 10 at 194.

[18] United States of America et al. v. The Charlotte-Mecklenburg Hospital Authority, Case 16-0311 (W.D.N.C.)("Carolinas Healthcare System").