ANTITRUST ANALYSIS OF VERTICAL CONTRACTS IN TWO-SIDED PLATFORMS: THE *AMEX* DECISION

BY BENJAMIN KLEIN[1]

1 Professor Emeritus of Economics, UCLA and Visiting Professor, UCLA Law School.

I. INTRODUCTION

The debate that surrounds the recent Supreme Court *Amex*[2] decision has concentrated on the narrow question of what relevant market definition should be used to determine if vertical restraints employed by a two-sided platforms meet the first anticompetitive effects test of rule-of-reason analysis. The Court concluded that the plaintiffs' evaluation of the anti-steering rules American Express included in its contracts with merchants failed to correctly consider the anticompetitive effects of the rules in a relevant market consisting of both the cardholder and merchant sides of the Amex transaction platform. The dissent, on the other hand, emphasized that to meet the first anticompetitive burden of rule-of-reason analysis one may look at direct evidence of anticompetitive effects of the Amex rules solely on the merchant side of the platform where the restraints operate, specifically the fact that the anti-steering rules resulted in higher Amex merchant fees. Unfortunately, this debate has led to questions, such as whether the two sides of the platform should be considered substitutes or complements or whether harm and benefits to buyers on both sides of the platform should be offset at the initial anticompetitive stage of the analysis, that have little relevance or insight into how antitrust analysis of vertical contracts used in two-sided platforms should be conducted.

This paper argues that antitrust analysis of vertical contract restraints used in two sided platforms should be conducted in the same way that vertical restraints are now analyzed under established U.S. antitrust law. If the vertical contracts are interbrand, as are the Amex restraints, the platform's overall market share should be used as a minimum screen for the existence of platform market power. If this screen is passed, economic analysis of the vertical restraints should then be undertaken on the side of the platform where the contract restraints operate to determine if they provide the platform with the ability to anticompetitively maintain or enhance its market power. This framework is different from both the decision and the dissent.

2 *Ohio v. American Express Co.*, 505 U.S.___ (2018), slip opinion cited throughout.

II. ANTITRUST FRAMEWORK OF ANALYSIS

The *Amex* decision and dissent both recognize that Amex supplies a credit card transaction platform that, as with all platforms, operates in two markets. Amex must make its credit cards desirable in both a consumer cardholder market and a merchant acceptance market. Moreover, the fact that the platform is a transaction platform means that the two markets are necessarily connected – the supply on one side of the market cannot be changed without a change on the other side. Amex then takes account of the presence of positive indirect network effects between the two sides of the platform in setting profit-maximizing relative prices in the two markets.[3]

Justice Thomas, writing for majority, observes that credit-card transaction platforms are "better understood as 'supplying only one product' – transactions … that 'are jointly consumed by a cardholder, who uses the payment card to make a transaction, and a merchant, who accepts the payment card as a method of payment.'"[4] Consequently, "competition cannot be accurately assessed by looking at only one side of the platform in isolation."[5] Accordingly, it is necessary to analyze "the two-sided market for credit card transactions as a whole to determine whether the plaintiffs have shown that Amex's anti-steering provisions have anticompetitive effects."[6] However, other than the Court's conclusion that the plaintiff did not meet the first rule-of-reason anticompetitive burden because it incorrectly focused solely on the effects of the Amex restraints on merchant fees on the merchant side of the market, it remains unclear from the decision exactly how this fundamental insight that platform competition involves both sides of the platform should influence antitrust analysis of a platform's vertical restraints.

A. Minimum Platform Market Share Screen

One way to interpret the *Amex* decision's view that the first anticompetitive step of rule-of-reason analysis of vertical contract restraints should involve the platform "as a whole" is to require an initial platform market power screen. This is a key element of the Court's analysis, incredibly presented in a single footnote.[7] Consistent with established U.S. antitrust law of vertical contractual restraints, the firm instituting a vertical restraint must possess a sufficient market share for the restraint to have an anticompetitive effect.

Justice Breyer in dissent legitimately asks what the legal support consists of for this proposition that the antitrust law of vertical contracts now generally requires a minimum market share for liability and criticizes the Court's sole reference to *Leegin*[8] in this regard. He argues that *Leegin* only moved the analysis of vertical restraints to a rule-of-reason standard, not to *per se* legality in situations where the firm lacks market power as evidenced by an insufficiently large market share.[9] Justice Breyer later further notes that an essential distinction must be made between the antitrust analysis of intrabrand vertical restraints that were at issue in *Leegin* and the Interbrand vertical restraints involved in *Amex*.[10] There has been a *de facto* movement to *per se* legality with regard to intrabrand restraints, culminating in *Leegin*, while interbrand restraints remain subject to a stricter antitrust standard.[11]

3 Jean-Charles Rochet & Jean Tirole, *Platform Competition in Two-Sided Markets*, J. European Economic Assoc. 990 (2003), Jean-Charles Rochet & Jean Tirole, *Two Sided Markets: A Progress Report*, 37 Rand J. Econ. 645 (2006) and Benjamin Klein, Andres V. Lerner, Kevin M. Murphy & Lacey L. Plache, *Competition in Two-Sided Market: The Antitrust Economics of Payment Card Interchange Fees*, 73 Antitrust L. J. 571 (2006).

4 *Amex* at 13, citing Klein et al, *id.* at 580.

5 *Amex* at 14.

6 *Amex* at 15.

7 *Amex* at 11, fn. 7.

8 *Leegin Creative Leather Products, Inc. v. PSKS, Inc.* 551 U.S. 877 (2007).

9 *Amex* dissent at 13-14.

10 *Amex* dissent at 24-25.

11 Three of the four potential anticompetitive motivations for resale price maintenance described in *Leegin* involve the use of resale price maintenance in connection with the enforcement of an interbrand contractual arrangement, such as the use of resale price maintenance to pay merchants to adopt exclusive distribution. The fourth anticompetitive motivation involves an anticompetitive conspiracy among retailers to coerce the manufacturer to adopt intrabrand fixed resale prices against its wishes. Benjamin Klein, *Inferring Agreement in Hub-and-Spoke Conspiracies*, Antitrust L. J., forthcoming (2019).

B. Intrabrand Platform Vertical Restraints

To illustrate the economic difference between intrabrand and interbrand vertical platform contracts consider first the purely intrabrand vertical price setting contract restraint instituted by the Uber ride-sharing platform. The Uber platform brings together drivers and riders and sets prices on the two sides of the platform. The Uber platform is analogous to the Amex credit card platform in the sense that there are significant indirect network effects in both directions. The value of the Uber platform to drivers, and therefore the demand by drivers to join the platform and supply ride services, is positively related to the number of consumers in the area that have downloaded and use the Uber app. In addition, the value of the Uber platform to consumers, and therefore the demand by consumers to download and use the Uber app to demand rides, is positively related to the number of drivers who supply services on the platform and are available to supply consumers with rides. Uber optimally sets the prices on the two sides of the platform to take account of these network effects. The Uber platform also corresponds to what the Court referred to in *Amex* as a single transaction platform; the prices set on the two sides of the platform are related to a single Uber trip transaction.[12]

The Uber pricing arrangement can be thought of as a form of intrabrand resale price maintenance. Uber sets retail prices and driver compensation share on the two sides of the platform for each trip and prevents drivers from competing with one another for passengers on the platform by offering a lower retail price. This intrabrand price-setting contract arrangement was the basis for the recent consumer class antitrust claim in *Meyer v. Kalanick*,[13] where it was alleged that Uber used its vertical control over pricing to create a price fixing conspiracy among its drivers. Uber, it was argued by the plaintiffs, benefited from this driver conspiracy by obtaining a share of the resulting collusive profits earned by the drivers.[14]

In evaluating this antitrust claim, it is essential to recognize that Uber's alleged price fixing is purely intrabrand. Therefore, even though the Uber platform may have a significant market share, Uber does not have an incentive to create an anticompetitive conspiracy among its drivers to fix retail prices with such a vertical pricing restraint and will consequently will not do so unless there are efficiencies associated with the vertical contract. Uber should be thought of as purchasing driver services at a cost equal to the difference between its set retail price and the approximate 25 percent gross margin Uber takes on a trip before payment to the driver of the residual. Uber could continue to collect the same amount per trip based on 25 percent of the list retail price and permit driver retail price competition on transaction prices. This would reduce what the driver receives and therefore for Uber the implicit cost of the driver services it is purchasing. The lower transaction retail prices would then appear to have the advantage of increasing consumer demand for rides and Uber revenues. Uber does not have an anticompetitive motivation to create a conspiracy among its drivers to prevent such retail price competition because there is no additional collusive profit Uber can obtain from such a conspiracy. Uber, if it wished, could always just increase the list retail price and decrease the driver share to keep driver compensation at unchanged, presumably competitive levels. The economics of purely intrabrand vertical restraints, including intrabrand vertical restraints adopted in two-sided platforms, therefore recognizes that such restraints are unlikely to be instituted by a platform for anticompetitive purposes. In spite of the fact that the vertical restraint may increase prices, the platform must be adopting the intrabrand vertical contract for procompetitive efficiency reasons.[15]

12 To avoid government regulatory constraints on suppliers of transportation services, Uber initially insisted that it was merely a platform that brought together demanders (passengers) and suppliers (drivers) and was not itself a supplier of transportation services. The fact that Uber actually sets prices and other transaction terms on the two sides of the platform indicates that Uber is more than merely a platform that facilitates transactions between independent buyers and sellers of rides.

13 *Spencer Meyer v. Travis Kalanick*, 174 F. Supp. 3d 817 (2016).

14 The primary motivation for the complaint was Uber's introduction of a "surge" pricing formula, whereby retail prices were increased during high demand periods. However, the retail price fixing structure existed prior to adoption of the "surge" pricing formula. The District Court certified a class of Uber consumers but was reversed by the Appeals Court on the basis that consumers, by downloading the Uber app and registering with Uber, had agreed to Uber's "Terms of Service," including an agreement to arbitrate any claims. *Meyer v. Uber Technologies and Travis Kalanick*, (2nd Cir 2017) U.S. App. Lexis 15497.

15 There are, in fact, important efficiency reasons for Uber to set retail prices and prevent driver price competition on its platform in terms of preserving optimal relative prices. By preventing drivers from bidding for rides, a minimum driver payment is assured which encourages a greater supply of drivers and shorter waiting time for riders. An individual driver that reduces prices creates a negative platform externality by reducing driver supply and increasing average customer waiting time. Uber's policy of increasing prices to clear the market in high demand periods, in addition to increasing its revenues, efficiently allocates rides across demanders and, by increasing driver compensation, encourages an increased supply of drivers during high demand periods.

C. Interbrand Platform Vertical Restraints Should Be Evaluated on the Side of the Platform Where the Restraint Operates

In contrast to purely intrabrand platform vertical contracts, the economic forces are fundamentally different when the platform's vertical contract specifies how participants on one or both sides of the platform must behave with regard to the platform's rivals. In these types of cases, even when there are no efficiencies associated with the vertical contract, the platform's profits may be increased by an interbrand vertical contract that significantly disadvantages the platform's rivals. This occurs when the platform possesses market power and the interbrand contract anticompetitively preserves or increases the platform's market power. For example, let us hypothetically assume that Uber contractually required its drivers to enter exclusive dealing contracts, so that they could not drive for any other competing ride-providing platform such as Lyft. Antitrust analysis of such an interbrand vertical contract would then require an economic analysis of Uber's market share, the time period over which the restraint is imposed, and the potential resulting effect of the restraint in anticompetitively raising costs and foreclosing rival ride-providing platforms in the driver services supply market.

The *Amex* dissent notes that the Supreme Court clearly recognized more than 60 years ago the necessity to examine the potential anticompetitive effects of a platform interbrand vertical contract restraint in the market on the side of the platform where the restraint operates. *Times Picayune*,[16] involved a dominant newspaper publisher in New Orleans that operated a two-sided platform in the sense that it supplied content to newspaper readers on one side of the platform and advertising space to advertisers on the other side of the platform.[17] In setting relative prices, Times Picayune took account of the largely one-way network effects of increased readers on the increased demand for advertising to underprice subscriptions relative to advertising.

The case involved the introduction by Times Picayune of a vertical contract restraint on advertisers on one side of its newspaper platform. The contract required all advertisers that purchased an ad in its dominant morning paper to also purchase the ad in its evening paper, where it faced an evening newspaper rival. In this way Times Picayune intended to disadvantage its evening newspaper rival.[18] The Court decided that because the restraint did not involve tying of reader demand but only of advertiser demand, the potential anticompetitive effects of the restraint should be determined solely in the advertising market where the contract restraint operated.[19] Examining the effects of the Times Picayune vertical contract restraint in the New Orleans newspaper advertising market, the Court found that the rival newspaper's share of advertising lineage did not decline and therefore concluded that the "factual data, in sum, do not demonstrate that the Publishing Company's advertising contracts unduly handicapped its extant competitor … The record in this case thus does not disclose evidence from which demonstrably deleterious effects on competition may be inferred."[20] The *Amex* dissent uses this reasoning to conclude that the anticompetitive effects of the Amex anti-steering rules should similarly be examined only on the merchant side of the Amex platform.[21]

16 *Times Picayune Publishing Co. v. U.S.* 345 U.S. 594 (1953).

17 "[E]very newspaper is a dual trader in separate though interdependent markets; it sells the paper's news and advertising content to its readers; in effect that readership is in turn sold to the buyers of advertising space." *Id.* at 610, cited in *Amex* dissent at 10.

18 *Id.* The vertical contract restraint is less restrictive than a normal tying arrangement where the contract requirement essentially eliminates rival demand for the tied product. In this case advertisers could and often did purchase ads in both the Times Picayune and rival evening papers.

19 *Id.*

20 *Times Picayune at 619.*

21 The *Amex* decision implicitly attempts to distinguish *Times Picayune* by limiting its conclusions to cases where network effects occur in both directions, rather than the largely only one direction network effects in *Times Picayune*, and to cases where the platform is a transactional platform so that, in contrast to *Times Picayune*, quantity cannot be changed on one side of the platform without an identical change on the other side of the platform. However, neither of these factors changes the basic economic and competitive forces present in *Times Picayune* compared to *Amex.*

III. AMEX

A. Early Use by Amex of Anti-Steering Rules

Applying the above legal framework of analysis of interbrand platform vertical contract restraints to the Amex anti-steering rules it is obvious, first of all, that the vertical restraints would very likely have passed antitrust muster throughout most of the 1990s when Amex had a relatively small market share of around 15 percent. American Express was supplying a somewhat unique product compared to Visa and Mastercard that focused on spending by high-income individuals and the Amex card was accepted by relatively few merchants primarily selling products aimed at these high-income individuals. The merchants who decided to accept the Amex card with its associated higher Amex merchant fee, and as a condition agreed to comply with the Amex anti-steering restraints, considered the incremental advantages of doing so sufficient to offset the higher merchant fee.[22] Although American Express had a group of loyal cardholders that preferred the higher Amex spending limits and the particular rewards offered, no one would claim at this point in time that Amex possessed market power. Competitive firms that supply differentiated products generally face less than perfectly elastic demands by their loyal consumers and also may earn economic rents in competitive equilibrium.[23] While the anti-steering rules may have permitted American Express to maintain its higher merchant fees, pay higher cardholder rewards and possibly earn positive rents, the presumption of antitrust law is that firms without market power should be permitted as part of the normal competitive process to adopt the particular distribution arrangements they desire.

B. Changes in Credit Card Platform Market Conditions

American Express, and more significantly Visa and Mastercard, changed their business strategies in the late 1990s and moved substantially closer to one another in terms of their products offerings. American Express entered issuing contract arrangements with organizations that had established relationships with potential cardholders and also began offering cardholders credit terms for delayed payment. Meanwhile, Visa and Mastercard introduced some types of cards with substantially higher cardholder spending limits and greater rewards along with higher associated merchant fees. Visa and Mastercard were also forced to increase merchant fees as a result of the increased competition they faced to obtain issuance by large financial firms such as Capital One. These card issuing firms developed independent consumer brand names and cardholder loyalty and played off Visa and Mastercard against one another with offers of partial exclusivity in return for increased credit card company compensation. Increased credit card company compensation of issuers funded increased rewards that reinforced issuer cardholder loyalty and resulted in higher Visa and Mastercard fees.[24]

In addition to vividly illustrating that the competitive process in the credit card platform market occurs on both sides of the platform, the growth of high reward Visa/Mastercard credit cards resulted in a substantial narrowing of the average merchant fee gap between American Express and Visa/Mastercard. This, in turn, led to increased merchant acceptance of American Express and the associated growth of Amex as a share of credit card platform market to its now approximately 25 percent level. The somewhat higher Amex market share may suggest that at the time of the litigation American Express perhaps exceeded the proposed initial minimum market share screen required for potential anticompetitive effects. However, other vertical interbrand contract restraints, that are significantly more restrictive in terms of potential anticompetitive effects by foreclosing rivals from particular distribution channels or market segments, generally require a significantly larger minimum market share for antitrust liability.[25]

22 Given the fact that average merchant gross margins are approximately 25 percent, and substantially higher for some products consumed by higher-income individuals such as jewelry or travel-related services, incremental merchant sales need not increase very much to make it worthwhile for some merchants to decide to accept the Amex card. Klein et al, *supra* note 3, at 585-86.

23 Benjamin Klein, *Market Power in Antitrust: Economic Analysis After Kodak*, 3 Sup. Ct. Econ Rev. 43 (1993).

24 *Id*. at 603-09.

25 For example, vertical interbrand tying contracts as well as exclusive dealing contracts require the firm to possess more than a 30 percent market share. *Jefferson Parish Hosp. Dist. No. 2 v. Hyde* 466 U.S. 2 (1984).

C. Claimed Direct Evidence of Anticompetitive Effects

The Amex dissent ignores the question of whether the overall platform market power screen is met and moves directly to an analysis of evidence of anticompetitive effects on the merchant side of the Amex platform. The dissent concludes that, in fact, there is "strong *direct* evidence of anticompetitive effects flowing from the challenged restraint"[26] and hence "proof of actual detrimental effects on competition."[27] The dissent states that this direct evidence of anticompetitive effects implies *a fortiori* the presence of market power.[28] Presumably, this means that the platform market power screen necessary for finding that vertical restraints have been used anticompetitively to increase or maintain monopoly also is met by this evidence.

The dissent's primary claimed direct evidence of anticompetitive effects is asserted to consist, first of all, of the fact that Amex increased merchant fees without a loss of merchant acceptance or market share.[29] This is merely the other side of the Cellophane Fallacy.[30] Does it mean that American Express was not profit-maximizing before it increased merchant fees? What it more likely illustrates is that to measure elasticity of demand one must compare the increase in Amex merchant fees relative to the increase that was simultaneously occurring in Visa and Mastercard merchant fees. As noted above, Visa and Mastercard merchant discounts were generally increasing due to increased competition for issuance, with the difference in merchant discounts between Amex and Visa and Mastercard generally narrowing over time. Moreover, to determine potential anticompetitive effects of a restraint it is necessary to observe market changes in merchant acceptance and market share after the introduction of the vertical restraint at issue, as was done by the Court in *Times Picayune*, not by inferring a much later claimed anticompetitive effect to a long-established restraint.

The *Amex* dissent also uses as direct evidence of anticompetitive effects the fact that the "merchant price increases that resulted from the nondiscrimination provisions 'were not wholly offset by additional rewards expenditures or otherwise passed through to cardholders, and *resulted in a higher net price*.'"[31] The *Amex* Court does not adopt this standard, stating somewhat less precisely, but legally more accurately, that the law requires the plaintiffs to offer "evidence that the price of credit-card transactions was higher than the price one would expect to find in a competitive market."[32] As noted above[33], when firms supply differentiated products, market price, neither the price on one side of a two-sided transaction platform nor the total "net" price on the two sides together, fully describes the nature of competition and cannot by itself demonstrate that vertical restraints have been used to anticompetitively exercise monopoly power to disadvantage rivals.

26 *Amex* dissent at 12, citing 88 F. Supp 3d, at 207-224.

27 *Amex* dissent at 14. The *Amex* decision at 11, n7 notes that the plaintiff's argument that it is not necessary to define a relevant market when there is actual evidence of adverse effects on competition relies on cases that deal with horizontal restraints, for example, *FTC v. Indiana Federation of Dentists*, 476 U.S. 447 (1986) and *Catalano, Inc. v. Target Sales, Inc.* 446 U.S. 643 (1980). In these cases, agreement among competitors not to compete on certain dimensions may be reasonably considered anticompetitive on their face.

28 *Amex* dissent at 14.

29 *Amex* dissent at 12.

30 *U.S. v. E. I. Dupont DeNemours & Co.*, 331 U.S. 377 (1956).

31 *Amex* dissent at 22 citing District Court factual finding, 88 F. Supp. 3d at 215. (emphasis added)

32 *Amex* decision at 16. The Court goes on to say that the District Court found that "the plaintiffs failed to offer any reliable measure of Amex's transaction price or profit margins." *Id*. These are irrelevant measures unless perhaps there is a claim of predatory pricing.

33 *Supra* note 23.

IV. CONCLUSION

The *Amex* dissent believes that American Express, through its anti-steering rules, has "disrupt[ed] the normal price-setting mechanism."[34] However, all vertical restraints disrupt the competitive process in the sense that they alter what would otherwise occur in the absence of the restraint. Leegin's intrabrand vertical resale price maintenance contracts change market prices. To meet the first anticompetitive condition of rule-of-reason analysis, one must show that a vertical contract restraint distorts the competitive process so that monopoly power is created or maintained. We do not want to assume that any vertical contract restriction that alters relative prices on the two sides of a platform necessarily involves a distortion of "the competitive process."[35] To meet the first step condition for the demonstration of anticompetitive effects the platform must possess market power and the restraint used to maintain or expand that power.[36]

The antitrust law of vertical restraints that has developed in the United States is based on the fundamental proposition that one should let competitive firms that do not possess market power determine how their products are marketed, including the restricted distribution arrangements they choose to adopt, as long as monopoly power is not created or maintained as part of this competitive process. Rather than microregulating the competitive process, a social judgement has been made that the legal framework provided by antitrust law which gives competitive firms discretion to implement the vertical arrangements they desire as part of the normal competitive process optimally leads in the long-run to maximum consumer welfare.

34 *Amex* dissent at 9, quoting District Court at 209.

35 Dennis W. Carlton & Ralph A. Winter, *Vertical MFNs and Credit Card No-Surcharge Restraints*, 61 J. Law & Econ 215, 230 (2018).

36 If a plaintiff is successful in demonstrating anticompetitive effects, the burden shifts to the defendant to demonstrate procompetitive platform efficiencies. While Carlton & Winter, *id.*, claim that the Amex no surcharge rule, which prohibits merchants from imposing a fee on Amex transactions, is equivalent to a merchant being prohibited from setting a higher retail price for Amex's product than the retail price of a rival firm's product even though Amex's product has a higher wholesale price, they ignore that the Amex credit card is not a product but a medium of exchange. Letting merchants add a transaction fee on Amex transactions, in addition to changing relative prices, would significantly decrease the value of the Amex card brand name as a medium of exchange. This may explain why the Visa/Mastercard consent judgement permitted continuation of the no surcharge rule and, in fact, the government did not challenge the no surcharge rule in the Amex litigation.