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4-24-2018

# Assessing the Competitive Effects of Surcharging the Use of Payment Mechanisms

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## Recommended Citation

Steven Semeraro, *Assessing the Competitive Effects of Surcharging the Use of Payment Mechanisms*, 26 U. Miami Bus. L. Rev. 29 (2018)  
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# Assessing the Competitive Effects of Surcharging the Use of Payment Mechanisms

Steven Semeraro<sup>1</sup>

*The Department of Justice's theory of liability in its case attacking the non-discrimination provisions in American Express's merchant contracts contends that point-of-sale competition on the price of making a purchase with a credit card is an instrument creating economic efficiency. That is, the economy would run more efficiently, and consumers would be better off, if merchants were free to charge variable prices for different types of credit cards. After all, charging different prices for using different types of payment mechanisms appears to be just another form of presumptively positive price competition.*

*The Second Circuit rejected that conclusion, recognizing that in credit card markets competition already occurs at multiple points. American Express must compete to:*

- *convince cardholders to apply for and use its cards; and*
- *convince merchants to accept its cards.*

*The question, the Second Circuit correctly recognized, is whether adding a third type of competition – for cardholders to use the*

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<sup>1</sup> Steven Semeraro is a professor of law at Thomas Jefferson School of Law and the author of numerous articles on the impact of surcharging credit card transactions on retail prices including *The Antitrust Economics (and Law) of Surcharging Credit Card Transactions*, 14 STAN. J. OF BUS. & FIN. 343 (2009) and *The Reverse-Robin-Hood-Cross-Subsidy Hypothesis: Do Credit Card Systems Tax the Poor and Reward the Rich?*, 40 RUTGERS L. J. 419 (2009).

*card when merchants pass through their card acceptance fees – would make American Express’s card network more efficient?*

*By prohibiting merchants who accept American Express cards from discriminating against the brand, the card company imposed a unilateral vertical restraint. Such restraints are often deemed to be reasonable under the antitrust laws because they may “stimulate inter-brand competition.” This is because an upstream provider, like American Express, has little interest in reducing its downstream sales. It would only impose a vertical restraint if that restraint efficiently helped it to sell more products. Only when an upstream or downstream provider has market power enabling it to impose restraints that harm consumers by raising price or lowering quality does a vertical restraint violate the antitrust laws.*

*The Department of Justice’s theory postulated that the non-discrimination provisions in American Express’s merchant agreements harmed consumers by effectively requiring merchants to increase their prices to cover higher credit card fees for all customers because merchants could not pass the cost of accepting American Express directly to American Express’s own customers.*

*The Second Circuit acknowledged the potential for consumer harm would exist if American Express charged merchants supra-competitive prices and pocketed the excess as rents. But the court held that the government failed to prove that rivalry on the price consumers pay to use a credit card at the point of sale would increase efficiency in credit card markets. As the Second Circuit explained, credit card markets are two-sided. In order to prove harm to consumer welfare in a two-sided market, an antitrust plaintiff needs to show that a restraint makes the overall system less efficient. That is, do consumers overall pay more for less because of the restraint.*

*A card network like American Express must compete for both cardholders and merchants. One therefore cannot demonstrate that price increases on one side of the market are inefficient without examining how those prices impact competition on the*

*other side of the market. American Express argued that it used increased revenue from the merchant side to offer a better card product to its cardholders and compete more effectively with other card networks, like Visa, for cardholder loyalty.*

*The Second Circuit did not definitively decide whether American Express's non-discrimination provisions were pro- or anticompetitive. It simply concluded that two-sided market economics made the question more complex than the government plaintiffs acknowledged in trying the case. And based on the record evidence, the court couldn't tell whether the non-discrimination provisions made the market more or less efficient. Since the plaintiff bears the burden of proving harm to competition, i.e. a reduction in efficiency to the overall market, the government plaintiffs had failed to prove their case.*

*Part I reviews the economics of two-sided markets and provides reasons to conclude that non-discrimination provisions in credit card markets are efficient. Part II explains that a market's two-sided nature does not guarantee that participants in that market will charge competitive prices. Card systems with market power could set merchant fees at supra-competitive levels, leaving the market less efficient. This Part then contrasts Visa's and MasterCard's fees in the 1990s and early 2000s—which were challenged by merchants in a class action—with American Express's current fees. It concludes that the factors giving the merchants a plausible case against Visa and MasterCard do not support the government plaintiffs in their case against American Express. Part III addresses a systemic concern expressed in a recent New York Times editorial about how a decision in American Express's favor might impact the future enforcement of antitrust claims against dominant firms. This Part concludes that those concerns are unfounded. The Sherman Act has two principle sections. Truly dominant firms would remain subject to scrutiny under Section 2 of the Sherman Act, and Section 1 vertical restraint cases already require proof of consumer harm no different from what the Second Circuit required in its decision favoring American Express.*

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### INTRODUCTION

In his seminal law review article *The Limits of Antitrust*, Judge (then-Professor) Frank Easterbrook argued that “[a] ‘competitive market’ is not necessarily the one with the most rivalry moment-to-moment . . . . Every market entails substantial cooperation over some domain in order to facilitate competition elsewhere.”<sup>2</sup> “Antitrust aims at preserving competition as an instrument for creating economic efficiency . . . . [C]ompetition cannot be defined as the state of maximum rivalry, for that is a formula of disintegration.”<sup>3</sup>

The Department of Justice’s theory of liability in its case attacking the non-discrimination provisions in American Express’s merchant acceptance contracts illustrates how difficult Easterbrook’s insight can be to apply.<sup>4</sup> Under the DOJ’s theory, which the Federal District Court accepted, point-of-sale competition on the price of making a purchase with a credit card is an instrument creating economic efficiency.<sup>5</sup> That is, the economy would run more efficiently, and consumers would be better off, if merchants were free to charge variable prices for different types of

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<sup>2</sup> Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1, 1 (1984).

<sup>3</sup> *Id.* at 13.

<sup>4</sup> See generally *United States v. American Express Co.*, 88 F. Supp. 3d 143, 150 (E.D.N.Y. 2015).

<sup>5</sup> The District Court held that the government had proven “American Express’s NDPs have caused actual anticompetitive effects on interbrand competition. By preventing merchants from steering additional charge volume to their least expensive network, for example, the NDPs short-circuit the ordinary price-setting mechanism in the network services market by removing the competitive ‘reward’ for networks offering merchants a lower price for acceptance services. The result is an absence of price competition among American Express and its rival networks.” *American Express Co.*, 88 F. Supp. 3d at 151.

credit cards.<sup>6</sup> After all, charging different prices for using different types of payment mechanisms appears to be just another form of presumptively positive price competition.

By contrast, the Second Circuit's decision reversing the trial court questioned that conclusion.<sup>7</sup> To be sure, the antitrust laws presume that price competition will produce efficient price levels.<sup>8</sup> As Easterbrook recognized, though, one cannot simply take as given that forcing rivalry at every potential point where competition might occur will yield these positive results.<sup>9</sup> And the Second Circuit recognized that in credit card markets, competition already occurs at multiple points.<sup>10</sup> American Express must compete to:

- convince cardholders to apply for and use its cards; and
- convince merchants to accept its cards.

The question, the Second Circuit correctly recognized, is whether adding a third type of competition—for cardholders to use the card when merchants pass through their card acceptance fees—would make American Express's card network more efficient or would it be, in Easterbrook's words, a “formula [for] disintegration” of the credit system?<sup>11</sup>

By prohibiting merchants who accept American Express cards from discriminating against the brand, the card company imposed a unilateral vertical restraint.<sup>12</sup> Such restraints are often deemed to be reasonable under the antitrust laws because they may “stimulate interbrand competition.”<sup>13</sup> This is because an upstream provider, like American Express, has little interest in reducing its downstream sales. It would only impose a vertical restraint if that restraint efficiently helped it to sell more products. Only when an upstream provider has market power enabling it to impose restraints that harm consumers by raising price or lowering quality does a vertical restraint violate the antitrust laws.<sup>14</sup>

The Department of Justice's theory postulated that the non-discrimination provisions in American Express's merchant agreements

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<sup>6</sup> *See id.*

<sup>7</sup> *See generally* United States v. American Express Co., 838 F.3d 179, 204–06 (2nd Cir. 2016).

<sup>8</sup> *See* National Soc. Of Professional Engineers v. United States, 435 U.S. 679, 695 (1978).

<sup>9</sup> *See generally* Easterbrook, *supra* note 2, at 6.

<sup>10</sup> *See generally* American Express Co., 838 F.3d 179.

<sup>11</sup> Easterbrook, *supra* note 2, at 13.

<sup>12</sup> *See id.* at 195.

<sup>13</sup> *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877, 878 (2007).

<sup>14</sup> *Id.* at 894 (“A manufacturer with market power . . . might use resale price maintenance to give retailers an incentive not to sell the products of smaller rivals or new entrants.”)

harmed consumers by effectively requiring merchants to increase their prices to cover higher credit card fees for all customers because merchants could not pass the cost of accepting American Express directly to American Express's own customers.<sup>15</sup>

The Second Circuit acknowledged that the potential for consumer harm would exist if American Express charged merchants supra-competitive prices and pocketed the excess as rents, but the court held that the government failed to prove that rivalry on the price consumers paid to use a credit card at the point of sale would increase efficiency in credit card markets.<sup>16</sup> As the Second Circuit explained, credit card markets are two-sided.<sup>17</sup> In order to prove harm to consumer welfare in a two-sided market, an antitrust plaintiff needs to show that a restraint makes the overall system less efficient.<sup>18</sup> In other words, would consumers overall pay more for less because of the restraint?

A card network like American Express must compete for both cardholders and merchants. One, therefore, cannot demonstrate that price increases on one side of the market are inefficient without examining how those prices impact competition on the other side of the market. American Express argued that it used increased revenue from the merchant side to offer a better card product to its cardholders and compete more effectively with other card networks, like Visa, for cardholder loyalty.<sup>19</sup>

The Second Circuit did not definitively decide whether American Express's non-discrimination provisions were pro- or anticompetitive.<sup>20</sup> Based on the record evidence, the court couldn't tell whether the non-discrimination provisions made the market more or less efficient.<sup>21</sup> It simply concluded that two-sided market economics made the question more complex than the government plaintiffs acknowledged in trying the case.<sup>22</sup> Since the plaintiff bears the burden of proving harm to competition—*i.e.*, a reduction in efficiency to the overall market—the government plaintiffs had failed to prove their case.<sup>23</sup>

Part I reviews the economics of two-sided markets and provides reasons to conclude that non-discrimination provisions in credit card markets are efficient. Part II explains that a market's two-sided nature does not guarantee that participants in that market will charge competitive

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<sup>15</sup> See *American Express Co.*, 838 F.3d at 184.

<sup>16</sup> *Id.* at 204–06.

<sup>17</sup> *Id.* at 198.

<sup>18</sup> See *id.* at 193.

<sup>19</sup> See *id.* at 202–03.

<sup>20</sup> See *id.* at 205–06.

<sup>21</sup> See *American Express Co.*, 838 F.3d at 206.

<sup>22</sup> See *id.* at 206–07.

<sup>23</sup> See *id.* at 205–06.

prices. Card systems with market power could set merchant fees at supra-competitive levels, leaving the market less efficient. This Part then contrasts Visa's and MasterCard's fees in the 1990s and early 2000s—which were challenged by merchants in a class action—with American Express's current fees. It concludes that the factors giving the merchants a plausible case against Visa and MasterCard do not support the government plaintiffs in their case against American Express. Part III addresses a systemic concern expressed in a recent New York Times editorial about how a decision in American Express's favor might impact the future enforcement of antitrust claims against dominant firms.<sup>24</sup> This Part concludes that those concerns are unfounded. The Sherman Act has two principle sections. Truly dominant firms would remain subject to scrutiny under Section 2 of the Sherman Act, and Section 1 vertical restraint cases already require proof of consumer harm no different from what the Second Circuit required in its decision favoring American Express.

#### I. THE ECONOMICS OF CREDIT CARD NETWORKS

In setting prices, card systems face two distinct customer bases: cardholders and merchants. Within such a two-sided market, prices are efficiently set at the level necessary to recover the system's marginal costs, but the efficient price for the cardholder and for the merchant may not equal the marginal cost of providing the services received by each. On the contrary, in a two-sided market customers that are less sensitive to price—*i.e.*, have lower demand elasticity—will pay more than the cost of serving them while the more price-sensitive customers will pay less than the cost of serving them.<sup>25</sup> Assuming that merchant demand for card acceptance is less elastic than cardholder demand, efficient pricing will place more of the cost of the system on merchants than cardholders.<sup>26</sup> If merchants pass the cost of card acceptance on to the cardholders, however, the efficient pricing structure would be disrupted. Pass-through pricing would undo the balance between the relative elasticities of demand between card users and merchants with respect to card use and would thus drive card usage down below the efficient level.<sup>27</sup>

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<sup>24</sup> Lina M. Khan, "The Supreme Court Case That Could Give Tech Giants More Power," N. Y. TIMES (Mar. 2, 2018) (<https://www.nytimes.com/2018/03/02/opinion/the-supreme-court-case-that-could-give-tech-giants-more-power.html>).

<sup>25</sup> SEMERARO, *supra* note 1, at 347.

<sup>26</sup> SEMERARO, *supra* note 25, at 353.

<sup>27</sup> *See id.* at 353–58.



### A. Understanding Two-sided Markets

Credit card markets are far from unique. There are many markets in which the use of the product or service by consumers on two different sides directly impacts the utility of the product or service to the consumers on the other side. Common examples of markets functioning this way include newspapers (readers and advertisers), dating services (men and women), and optical disc technology suppliers (disc pressers and player manufacturers).<sup>28</sup> The more readers, men, and disc pressers use these products and services, the more valuable they will be to advertisers, women, and player manufacturers, and vice versa.<sup>29</sup>

Although the connection between value and use across customer types in a two-sided network market is intuitively obvious, the implication of this economic effect for efficient pricing is rather opaque. In a typical *one-sided* market, an efficient price—one that will lead to an optimal consumption level—will generally approximate the marginal cost of production plus the profit necessary to attract investment to the industry.<sup>30</sup> This pricing model is efficient because it maximizes short-run output consistently with the producer earning sufficient revenue to continue providing the product or service.

In a two-sided market, the same principle applies, but efficient pricing must take account of both total cost *and* the relative elasticities of demand between the two customer sets.<sup>31</sup> If the customers on each side of such a market were charged the marginal cost of serving just their side of the market, they could fail to internalize the impact of their decisions to the customer set on the other side.<sup>32</sup> For example, a card-accepting merchant would fail to account for the benefits of card use to a customer who would make the same purchase with or without a card.

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<sup>28</sup> For a detailed discussion of the economics of two-sided markets *see generally* David S. Evans & Michael Noel, *Defining Antitrust Markets When Firms Operate Two-Sided Platforms*, 2005 COLUM. BUS. L. REV. 667; David S. Evans, *The Antitrust Economics of Multi-Sided Platform Markets*, 20 YALE J. ON REG. 325 (2003).

<sup>29</sup> *See generally* EVANS & NOEL, *supra* note 28.

<sup>30</sup> Michael L. Katz, *What Do We Know About Interchange Fees and What Does it Mean for Public Policy?: Commentary on Evans and Schmalensee*, FED. RES. BANK OF KAN. CITY 127 (2005), <https://www.kansascityfed.org/bXkVg/publicat/pscp/2005/katz.pdf>.

<sup>31</sup> EVANS & NOEL, *supra* note 28, at 681.

<sup>32</sup> *See* KATZ, *supra* note 30, at 126–27; *see generally* Julian Wright, *Optimal Card Payment Systems*, (May 8, 2002) (manuscript at 8) ([http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=278047](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=278047)); *see generally* Margaret E. Guerin-Calvert & Janusz A. Ordober, *Merchant Benefits and Public Policy Towards Interchange: An Economic Assessment*, 4 REV. NETWORK ECON. 384, 384–85 (2006) (explaining that “[t]he network externalities that link merchants who accept cards and card-holders who use them compel a price/fee structure that will likely entail deviations from the cost-causality principles that call for prices to be closely linked to the underlying costs of providing *direct* benefits to either side of the market.”).

Two-sided market economic theory predicts that if demand elasticities diverge to any significant degree between the customers on each side of the market, output under a pricing scheme that covered marginal-cost separately on each side of the market would be inefficiently low. To obtain an efficient output level, a producer must charge the customer set that is more sensitive to price less than marginal cost of serving that customer (effectively enabling those consumers to internalize the benefits to both sides of the market).<sup>33</sup>

The classic example is the daily newspaper.<sup>34</sup> Readers have many sources of news, including television, magazines, and the internet. Reader demand for newspapers is thus likely to be quite elastic, leading them to turn away from the morning paper if the subscription prices were to approach the marginal cost of producing and delivering it.<sup>35</sup> By contrast, advertisers perceive significant benefits in print advertising (so long as readership is high), and are thus willing to pay substantially above the newspapers' marginal cost of printing and providing associated services to the advertiser because of the value of exposure through a high circulation paper.<sup>36</sup> As a result, readers pay significantly below marginal cost and advertisers pay substantially more.<sup>37</sup> Competition between newspapers and other media for advertising space still drives pricing, but not to marginal cost plus normal profit for each customer set. This pricing pattern efficiently optimizes newspaper circulation, satisfying both the advertisers' need for broad exposure and the readers' need for information.<sup>38</sup>

Assuming that newspapers have little market power, both advertisers and readers would be worse off if pricing were forced into line with marginal cost on each side of the market. If advertising fees were to drop and reader fees proportionally increased, prices would move toward marginal cost on each side of the market. Because reader demand is more elastic, however, readership would drop more than advertising would increase, and advertising rates would thus fall. As a result, the paper would (1) earn lower overall revenue; (2) be less valuable to advertisers because readership would fall; and (3) be less valuable to readers because the paper would have less revenue for newsgathering.

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<sup>33</sup> KATZ, *supra* note 30, at 127; see Jean-Charles Rochet & Jean Tirole, *Cooperation Among Competitors: Some Economics of Payment Card Associations*, 33 RAND J. ECON. 549, 566 (2002); see Wright, *supra* note 32, at 17.

<sup>34</sup> For a formal treatment of this example see Benjamin Klein, Andres V. Lerner, Kevin M. Murphy & Lacey L. Plache, *Competition in Two-Sided Markets: The Antitrust Economics of Payment Card Interchange*, 73 ANTITRUST L. J. 571, 577-79 (2006).

<sup>35</sup> *Id.* at 579.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 577.

<sup>38</sup> See *id.* at 579.

### *B. Applying Two-sided Market Theory to Card Markets*

To the extent that the elasticity of demand varies significantly between merchants and cardholders, card systems resemble newspapers.<sup>39</sup> Merchants, like print advertisers, have been willing to pay significantly above the marginal cost of the credit card acceptance services presumably because of the value card acceptance creates for a merchant.<sup>40</sup> Cardholders, like newspaper readers, would be reluctant to pay the marginal cost of providing credit cards and associated services.<sup>41</sup> Thus, two-sided market theory predicts that efficient credit card pricing would resemble the existing marketplace—a greater share of the total costs of the payment system are placed on merchants.<sup>42</sup>

To be sure, relative elasticities across customer groups are difficult to measure. Long standing practice in credit card markets, however, appears to confirm that cardholder demand is considerably more elastic than merchant demand and thus merchants pay more than the marginal cost of serving them and cardholders pay less.<sup>43</sup> Since the beginning, card systems have adopted cost allocation systems that empower cardholders to use cards without taking account of the per transaction costs that arise as a result of their decision.<sup>44</sup> Every existing credit card system, until recently, prohibited merchants from passing on the price that they pay for card acceptance to cardholders, and each system adopted that pricing policy well before it had market power.<sup>45</sup> By uniformly adopting a pricing policy in a competitive market that shifts revenue from the merchant side to the

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<sup>39</sup> *Id.* at 580.

<sup>40</sup> *See id.* at 585.

<sup>41</sup> *See id.* at 585–88.

<sup>42</sup> *Id.* at 584; *see also* Richard Schmalensee, *Payment Systems and Interchange Fees*, 50 J. OF INDUS. ECON. 103, 115 (2002) (explaining that “increasing total output . . . by subsidizing price cuts where demand elasticity is high . . . increases the size of the pie for the system as a whole.”).

<sup>43</sup> In ATM and PIN debit card markets, by contrast, interchange fees have in some cases flowed away from cardholders to those who accept debit cards as a means to access cash.

<sup>44</sup> *See* Steven Semeraro, *Credit Card Interchange Fees: Three Decades of Antitrust Uncertainty*, 14 GEO. MASON L. REV. 941, 967, 988 (2007).

<sup>45</sup> *See id.* at 988 (explaining that “[t]he direction of interchange fee payments . . . appears to be consistent with an efficient and competitive market.”); *see also* KATZ, *supra* note 30, at 123 (virtually all debit card systems also have interchange fees flowing from merchants to issuers). Recently, Visa and MasterCard agreed as part of a settlement agreement to permit merchants to surcharge credit card transactions. That agreement was rejected by the courts. And even if it remained in place, it was designed to compel merchants to inflict more harm on American Express than they would on Visa and MasterCard.

cardholder side, the card systems practice accords with what two-sided market theory would predict.<sup>46</sup>

The efficiency of this form of elasticity-based pricing garners further support by the growth in both merchant acceptance and card use over time.<sup>47</sup> If a pricing policy placing a greater burden on the merchant side were inefficient, one would expect to see merchants rejecting credit cards. But that has not happened. Card acceptance has spread to more and more segments of the economy. Although many card-accepting merchants do not accept American Express cards, the number of merchants who do has been increasing.<sup>48</sup> The existing system of cost allocation thus appears to be efficient because forcing cardholders to cover costs now paid by merchants would be likely to lead to an inefficient under-use of cards.<sup>49</sup>

To understand the anticompetitive effect of allowing merchants to pass the cost of card acceptance on to consumers, consider a chess club that when charging uniform dues to all players has a membership that is (1) disproportionately low-skill and (2) lower in number than the club could efficiently accommodate. The club organizers therefore decide to offer free admission to high-skilled players, while increasing the dues charged to low-skilled club members. This differential pricing:

- (1) attracts more high-skilled players;
- (2) makes the club more desirable for low-skilled players who thus attend more often; and
- (3) increases membership and utilization of club facilities.

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<sup>46</sup> See Steven Semeraro, *The Efficiency and Fairness of Enforced Sharing: An Examination of the Essence of Antitrust*, 52 U. KAN. L. REV. 57, 97-98 (2003) (discussing generally how practices undertaken by firms in competitive markets are presumptively efficient).

<sup>47</sup> Judge Easterbrook has famously explained that practices increasing output over time are likely to be efficient. See Frank H. Easterbrook, *On Identifying Exclusionary Conduct*, 61 NOTRE DAME L. REV. 972, 979 (1986); see also EASTERBROOK, *supra* note 2, at 30-34.

<sup>48</sup> Robert Harrow, *More Consumers and Merchants Turning To American Express Credit Cards*, <https://www.valuepenguin.com/2017/07/more-consumers-and-merchants-turning-american-express-credit-cards> (updated Apr. 5, 2018).

<sup>49</sup> KATZ, *supra* note 30, at 126 (explaining that surcharging can undo the effects of interchange fees). Alan Frankel has questioned this justification for the no-surcharge rule, arguing that if merchants want to encourage additional card use, they could easily do so themselves through point-of-sale discounts and other incentives. Alan S. Frankel & Allan L. Shampine, *The Economic Effects of Interchange Fees*, 73 ANTITRUST L. J. 627, 647 (2006). But merchants face conflicting incentives. The benefits that they receive from credit cards are often infra-marginal, such as an overall increase in spending levels not directly tied to individual transaction purchase decisions. Merchants benefit at the margin only when the cardholder would not make the purchase without the card. If the customer would make the purchase in all events, a merchant may experience a marginal benefit from the use of another means of payment, but an infra-marginal loss if cardholders stopped carrying credit cards altogether. See Adam Levitin, *Priceless? The Competitive Costs of Credit Card Merchant Restraints*, 55 UCLA L. REV. 1321, 1348-49, 1353 (2008).

By attracting more high-skilled players through differential pricing, the club functions more efficiently and thus all of its members benefit. To be sure, low-skilled players bear a greater percentage of the cost of operating the club than high-skilled players, but the club provides more value to them—*i.e.*, the chance to play against and learn from higher-skilled players. If this pricing strategy were not efficient, low-skilled players would leave the club rather than pay the higher dues.

The chess club with differential pricing corresponds to the existing credit card market in which merchants, like low-skilled players in the hypothetical, pay a higher percentage of the costs of the payment system than necessary to recover the marginal cost of serving them. The DOJ's theory of the case presumes that the chess club's pricing policy would be inefficient because high-skilled players were not covering the club's full cost of serving them and revenues generated by low-skilled players, the analogy continues, inefficiently subsidized the high-skilled players.

By choosing to frequent the club in greater numbers, however, the low-skilled players demonstrated that they preferred the club with differential pricing to the less expensive club with a single price. Merchants' willingness to accept credit cards in ever increasing numbers within the card systems' existing pricing models communicates the same message.

Discrimination among payment systems in the card market would disrupt this presumptively efficient pricing mechanism by shifting some costs onto cardholders. A similar disruption might occur in the chess club if the meeting organizers surcharged high-skilled players by, for example, charging them more for refreshments at club meetings than the low-skilled players must pay, undoing the benefit of the differential pricing. High-skilled players enticed to join the club by the *no-dues* policy would soon realize that they were paying more for refreshments. The meeting organizer, like a merchant surcharging card transactions, would negate the benefit of the *no-dues* policy. The likely effect would be that high-skilled players would quit, and the club would thus end up back where it started: with an inefficiently low number of members all paying the same entry fee.

Just as high-skilled chess players would quit the club if short-sighted meeting organizers surcharged their refreshments, cardholders would reduce their use of cards if merchants passed on acceptance fees by charging their customers a per transaction fee to use a particular means of payment.

## II. SUPRA-COMPETITIVE CREDIT CARD PRICING

Two-sided market economics provide a reason why placing a greater share of a card network's costs on the merchant side is likely to be efficient. But it does not insulate card networks from violating the antitrust laws by charging merchants fees at a level above what efficient two-sided market pricing would require. When merchants first sued Visa and MasterCard—but tellingly not American Express—attacking the networks' merchant fees, I presented a theory explaining why the merchants had a strong case that the Visa and MasterCard fees—though lower than American Express's fees—might nonetheless be inefficiently high.<sup>50</sup> Two points were critical to that theory.

First, merchants had a legitimate argument that the banks controlling Visa and MasterCard exercised sufficient market power to block merchants from dropping either brand because too many consumers rely exclusively on their cards and thus, in the United States, virtually all card-accepting merchants accept Visa and MasterCard.<sup>51</sup> By contrast, “roughly one-third of credit card-accepting merchants in the United States” do not accept American Express cards.<sup>52</sup>

Second, there appeared to be no plausible justification for the increases in merchant fees that proceeded the filing of that class action. The banks controlling Visa and MasterCard were growing revenues through the revolving credit business and improved technology was lowering the costs of fraud risk and other aspects of merchant acceptance.<sup>53</sup> Visa and MasterCard never offered a plausible explanation for their fee increases during the relevant period before the complaint was filed.<sup>54</sup> Curiously, the Department of Justice never joined the merchant class action against Visa and MasterCard.

In this case, American Express did offer a plausible explanation for its increasing merchant fees.<sup>55</sup> Its strategy to compete for cardholders—most of whom did not carry revolving credit balances—by offering an elite package of cardholder rewards and marketing the superiority of its reward program to potential cardholders.<sup>56</sup> This competitive strategy explained the network's merchant pricing policies to a far greater extent than Visa and MasterCard explained their fee increases in the 1990s and early 2000s.

The following sections set out two reasons that the DOJ might have concluded that merchant discrimination would produce more efficient card

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<sup>50</sup> SEMERARO, *supra* note 44, at 989–91.

<sup>51</sup> *Id.*

<sup>52</sup> *American Express Co.*, 838 F.3d at 203.

<sup>53</sup> *See* SEMERARO, *supra* note 44, at 992–96.

<sup>54</sup> *Id.*

<sup>55</sup> *See American Express Co.*, 838 F.3d at 202–03.

<sup>56</sup> *Id.*

pricing: (1) Visa and MasterCard in litigation settlements had agreed to permit surcharging; and (2) prohibiting discrimination inefficiently compelled merchants to impose American Express's high cost on all of its consumers. It finds both theories unavailing.

*A. Visa and MasterCard Settlements*

Perhaps the Antitrust Division believed that by agreeing to permit discrimination among payment schemes through surcharging, Visa and MasterCard had acknowledged that prohibiting discrimination was not necessary to ensure efficient card pricing. But that settlement was configured specifically to ensure that any surcharging would necessarily benefit Visa and MasterCard when compared to American Express.<sup>57</sup> The settlement prohibited merchants from surcharging a lower-priced card without also surcharging a higher priced one, even if the merchant perceived more value from the higher priced card.<sup>58</sup> Given state laws prohibiting surcharging, and American Express's continuous enforcement of its non-discrimination restraint,<sup>59</sup> Visa and MasterCard knew that significant surcharging was extremely unlikely to occur and, if it did, it would only hurt American Express more than it would hurt them. The Visa and MasterCard settlement agreements thus provide little confidence that discrimination would make card fees more efficient.

*B. Inefficient Cost-Shifting Among Consumers*

The DOJ surely recognizes that permitting discrimination would reduce the welfare of American Express cardholders by denying the card network the ability to obtain the revenue it needs from merchants to support the rewards it provides to cardholders. The Division must, therefore, believe that this loss would be outweighed by the gains of other consumers who presumably pay higher prices because of American Express's higher cardholder fees, but who do not receive any rewards. But it is unclear why this would be the case. The Division appears to assume implausibly that merchants who accept American Express cards receive no benefits from doing so and simply pass on the cost of card acceptance

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<sup>57</sup> See generally Steven Semeraro, *Settlement without Consent: Assessing The Credit Card Merchant Fee Class Action*, 2015 COLUM. BUS. L. REV. 186, 208–11 (2015).

<sup>58</sup> See generally *id.* (citing *In re Payment Card Interchange Fee & Merch. Discount Antitrust Litig.*, 986 F. Supp. 2d 207 (E.D.N.Y. 2013) (No. 05–MD–1720) (these paragraphs permitting surcharging: ¶ 41 (brand level surcharging, but ¶¶ 41–45 prohibiting surcharging one brand if a more expensive card were not surcharged))).

<sup>59</sup> See *id.* at 216–18. These provisions would also sunset in 2021, freeing the networks to again prohibit surcharging or other forms of discrimination; see also *id.* at 242.

to their consumers on a dollar-for-dollar basis.<sup>60</sup> But, if it were the case that merchants obtained no benefits from accepting American Express cards, they would simply not accept the card, joining the one-third of card-accepting merchants who do not accept American Express cards now. The reason that merchants accept American Express cards thus must be because they obtain the benefit of increased sales as a result of accepting the card.

If accepting American Express cards enables a merchant to increase sales, then one cannot presume that the merchant's prices will increase on a dollar-for-dollar basis to cover the fees it pays to American Express.<sup>61</sup> By increasing its sales, a merchant can spread its fixed costs over a larger total sales volume, potentially enabling it to lower its prices compared to what they would be if it did not accept American Express cards at all.<sup>62</sup> Whether the increase in sales that accepting a card brand brings to a merchant increases or decreases its ultimate prices is a particularly difficult empirical question, but one cannot simply assume that prices will increase, much less on a dollar-for-dollar basis.

Moreover, discrimination schemes are not costless to implement, and they would thus add to a merchant's costs. Whether the merchant would save more on reduced card acceptance fees than the cost of a discrimination program is again an empirical question. That merchants have refused to implement cash discounting schemes, despite the right to do so, for decades suggests that the savings in reduced card fees would not outweigh the cost of a discrimination scheme.

In the end, it is entirely possible that permitting merchant discrimination would simply enable merchants with market power to extract even more rents from their customers by discouraging consumers who would make purchases with or without cards to refrain from using them or paying higher prices. But there is no reason to presume that this practice will lead a merchant with market power to lower its prices to other customers.

And even if American Express's merchant fees are inefficiently high, merchants that discriminated against American Express would be extremely unlikely to calculate a surcharge or other form of discrimination at precisely the level needed to strip a card network of its inefficient overcharge. This is true because merchants generally would not have access to knowledge about the relative cross-elasticities between cardholders and merchants on which efficient card network pricing

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<sup>60</sup> See Steven Semeraro, *The Reverse-Robin-Hood-Cross-Subsidy Hypothesis: Do Credit Card Systems Tax the Poor and Reward the Rich?*, 40 RUTGERS L. J. 419, 429-33 (2009).

<sup>61</sup> See *id.*

<sup>62</sup> See *id.*



depends, and even if merchants had perfect knowledge, they wouldn't impose the right surcharge because they do not have the right incentives. Merchants care only about whether a customer makes a purchase. Any benefit that accrued to a card-using customer from the use of the card in situations where the customer would make the purchase even without the card would be ignored by the merchant.

Ultimately, merchants would likely divide into roughly two camps. The first group—merchants in reasonably competitive markets—would likely find the costs of discriminating prohibitive.<sup>63</sup> The second group—merchants with substantial market power—might impose a surcharge or other form of discrimination, but these merchants could potentially retain a significant portion of the card fee savings as profit rather than pass it on to their customers.<sup>64</sup> This second group of merchants may even use the surcharging power to exact greater profits from those consumers who must use a credit card for a particular transaction.<sup>65</sup>

### III. SYSTEMIC ANTITRUST CONCERNS

In a recent op-ed in the *New York Times*, Lina M. Khan, the director of legal policy at Open Markets Institute and a visiting fellow at Yale Law School, argued that a holding in favor of American Express “would create de facto antitrust immunity for the most powerful companies in the economy,” such as Google, Facebook, and Amazon.<sup>66</sup> This fear is misplaced for two reasons.

First, the companies she identified are true dominant firms in their industries. As she correctly recognizes, “antitrust scrutiny of their conduct [is] especially important.”<sup>67</sup> These firms, however, would be subject to that scrutiny under Section 2 of the Sherman Act as Microsoft was in the U.S.<sup>68</sup> and Google has been under the European Union equivalent.<sup>69</sup> The issue here is not the law, but the fortitude of U.S. enforcement authorities to bring monopolization cases.

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<sup>63</sup> See Zhu Wang, *Market Structure and Credit Card Pricing: What Drives Interchange?*, 28 INT'L J. OF INDUS. ORG. 86, 95 (2010) (concluding that the no-surcharge rule “does not play a role” with respect to merchants in competitive markets).

<sup>64</sup> See WRIGHT, *supra* note 32, at 8 (explaining that “[w]hen surcharging is allowed, merchants with monopoly power will exploit their power by setting a price to extract surplus from inframarginal cardholders”).

<sup>65</sup> See Semeraro, *supra* note 1, at 365.

<sup>66</sup> KHAN, *supra* note 24.

<sup>67</sup> *Id.*

<sup>68</sup> See generally *United States v. Microsoft*, 253 F.3d 34 (D.C. Cir. 2001).

<sup>69</sup> Mark Scott, *Google Fined Record \$2.7 Billion in E.U. Antitrust Ruling*, N.Y. TIMES, Jun. 27, 2017, <https://www.nytimes.com/2017/06/27/technology/eu-google-fine.html>.

American Express, by contrast, is not similarly dominant. It has less than a thirty percent market share, smaller than Visa and on a par with MasterCard, both of which have the entire banking industry behind them and significantly larger merchant networks.<sup>70</sup> Although Khan claims that “[t]he credit card industry is a classic case of oligopoly,”<sup>71</sup> it is hard to find evidence of that. In an oligopoly, one would expect stable pricing and a lack of innovative competitive efforts. The card networks, however, compete fiercely for cardholders and have maintained a differing range of merchant fees. Visa and MasterCard have made great strides eating into American Express’s strength at the high end of the market while American Express has competed to capture more middle-class card holders. To be sure, all of the networks charge merchants more than the cost of providing service to them, but that is the expected result of the nature of efficient pricing given market conditions, not evidence of oligopoly behavior. To claim that credit card networks are anticompetitive because they charge merchants a lot and cardholders very little would be the equivalent of claiming that newspapers are anticompetitive because they charge advertisers a lot and readers very little.

Second, the concern that Khan expresses about the difficulty of proving a vertical restraint case is—for better or worse—already part and parcel of antitrust law. If American Express wins this case, she argues, tech “platforms will be able to engage in anticompetitive activity with one set of users, so long as they can plausibly claim that harmful conduct enabled them to benefit another group.”<sup>72</sup> She offers as an example that Uber could prohibit its drivers from also serving rivals like Lyft and suppress the drivers’ income.<sup>73</sup> “Under the current approach,” she argues “these exclusive agreements would likely violate antitrust law. But under the Second Circuit’s analysis, the case would go nowhere unless plaintiffs could show that this practice also harmed riders.”<sup>74</sup>

That’s simply not an accurate description of either current law or the law that would exist if the Supreme Court upholds the Second Circuit. Current law governing vertical restraints under Section 1 of the Sherman Act requires proof that the defendant has the ability to harm consumers and that the restraint in question could plausibly have that effect.<sup>75</sup> Under current law, a court considering Uber’s exclusivity policy would ask why Uber would impose such a restraint on its own drivers. An obvious reason would be that exclusive Uber drivers would accept calls from riders more

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<sup>70</sup> *United States v. Visa, U.S.A., Inc.*, 344 F.3d 229, 235, 240 (2d Cir. 2003).

<sup>71</sup> KHAN, *supra* note 24.

<sup>72</sup> *Id.*

<sup>73</sup> *See id.*

<sup>74</sup> *Id.*

<sup>75</sup> *See Leegin*, 551 U.S. at 890.

quickly, making Uber a more effective competitor against other taxi services and increasing its output, which would benefit both Uber and its drivers as well as their customers.

No similarly obvious anticompetitive story exists. Assuming Uber has market power—which it probably does not in any market including Lyft—it could benefit either by driving down the fee it pays drivers or driving up the fee it receives from riders, but the proposed exclusivity restraint would do neither. By limiting a driver's sources of income, Uber would need to pay that driver more to convince her to accept the exclusive deal. Riders would be hurt as prices went up, but not in a way that would benefit Uber because it would be using the price increase to pay drivers more.

A plausible antitrust theory attacking Uber's hypothetical exclusivity policy would exist under current law if, by imposing exclusivity requirements on its drivers, Uber could deny Lyft and other competitors adequate access to drivers. But by limiting the ability of its competitors to meet consumer demand, Uber could raise its prices to riders, violating the antitrust laws. Contrary to Khan's assertion, current law would thus require proof that the restraint on drivers hurt riders in order for it to violate the antitrust laws.

And nothing would change were American Express to win its case. The issue in a Rule of Reason case is whether a restraint is likely to increase output in the market and thus better serve consumer demand, or lower output and, therefore, drive up prices.<sup>76</sup> In a two-sided market, a price increase on one side of the market may increase output across the entire system and that appears to have been the effect of American Express's non-discrimination provision.<sup>77</sup> Credit card use has increased, by definition benefiting the consumers who use credit cards.

To prove an anticompetitive effect, a plaintiff would need to show offsetting consumer harm either through a reduction in the defendant's own output or through a reduction in market output because the restraint hinders the ability of competitors in that market.<sup>78</sup> In a case against Google, for example, the plaintiff would be required to show either a reduction in ads or searches on Google, or a hindering of competitive search engines' ability to compete with Google because of the restraint. The Second Circuit properly recognized that the government plaintiffs had failed to articulate a plausible story for how American Express's non-discrimination provisions could decrease its own output or the output of the broader market.<sup>79</sup>

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<sup>76</sup> See *American Express Co.*, 838 F.3d at 205.

<sup>77</sup> See *id.* at 206.

<sup>78</sup> See *id.* at 204–06.

<sup>79</sup> See *id.* at 206.

#### CONCLUSION

The economics of two-sided markets do rule out the possibility of anticompetitive harm, but the Second Circuit correctly concluded that the government plaintiffs failed to prove harm in this case. The merchant class may have a stronger case against Visa and MasterCard in that on-going litigation if it ever gets to trial.