Creating a Payment System Network: The Tie that Binds or an Honorable Peace?

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INTRODUCTION

Payment system joint ventures, such as VISA, MasterCard, and the various ATM networks, are frequently the subject of antitrust litigation. Some of the most important cases clarifying the treatment of joint ventures have involved these networks. The amount of antitrust controversy is due to a number of factors, including the facts that the antitrust laws offer few bright line rules and these ventures are very large and appear to possess market power.

One of the most difficult aspects of network joint ventures is that many types of conduct may have both procompetitive and anticompetitive effects. In network markets, many types of conduct that attempt to "bind" network members may play a critical role in developing the network. Rules such as exclusivity provisions that restrict network members from participating in other networks may be necessary to ensure the commitment of the members of a network to its success. Yet once a network reaches a dominant position, the procompetitive aspects of these rules may have diminished, and they may serve to erect unnecessary barriers to the development and growth of alternative networks.

The antitrust laws are traditionally very skeptical about rules that limit market access. In the network context, antitrust faces a difficult trade off: when do restrictions that aid the development of a network become overly restrictive and stifle network competition? To illustrate this issue, this Article looks at one type of restriction that a network may engage in to develop a new network. VISA and MasterCard, the two largest card associations, require merchants, as a condition of accepting their credit cards, to accept any other card with their trademark. This rule is known as the "honor all cards" rule and is currently at issue in antitrust litigation

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between VISA and MasterCard and a group of merchants.[1] These merchants have charged that VISA's "honor all cards" rule violates the antitrust laws and specifically is an act of illegal tying. The Article discusses how these claims should be analyzed and discusses some of the policy issues raised by these types of arrangements.

BACKGROUND

Debit cards were first issued by the regional ATM networks in the late 1970s. The debit card networks piggybacked on the ATM network—they used the same switch and trademark, and the banks issued a single card with dual ATM/debit functionality. The networks issued numerous cards during the 1980s, but the growth of online debit was rather slow because relatively few merchants accepted the cards. One major impediment was providing incentives for merchants, since a merchant must purchase point of sale (POS) authorization terminals to conduct online transactions.

One key source of controversy was how compensation would work between banks and merchants. Traditionally, in credit card and ATM networks an "interchange fee" (a per transaction charge) is paid to compensate the party with the greater costs and to provide incentives for investments. In the debit card environment, banks and merchants could not agree which party had the greater costs or which party needed the incentive to make investments. From the merchants' perspective they should receive interchange since they had to invest in POS terminals. The banks believed they should receive interchange for card issuing expenses. Some networks chose no interchange fee, some paid the merchant, and others required a small interchange to the banks.

VISA and MasterCard have had, at best, an ambivalent attitude toward the development of debit cards, because they were perceived as a threat to the far more lucrative credit card programs. In the early 1980s, VISA and MasterCard developed offline debit cards, known respectively as VISA check and MasterMoney. Neither association promoted the offline product significantly, relatively few cards were issued and the products were generally unknown.[2]

Neither association issued online debit cards. In 1987, VISA and MasterCard announced the creation of a joint venture known as Entree, to issue online debit cards. VISA had earlier acquired the largest regional debit network, Interlink, which was based in California. About the same

1. *See In re* VISA Check/Mastermoney Antitrust Litig., No. 96-CV-5238, 2000 WL 220507, at *1 (E.D.N.Y. Feb. 22, 2000). Both VISA and MasterCard have similar rules, but for ease in exposition this Article will simply refer to VISA.

2. In fact, the leading treatise on the subject does not even mention the offline products in its chapters on debit cards in its 1988 edition. *See* 1 DONALD I. BAKER & ROLAND E. BRANDEL, THE LAW OF ELECTRONIC FUND TRANSFER SYSTEMS (2d ed. 1988).

time MasterCard and VISA acquired controlling interests in the two national ATM networks: Cirrus and Plus respectively.

Fourteen State Attorneys General challenged the formation of Entree in 1989.[3] The states alleged that by forming Entree and acquiring the ATM networks, the associations intended to retard the development of debit, which they feared would compete with and erode the profitability of credit cards. If debit prospered, consumers might begin using debit as an alternative to the relatively high cost credit card systems. Debit cards charged much lower interchange fees and, unlike credit cards, typically did not charge consumers annual fees.

The states alleged that Entree was a combination of the five most likely entrants into the debit market. As part of the joint venture, MasterCard and VISA had agreed not to introduce their own separate debit systems to compete with Entree. The states' theory was that such a large national network would inhibit entry or the growth of the smaller regional ATM networks into the debit market.[4]

In 1990, VISA and MasterCard settled and agreed to abandon Entree.[5] VISA retained Interlink and both card associations were permitted to keep their interests in the national ATM networks. The decree permitted the two associations to enter the online market but compelled them to keep memberships in the new debit networks separate. (Merchants, however, were permitted to accept both cards.)

VISA and MasterCard set different courses for online debit. VISA used Interlink as its brand and attempted to build from its base in California. MasterCard created a new brand: "Maestro." Both networks promoted online debit cards and experienced moderate growth during the late 1980s and early 1990s.

The commitment of VISA and MasterCard to online debit seemed to change dramatically in the mid-1990s. At that time, Interlink and Maestro lagged behind the online debit networks of the regional ATM networks. Although the reasons for the change in strategy are unclear, VISA and MasterCard appeared to significantly dampen their efforts to promote Interlink and Maestro and instead began to focus their attention on offline debit.[6] The number of offline debit cards and transactions have more than

3. *See* New York v. VISA U.S.A., Inc., 1990-91 Trade Cas. (CCH) ¶ 69,016, at 63,566 (S.D.N.Y. 1990) (listing as plaintiffs the states of New York, Arizona, California, Connecticut, Louisiana, Maryland, Massachusetts, Minnesota, Tennessee, Texas, Utah, Washington, West Virginia, and Wisconsin); David A. Balto, *Can the Promise of Debit Cards Be Fulfilled?*, 53 BUS. LAW. 1093 (1998).

4. The complaint sought divestiture of CIRRUS by MasterCard, and PLUS and Interlink by VISA, as well as an injunction against the implementation of Entree.

5. *VISA U.S.A.*, 1990-91 Trade Cas. (CCH) at 63,566.

6. Almost all of VISA's promotional funds went to offline debit rather than Interlink. *See Interlink Plans for a Bright Future Despite a Gloomy POS Forecast*, DEBIT CARD NEWS, Mar. 17, 1997, *available in* 1997 WL 8934264.

doubled and now far outpace online debit (1.6 billion offline transactions compared to 1.1 billion online transactions[7]). The growth of offline debit has been so remarkable that some regional network executives and commentators have predicted the extinction of online debit.[8] In reality, however, online debit has continued to grow although at a slower rate than offline debit.[9]

From the perspective of merchants and consumers, online transactions are preferable in a number of respects. First, for online transactions the funds are transferred the same day; for offline transactions the funds transfer may take as long as three days. Second, because of the PIN requirement (a consumer must enter a personal identification number) there is a much lower risk of fraud for online transactions.[10] This is consistent with statements of consumer protection advocates who have questioned the risk and high rate of fraud of offline debit.[11]

The most significant difference between online and offline is the amount of interchange fees charged by the associations. Interchange fees are paid by the merchant to the card issuing bank to compensate the bank for certain costs, typically the risk of loss and the float. The interchange fees for offline debit transactions mimic the pricing structure of the VISA and MasterCard credit card programs, that is they are a percentage of the transaction amount *(ad valorem* fees). Initially, VISA and MasterCard set the offline debit card interchange fee at a level identical to the credit card interchange fee and it has remained identical until recently. The typical offline interchange fees are approximately 1.4% of the transaction cost.

For online transactions the fees are comparable to the interchange fees in ATM networks. Generally the online fee is about five to seven cents per transaction, regardless of the amount of the transaction. On a $100 transaction the difference between offline and online would be between $1.40 and seven cents. Considering the amount of offline debit interchange fees are currently over $2 billion the additional costs to merchants and consumers can be substantial.[12] On an average transaction ($40), offline interchange fees are about sixty cents a transaction, compared to seven cents for online debit.[13] In the antitrust suit between the merchants and VISA the retailers are seeking over $8 billion in damages for allegedly supracompetitive interchange fees.[14]

7. *See* Alison Orenstein, *Off-line or On-line?*, BANK SYSTEMS & TECH., Aug. 1, 1998, *available in* 1998 WL 2006878.

8. *See* Joanna Kolor, *The Online-Offline Debit Card Debate*, BANK TECH. NEWS, Jan. 1, 1997, *available in* 1997 WL 9510979.

9. *See generally* Orenstein, *supra* note 7.

10. *See id.*

11. *See* Balto, *supra* note 3, at 1103-05.

12. *See* Orenstein, *supra* note 7.

13. *See* Cathy Bowen, *Promoting Online Debit*, CREDIT CARD MGMT., May 1999, *available in* LEXIS, News library, Faulkner & Gray Credit Card Management file.

14. *See In re* VISA Check/MasterMoney Antitrust Litig., No. 96-CV-5238, 2000 WL

Some merchants question whether the credit card interchange fee structure makes sense in the debit environment. They claim that the credit structure should not apply because, unlike credit transactions, debit has a much smaller risk of loss and practically no float. Thus, the costs that provide most of the basis of the interchange fee are absent—the card issuing bank needs a much smaller level of compensation. Up until now VISA and MasterCard have failed to explain why the offline interchange fee should mimic the credit card structure or amount.

The problem posed by interchange fees is illustrated by the seemingly paradoxical way that competition seems to result in higher, not lower prices. In the world of offline debit VISA is much larger than MasterCard. Yet it initiated a price war. In 1998 VISA announced that it would increase its off-line debit card interchange fee by about twenty percent effective April 1999.[15] In response, MasterCard announced that it would increase its interchange fees.[16] Following MasterCard's announcement, VISA increased its fee by an additional five percent. MasterCard responded with still another increase. VISA and MasterCard engaged in an aggressive bidding war, increasing prices even before the initial price change took effect. At the end of the process, overall interchange fees had increased by over $300 million per year.

Why did interchange fees increase? The associations claimed the reasons were an increase in cost as well as the need to encourage appropriate incentives for issuers and merchants. But the basis for those claims were cloaked in secrecy. Data communications and processing costs continue to plummet throughout the economy. Meanwhile, debit card volumes have been increasing at a dramatic rate. One might logically expect per transaction costs to be decreasing. To put it bluntly, the bidding war seemed to provide incentives solely for issuers.

The crux of the controversy over the "honor all cards" rule focuses on the ability of merchants to "steer" consumers to lower cost payment mechanisms and enable the online debit networks to effectively compete with the offline networks. There are two bylaws adopted by both associations that operate to restrict the ability of merchants to direct consumers in this fashion. The first, a tying rule, requires the merchant to accept all cards with the VISA trademark.[17] This is the "honor all cards" rule and it effectively requires merchants to accept the higher priced offline debit

220507, at *1 (E.D.N.Y. Feb. 22, 2000); John R. Wilke, *Retailers' Suit Names VISA, MasterCard*, WALL ST. J., Jan. 25, 2000, at A3.

15. *See Interchange Fee Hikes Test Merchants' Muscle*, DEBIT CARD NEWS, June 25, 1998, *available in* 1998 WL 11240618.

16. *Growing Interest in Gift Cards Leads Merchants into a Prepaid Frenzy*, DEBIT CARD NEWS, Feb. 16, 1999, *available in* LEXIS, News Library, Faulkner & Gray Debit Card News File (increasing from 55.2 cents to 64.4 cents on a $40 transaction).

17. *See In re* VISA Check/MasterMoney Antitrust Litig., No. 96-CV-5238, 2000 WL 220507, at *11 (E.D.N.Y. Feb. 22, 2000).

card. The second rule prevents merchants from charging consumers an additional charge for a transaction, known as a surcharge.[18] Surcharges are another means with which merchants could direct consumers to lower priced payment systems.

Recently, some merchants have attempted to reject the VISA offline debit card and VISA threatened to enforce the rule.[19] In 1997, a group of merchants, including Wal-Mart and The Limited filed a class action antitrust suit against VISA and MasterCard charging that these rules constituted an illegal tying, an attempt to monopolize and a conspiracy to monopolize.[20] That case is scheduled to go to trial later this year.

As explained in more detail below, the two bylaws work together to inhibit competition between the offline and online networks. The plaintiffs in the litigation argue that if merchants could threaten to reject offline cards or assess surcharges, VISA would be forced to lower its interchange fees. Because, however, the merchant must accept VISA's offline debit cards, if it also accepts VISA's credit cards (which are indispensable for almost all merchants), the "honor all cards" rule prevents merchants from securing more competitive interchange fees from VISA.[21] In addition, VISA's "no surcharge" rule prevents merchants from passing along the savings from the lower cost online payment systems and thus encouraging their customers to use such alternatives.

COMPETITIVE ANALYSIS

VISA's conduct could be analyzed under a number of legal theories. The rule which prevents surcharging could be a form of horizontal price fixing.[22] In turn, the "honor all cards" rule could be interpreted as a group

18. Neither VISA nor MasterCard apply the honor all cards or the antisurcharge rule to other products. For example, VISA does not apply the honor all cards rule to VISA TravelMoney cards, VISA Travelers Checks, and VISA's smart card (VISA cash). Similarly, neither VISA nor MasterCard apply the surcharge prohibition to either their online debit networks or their ATM network.

19. Class Action Complaint at ¶¶ 115-44, Wal-Mart Stores, Inc. et al. v. VISA USA, Inc., No. CV965238 (E.D.N.Y. Oct. 25, 1996) (on file with *The Business Lawyer*, University of Maryland School of Law).

20. *See VISA Check*, 2000 WL 220507, at *1.

21. *See id.* at *3. This ability to decline a payment mechanism (or the ability to make the threat) serves an important function. For example, it has been speculated that the fact that some merchants refuse to accept American Express cards forced American Express to lower its interchange fee.

22. Prohibitions on surcharging have faced antitrust challenges with mixed results. *See* Southtrust Corp. v. PLUS Sys., Inc., 913 F. Supp. 1517, 1522 (N.D. Ala. 1995) (upholding surcharge ban); *In re* Arbitration Between First Texas Sav. Ass'n & Fin. Interchange, Inc., 55 Antitrust & Trade Reg. Rep. (BNA) 340, 364-66 (Aug. 25, 1988) (explaining ATM interchange fees were illegal unless network provided opportunity for surcharges or rebates); *see also* David Balto, *Regulatory, Competitive, and Antitrust Challenges of ATM Surcharges*, 71 BANKING REPORT (BNA) No. 2, at 82. The plaintiffs in the Wal-Mart litigation have not chosen to

boycott (refusing to deal with any merchants that decline to accept VISA's debit card). Or, the combination of rules could be attacked as a means of attempted monopolization of the debit card market. This Article presents a tying analysis which provides the best framework. Together, the two rules effectively act as a tie by which VISA uses its market power over credit cards to force merchants to also accept its offline debit cards.

From the merchant's perspective the potential competitive harm seems clear. Merchants would like to direct consumers to the least costly payment mechanism. VISA's rule appears to prevent this by compelling the merchant to accept all VISA cards and then preventing the merchant from favoring the lower-priced cards.

Online debit cards offer a tremendous potential for network competition. Transactions for most online debit cards can be sent over a number of networks. Thus, merchants can seeks out the lowest interchange fee by "routing" a transaction over the lowest priced network. This routing freedom enables merchants to play networks off against one another as they might do with any other supplier of a service.[23] In turn, this forces the networks to compete for merchants by offering more competitive (lower) interchange fees. The VISA rules effectively prevent this routing freedom.[24]

TYING

Under a tying arrangement the seller of a product conditions the sale of one product upon the buyer's agreement to purchase a second product. The first product is known as the "tying product" and the second is known as the "tied product." The typical concern raised by tying claims is that a party with market power in the tying product market is using that power to restrain competition in the tied product market. As the U.S. Supreme Court has stated, tying is illegal where a seller exploits "its control over the tying product to force the buyer into the purchase of a tied product that the buyer either did not want at all, or might have preferred to purchase elsewhere on different terms."[25] Tying law requires the analysis of four issues to find a per se violation: (i) whether two separate products

attack interchange fees as illegal price fixing. These fees have been upheld by the courts. *See, e.g.*, National Bancard Corp. (NaBanco) v. VISA U.S.A., Inc., 596 F. Supp. 1231, 1263 (S.D. Fla. 1984) (noting validity and necessity of fees for credit cards), *aff'd*, 779 F.2d 592 (11th Cir. 1986).

23. Recently Wal-Mart shifted a large amount of online debit transactions from the Honor network to AFFN, a lower cost network. *See Transaction Shift by Wal-Mart Raises the Interchange Ante*, DEBIT CARD NEWS, Apr. 30, 1999, *available in* 1999 WL 11642063.

24. For a description of the types of arrangements that may raise restrict routing freedom and raise antitrust concerns see David A. Balto, *Routing Rules of ATM Networks: The Antitrust Risks in Backbones of Electronic Commerce*, 20 J. RETAIL BANKING SERVS. 57 (1998), *available in* 1998 WL 12297543.

25. Jefferson Parish Hosp. Dist. No. 2 v. Hyde, 466 U.S. 2, 12 (1984).

are in fact involved; (ii) whether the seller in question has conditioned the purchase of one of these products on the purchase of the other; (iii) whether the seller has sufficient market power in the tying market to force purchases in the tied market, restraining competition on the merits in that market; and (iv) whether a substantial volume of commerce is thus foreclosed.[26] Under the rule of reason, the plaintiff also must demonstrate the existence of competitive harm in the tied product market.

MARKET DEFINITION/SEPARATE PRODUCTS

The first question is whether the tying and tied products are in separate product markets. If both products are in the same market, of course, there can be little anticompetitive effect from requiring the purchase of both products. In this case, the question is whether there are separate markets for credit and debit cards.

Market definition in payment systems is a fairly controversial and contentious issue.[27] Although there is some authority that suggests an "all payment system" market,[28] the antitrust agencies have defined markets more narrowly, looking at individual payment mechanisms as separate markets.[29] In litigation between Discover Card and VISA in the early 1990s, VISA stipulated that the market was all credit cards (and expressly excluded debit cards).[30]

There are several reasons why one might separate credit and debit cards: consumers use them for different type of purchases, credit cards provide a line of credit, and banks direct the products toward different customers. Here the fact that VISA markets both credit and debit cards together or the fact that transactions of both go through the same authorization system should not be dispositive. Indeed, these facts would be equally if not more consistent with the tying of separate products.

The U.S. Supreme Court has held that "the answer to the question whether one or two products are involved turns not on the functional

26. *See id.* at 11-18; Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451, 461-64 (1992). This Article addresses the first three factors. It is obvious that there is a substantial amount of commerce at issue.

27. *See generally* David Balto, *The Murky World of Network Mergers*, 42 ANTITRUST BULL. 793, 812 (1997) (describing evolution of analysis of market definition and errors made by courts and enforcement agencies).

28. *See, e.g.*, National Bancard Corp. (NaBanco) v. VISA U.S.A., Inc., 596 F. Supp. 1231, 1258 (S.D. Fla. 1984); *see also* Southtrust Corp. v. PLUS Sys., Inc., 913 F. Supp. 1517, 1524 (N.D. Ala. 1995).

29. *See* United States v. Electronic Payments Servs., Inc., Civ. No. 94-208, 1994 WL 730003, at *1 (D. Del. Apr. 21, 1994) (defining separate markets of "ATM access" and "ATM processing"); *Statement by the Board of Governors of the Federal Reserve System Regarding Notices to Acquire Certain Data Processing Assets and to Engage in Certain Nonbanking Activities*, 81 FED. RES. BULL. 492, 494 (May 1995) (defining separate markets of "network access," "network services," and "ATM processing").

30. *See* SCFC ILC, Inc. v. VISA U.S.A., 36 F.3d 958, 966 (10th Cir. 1994).

relation between them, but rather on the character of demand for the two items."[31] The two product requirement is met when there is "sufficient consumer demand so that it is efficient for a firm to provide" the two products separately.[32] Under the character of demand test, there are several plausible arguments that credit and debit cards are separate products. From the point of view of consumers, debit and credit cards are separate products.[33] Consumers typically use debit cards in order to control their expenditures and limit their use of credit. Credit cards may be used for larger purchases where consumers need to pay off their bills over time.

Moreover, the two products are marketed separately. Not all banks issue both debit and credit cards. Credit and debit cards are issued for different reasons and banks impose different qualifications for both. Retailers believe that credit cards lead to incremental sales whereas debit cards primarily substitute for cash and checks.

There is an important natural experiment which confirms the existence of separate credit and debit card markets. In antitrust analysis one often looks at the price relationship between two products to determine if they are in the same market.[34] If a price increase in one product results in increased customers turning to the second product as an alternative, both products may be considered in the same market. Where the price increase does not lead to increased sales of the second product, that suggests the two products are in different markets. Here, the fact that recent increases in credit card interchange fees have not led to increased debit card usage, provides strong evidence that credit and debit are separate markets.

MARKET POWER/CONDITIONING

There are several perspectives that suggest that VISA has the requisite market power in the tying product market (credit cards). Market power is "ordinarily . . . inferred from the seller's possession of a predominant share of the market."[35] In the credit card market, VISA possesses over a forty-five percent market share and together VISA and MasterCard possess over a seventy percent market share.[36] Those are clearly levels of dominance that demonstrate market power.

Market power can also be demonstrated where the defendant has "the ability . . . to raise price by restricting output."[37] Here, the evidence that

31. *Jefferson Parish*, 466 U.S. at 19.

32. Eastman Kodak Co. v. Image Technical Servs., Inc., 504 U.S. 451, 464 (1992).

33. *See Jefferson Parish*, 466 U.S. at 19 (products were separate where they "were distinguishable in the eyes of buyers").

34. *See, e.g.*, *SCFC ILC*, 36 F.3d at 966.

35. *Kodak*, 504 U.S. at 464.

36. *See SCFC ILC*, 36 F.3d at 967; *In re* VISA Check/MasterMoney Antitrust Litig., No. 96-CV-5238, 2000 WL 220507, at *1 (E.D.N.Y. Feb. 22, 2000).

37. *SCFC ILC*, 36 F.3d at 965 (footnote omitted).

VISA and MasterCard have been able to increase credit card interchange fees profitably for the past two years by over 5 percent a year provides strong evidence of market power.[38]

Although a high market share and the ability to increase prices provide a foundation for the market power analysis, in tying claims the critical question is whether the defendant has "the power to force a purchaser to do something he would not do in a competitive market."[39] There is substantial evidence to suggest VISA has market power under this test. The "honor all cards" rule obligates merchants to accept all VISA branded cards, thus the offline debit card is effectively tied to the credit card.[40] Several merchants have attempted to reject acceptance of the debit card but have been unable to because of VISA's rule.[41] So in a simple fashion merchants are obligated to accept VISA's debit card. Moreover, one of the most obvious ways a merchant could steer consumers away from the offline debit card would be to assess a surcharge, but VISA's rules prevent surcharges.

But that alone should not end the inquiry. Even if merchants must accept the debit card do they have other means to steer consumers to less expensive payment methods. Conditioning does not have to be iron-clad. As one court has observed, "competitors do not lose a segment of the tied market if there are genuine alternative paths to consumers."[42] In this case, the honor all cards rule is somewhat ambiguous about what actions a merchant can take to "steer" consumers to less costly payment mechanisms and whether those actions can alleviate the anticompetitive effects of the "conditioning." A large number of consumers are issued a single card which incorporates ATM access, online and offline debit. Thus, to avoid the higher cost offline debit card, a merchant may not even need to ask a consumer to use a different card, but can simply ask the consumer to treat the transaction as an online transaction and enter his or her PIN.[43]

38. In the last two years both VISA and MasterCard have increased interchange fees, resulting in 5% increases in both 1998 and 1999. *See Economics: Double Whammy; Associations Raise Interchange Again*, CREDIT CARD NEWS, Feb. 1, 1999, *available in* 1999 WL 1343992; Pete Hisey, *How High Can You Go?*, CREDIT CARD MGMT., Apr. 1999, *available in* 1999 WL 12460450; *New VISA Interchange Rates Upset Merchant Segment*, CARD NEWS, June 22, 1998, *available in* 1998 WL 9109945.

39. *Kodak*, 504 U.S. at 464.

40. Note that the tying arrangement only effects VISA's offline debit card, which VISA has named "the VISA checkcard." Other VISA products have non-VISA brand names: "PLUS" (ATM card), "Interlink" (online debit card), and "Electron" (smart card). VISA's rules do not obligate merchant acceptance of these other products.

41. Merchants would also like to reject a new VISA online debit card known as VISA CheckCard II, but can not because of the honor all cards rule. *See Retailers Seek an Ace to Trump a Debit Card*, DEBIT CARD NEWS (Faulkner & Grey, Chicago, Ill.), Oct. 13, 1998, at 2 [hereinafter *Retailers Seek an Ace*].

42. Roy B. Taylor Sales v. Hollymatic Corp., 28 F.3d 1379, 1383 (5th Cir. 1994).

43. A speech by a Vice President of VISA suggested that merchants can take a number of measures to direct consumers including: (i) "offering financial and other incentives,"

VISA may argue that such alternatives are possible, even despite the rule. In response, merchants would have strong arguments that steering consumers at the cash register may not be an effective alternative. First, it is difficult to identify an offline card or to recognize its online capability. When online ATM/debit cards are reissued to include offline capability they are significantly redesigned. The online network marks are taken off the front and placed on the back of the card.[44] The only logo on the front of the card is the VISA logo. Second, checkout personnel at mass merchandisers are high turnover employees, and these merchants have found it difficult to train employees to recognize the difference between these cards. Third, merchants do not like to place consumers in the position of appearing to be "second guessed" about their choice of payment mechanisms. Finally, a check out lane where consumers want swift transactions is not an effective place to attempt to educate consumers.

Another question likely to arise is whether there could be a technological solution, i.e., a means to automatically "direct" debit transactions to the online system. Many merchants, such as grocery stores, have consumer operated PIN pads where the consumer swipes the card through the machine. Conceivably these machines could be programmed so that, when a dual offline/online card is used, the machine prompts the consumer to enter her PIN and the transaction is executed online. However, no merchant as of yet has been able to implement this type of system.[45]

Most important, even if merchants are able to engage in some limited efforts of steering consumers, the relevant question is whether those efforts will be significant enough to force the associations to lower their interchange fees. That would require not just a small handful of merchants engaging in directing transactions, but enough defections to make the supracompetitive offline interchange fees unprofitable. For this to happen, merchants would need to shift a significant volume of transactions from offline debit cards. The fact that VISA and MasterCard have been able to increase their offline debit interchange fees without losing significant transaction volume provides strong evidence that merchant steering is insufficient to prevent the exercise of market power.

HARM TO COMPETITION

There are various forms of competitive harm that may arise from the tying arrangement. We present four possibilities: foreclosure of the re-

(ii) asking consumers to use the online debit card, or (iii) putting up signs that the merchant prefers the online debit card. Bill Stewart, Vice President, VISA, Adding Value with Debit, Remarks at the Equifax Conference (Apr. 29, 1997).

44. Several merchants have complained that the design of the card makes it difficult to identify the online capability. *See Retailers Seek an Ace*, *supra* note 41, at 2.

45. Even if a merchant was successful in technologically "directing" consumers VISA could either challenge this practice as a violation of its non-discrimination rule or could pass a new rule to prohibit the practice.

gional ATM networks, charging supracompetitive interchange fees, facilitating collusion with the online networks, and protecting VISA's market power in the credit card market (defensive leveraging).

FORECLOSURE

Tying may harm competition by disadvantaging rivals in the tied product market and making them less effective competitors. A firm that possesses market power in one market may be able to force consumers to use its products in a separate market. Absent coercion, some or all consumers would choose cheaper or superior goods offered by the firm's competitors in the tied market. Thus, tying may allow a firm to exclude its competitors from the tied product market or to inhibit more effective entry or expansion. Consumers of the tied product may subsequently pay higher prices or suffer reduced product quality.

This case does not present the most obvious form of disadvantaging rivals, absolute exclusion from the market. VISA's rules do not *prohibit* merchants from accepting other debit cards. Moreover, the online debit networks have generally experienced strong growth over the past few years.[46] An absolute foreclosure argument would have to posit that the regional ATM networks would be driven below minimum viable scale, or perhaps have their costs increased significantly. But the law does not require absolute foreclosure—anticompetitive harm may occur if rivals are significantly disadvantaged.

Although VISA's rules do not entirely foreclose the online networks, they severely disadvantage them making them less effective rivals. The online debit product is more attractive in a number of respects, particularly price, but the VISA rules deter competition between offline and online networks by reducing the incentives of banks to promote regional online networks and by restricting the ability of merchants to "steer" customers. Effectively, the antisteering rules eliminate the *scope* of price competition between the two types of cards thus creating incentives for both to increase prices. Because VISA need not lower its interchange fees in response to the lower online fees, VISA's strategy appears to dampen the ability of the online networks to compete on price and even creates incentive for them to *increase* their interchange fee.[47]

46. Although the number of transactions have doubled, the number of online cards has decreased by about 17 percent. *See* DEBIT CARD DIRECTORY 20 (1998) (comparing 1995 to 1997). In any case, even though the volume of transactions is increasing the regional networks may not be growing as quickly as they would if the tying rule did not exist. The regional networks actually first introduced debit into the market.

47. This would occur in the following fashion: Banks would prefer the higher offline interchange fee. In order to force the regional ATM networks to increase the online interchange fee the banks threaten not issue the online debit card, unless the fee is increased. Or as an alternative the banks refuse to fund promotional programs or other efforts to expand the online debit network.

SUPRACOMPETITIVE INTERCHANGE FEES

Another anticompetitive theory is that the tying arrangement enables VISA to charge supracompetitive offline interchange fees.[48] Offline debit cards are highly profitable and substantially more profitable than online cards. Indeed, the cost of an offline debit transaction is probably closer to that of an online transaction, yet the offline fee is almost identical to that of credit cards.

Whether the interchange fees are supracompetitive is a complex issue. There is some initial evidence to support the view that they may be. Typically, interchange fees for credit cards were set on a total cost basis and supported by detailed accounting cost studies. In the 1980s, VISA began using "incentive" fees which are set "below" total allocated costs. Currently, the vast majority of VISA's interchange fees are incentive fees. The interchange fee for offline debit cards is not an incentive fee and VISA's ability to charge its fully allocated costs suggests the existence of market power.

The offline interchange fees seem unresponsive to the lower online fees. Even though online fees are significantly lower, VISA and MasterCard both increased their offline fees by a substantial margin. This suggests that online debit does not restrain the market power of VISA in offline debit.

In contrast, in the mid-1990s when VISA sought to promote its online debit card, Interlink, it was forced to reduce interchange fees because of network competition. Originally Interlink's interchange fees were set on an *ad valorem* basis and were higher than the regional networks' online debit fees. Merchants declined to accept Interlink until it changed its fee to a flat fee, comparable to that of the regional networks.

COLLUSION

Another theory of competitive harm is that tying may facilitate or induce collusion between VISA and the online networks in the debit card market.[49] Because the ATM networks and VISA are joint ventures of many of the same banks there are significant reasons to be concerned about collusion. A tying arrangement can facilitate collusion and assure that the higher interchange fees are contagious and durable. In this case the fact that regional networks have been increasing their interchange fees to be closer to VISA's may suggest that collusion is a serious concern.

This strategy is not mere conjecture. Some regional ATM networks have recently increased their debit card interchange fees. Moreover, in the past banks have threatened to withdraw from regional ATM networks unless the networks increased the ATM interchange fee.

48. *See In re* VISA Check/MasterMoney Antitrust Litig., No. CV-96-5238, 2000 WL 220507, at *1 (E.D.N.Y. Feb. 22, 2000).

49. *See* HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY § 10.6(b)(3) (1994); Carbajo et al., *A Strategic Motivation for Commodity Bundling*, 38 J. INDUS. ECON. 283, 296 (1990).

One could argue that to protect the profitability of its offline debit card, VISA uses pre-existing merchant restrictions to force merchants to take the VISA offline debit card regardless of its high interchange fee, and attempts to prevent merchants from shifting transactions from the more profitable debit card to the less profitable online cards. VISA's protection of the offline debit card will result in increased online debit interchange fees, by one of two possible mechanisms: either the online networks, feeling little competitive pressure from VISA offline debit because of the large discrepancy in interchange fees, will decide to increase their fees to more profitable levels under the VISA umbrella, or more significantly these rules may force the regional networks to increase their interchange fees (really an input price paid to issuers) in order to continue to attract the interest of card-issuing banks.

These concerns were strengthened in 1998, when VISA announced the creation of a new debit card product, known as VISA Checkcard II (VCII).[50] As proposed VCII would have been a combined online and offline debit card, but it would have been limited to the VISA networks. The regional online networks would have been excluded from the card. VCII would have had a much higher online debit interchange fee. VCII could have increased interchange fees by more than $200 million a year.[51] To date, very few banks have issued the card.

However, the threat of the issuance of the VCII has compelled many regional ATM networks to significantly increase their online interchange fees.[52] Some networks have expressed concerns that card issuers will cease supporting their debit programs, if the interchange fees are not increased close to the level of VCII. One network has proposed an ad valorem interchange fee, even though that seems to have little foundation in an online environment.

These concerns over collusion leading to supracompetitive interchange fees are strengthened because of the overlapping ownership and governance of the regional ATM networks and VISA and MasterCard. Many banks are on the boards of the regional ATM networks and either VISA and MasterCard and some banks are on the boards of various regional ATM networks. This system of overlapping governance is known as duality.[53] The Justice Department has challenged credit card duality in a suit

50. *See Interchange Rate Creep Beginning to Set in*, BANK NETWORK NEWS, Apr. 12, 1999, *available in* 1999 WL 10293123 (noting that four of the top fourteen networks have increased online debit interchange fees).

51. Jeffrey Green, *Bracing for an Interchange Fight*, CREDIT CARD MGMT., Aug. 1998, *available in* 1998 WL 14388657.

52. *See id.*; Charles Keenan, *Honor Network Will Hike Its Interchange Fees*, AM. BANKER, Nov. 24, 1998, *available in* 1998 WL 13326181 (announcing Honor would adopt *ad valorem* online debit interchange fees which could quadruple interchange fee on an average transaction).

53. *See* New York v. VISA U.S.A., Inc., 1990-91 Trade Cas. (CCH) ¶ 69,016, at 63,566 (S.D.N.Y. 1990)

against VISA and MasterCard, because, in part, it stifles competition between the networks. Does duality between ATM networks raise similar concerns?

There are at least two ways in which dual governance could raise concerns. Assume, for example, that a large bank, which derives substantial revenue from VISA's offline debit card, is also on the board of a regional ATM network. First, the bank could attempt to increase the interchange fee of the regional online network, to reduce the competitive impact of the network's debit card. As one industry observer noted: "you can bet the big VISA issuers are going to approach the regionals and say: '[w]e are not going to play in your POS game unless you raise your interchange to at least close to what VISA's is.' "[54] Second, the bank could veto or delay efforts of the regional network to promote its debit card. In a joint venture, a single member can often exercise a veto power to prevent the network from engaging in new products or promotion.[55] It is notable that the regional ATM networks engage in relatively little promotion of their online debit cards, so this could be evidence that debit card duality is stifling promotion.[56]

DEFENSIVE LEVERAGING[57]

VISA and MasterCard are dominant in the credit card market, which has significant entry barriers. Rather than challenging VISA and MasterCard in this market, the regional online networks effectively attempted to develop the next generation of the payment systems product—ATMs and debit cards. In the online debit card market, VISA and the online networks compete on a relatively level playing field.

Why would VISA care about the debit card market if it is dominant in credit cards? Because markets evolve and dominance is not permanent. New markets may arise which may overtake the traditional market. In this

54. Donald Davis, *The Forgotten ATM Fees*, FIN. SERVICE ONLINE, July/August 1998, *available in* LEXIS, News library, Faulkner & Gray Financial Service Online file.

55. One example of this is Canadian Competition Bureau's challenge of certain rules of the national ATM network, Interac. D.I.R. & Bank of Montreal et al., CT-95/2 (June 25, 1996) (consent order) (on file with *The Business Lawyer*, University of Maryland School of Law); *see also* CompAct #2—Enforcement: The Interac Case, *available in* <http://strategis.ic.gc.ca>. Interac is the dominant ATM network in Canada and required its members to submit any proposed innovation or new product development to the Interac Board for approval. The rules further required all members to share equally in the costs of the product development and a two-thirds Board vote for approval. Because of this rule no new product development was approved for almost a decade. The case was settled with the abandonment of that rule.

56. *See* Bowen, *supra* note 13 (noting that regional networks "face an uphill battle" in securing commitment from financial institutions to promote online debit because they prefer offline debit because of its higher interchange fee).

57. For a discussion of defensive leveraging as an antitrust theory, see Robin Cooper Feldman, *Defensive Leveraging in Antitrust*, 87 GEORGETOWN L.J. 2079 (1999).

respect the tying rules may serve as a form of defensive leveraging to enable VISA to keep its rivals from successfully developing these new networks which may challenge its dominance in the credit card market. In effect VISA is attempting to leverage the power of its existing customer base into the debit card arena, in order to prevent the diminution of its credit card dominance. This type of claim has an important precedent under the antitrust laws: when a monopolist acts to preserve its monopoly through exclusionary conduct, this type of monopoly "maintenance" is illegal.[58] Thus, defensive leveraging may prevent the natural erosion of VISA's dominance in credit cards.

But there may be an important additional anticompetitive effect from defensive leveraging. Once a dominant firm has blocked an attempt at next generation substitution the strategy has a deterrent effect. Potential entrants are less likely to develop new technologies and enter the fray for fears that their efforts will be blocked (or "acquired" at a fire sale price) by the dominant firm. In this situation, the VISA tying rules may discourage firms from developing other payment systems since they know VISA can effectively transfer dominance into the new market through the honor all cards rule. Thus, these rules may diminish innovation and the development of the next generation of payment systems.

EFFICIENCY

There are several potential efficiencies, which need to be evaluated regardless of which theory of competitive harm is utilized. VISA can be expected to argue that the most significant efficiency is that the tying arrangement overcomes the "chicken and egg" problem that most networks face in their incipiency. Simply, banks may be unwilling to issue cards unless they are confident there is a sufficient merchant base. Typically that requires a network to engage in a long and costly process of signing up merchants and card issuers, convincing each that there will be a sufficient base of both merchants and card-issuers for the network to be viable. The tying arrangement overcomes this chicken and egg problem by creating an instantaneous, almost universal merchant base.

This instant market creation argument has a certain degree of credence to it. Creating a network is expensive and proposed networks often fail. VISA effectively can argue that the honor all cards rule can overcome many of the problems in network creation, especially developing a network of merchants. Consumers benefit by having a product come to market in a quicker, more ubiquitous fashion.

These arguments have merit but are not dispositive. Although using a tying arrangement may be legitimate at an early stage in the creation of a new product, the argument does not justify a tying arrangement once

58. *See id.* at 2114.

the product has reached a certain level of acceptance.[59] In this case, VISA will need to demonstrate that the tie is still reasonably necessary to the continued growth or maintenance of the network.

Also, there may be less restrictive means for VISA to create and keep an adequate base of both banks and merchants. VISA can attract bank participation by offering inducements, such as rebates to issue new cards. It can attract merchants through lower interchange fees. For example, VISA recently announced a program to encourage merchants to adopt its standards for Internet transactions by offering to waive interchange fees for those merchants.

Traditionally, VISA has built acceptance of its products by competing over price and quality, offering merchants and banks attractive prices and products. With the VISA brand name and transaction processing system, VISA would probably acquire sufficient merchant participation in the absence of the tying rules to make its debit card network profitable. Moreover, interchange fee competition could be more complex than simply offering higher fees to attract banks. In the absence of the tie, networks with lower interchange fees could offer participating banks more volume (assuming that merchants could steer).

A second argument will be that VISA's "honor all cards" has a legitimate purpose: to protect the value of their mark. VISA promotes its offline card in advertisements as "you can use it wherever you use your VISA card." The rule enables VISA to say to its cardholders "if you see the VISA mark, the merchant will accept any of your VISA cards." If a merchant could reject some VISA cards that might adversely affect the consumer's view of the value of the VISA product.

These arguments have a certain appeal, but they may prove too much. If VISA can compel merchant acceptance for any product simply by branding it "VISA" it can avoid the need to compete for merchant acceptance. This may mean that VISA will not have to be as responsive to consumer demand.

Moreover, the arguments lack a degree of credibility because the honor all cards rule is not applied consistently. VISA has never imposed the tying arrangement for its other card products, including its less expensive online debit card—Interlink. For example, VISA is currently promoting its smart card known as VISA cash. Although VISA's smart card has the VISA brand and uses the same processing system as credit cards, VISA has not sought to impose the tie to build its network or "jump start" smart card acceptance. Similarly, VISA does not enforce its antisurcharge rule on other products such as online debit cards and ATMs.

59. *See* United States v. Jerrold Elecs. Corp., 187 F. Supp. 545, 556 (E.D. Pa. 1960) (dealing with a tying arrangement necessary to break into market where there was a significant risk that others' equipment would not properly function with technologically sophisticated equipment), *aff'd per curiam*, 365 U.S. 567 (1961).

CONCLUSION

There appear to be persuasive arguments that VISA's honor all cards rule may be an illegal tying arrangement. VISA has conditioned acceptance of credit cards on the acceptance of debit cards, it has market power over credit cards, a sufficient number of merchants appear to have been coerced into acceptance, and the rule has resulted in anticompetitive effects, perhaps most prominently in terms of supracompetitive interchange fees. VISA's efficiency justifications appear to be either legally insufficient or factually pretextual. Moreover, it is likely that VISA could have achieved comparable efficiencies without the honor all cards rule.

This litigation poses important policy issues. Establishing a successful network is an expensive and risky task. In some respects, society benefits when the incumbent network broadens its products and creates an instant complementary network. But to permit the incumbent to extend its market power through exclusionary conduct will deny the marketplace the opportunities for new rivals to arise. In network industries, we must be careful not to sacrifice the long term opportunity for competition, for an ephemeral spur to network creation.