
*Antitrust Issues in
Two-Sided Network
Markets: Lessons
from In Re Payment
Card Interchange
Fee and
Merchant Discount
Antitrust Litigation*

BY ALAN O. SYKES

Antitrust Issues in Two-Sided Network Markets: Lessons from In Re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation

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In 2013, I served as a court-appointed expert in consolidated class and individual plaintiff antitrust litigation against Visa and Mastercard in the Eastern District of New York. The litigation involved a challenge to default interchange fees established by Visa and Mastercard, and to certain network rules imposed on affiliated merchants. Although it was not my task to adjudicate the dispute, an evaluation of the reasonableness of the eventual settlement from an economic perspective inevitably entails a comparison between what the plaintiffs received in the proposed settlement and the expected returns to the plaintiffs of litigating the case to conclusion. The returns to litigation in turn depend on the prospects of establishing liability, the likely magnitude of damages and the nature of any injunctive relief conditional on liability, and of course the costs of litigation. In this commentary, I focus on the liability, damages, and injunctive relief issues because of their economic novelty and broader implications for other antitrust cases.

I. INTRODUCTION

In 2013, I served as a court-appointed expert in consolidated class and individual plaintiff antitrust litigation against Visa and Mastercard in the Eastern District of New York. The litigation involved a challenge to default interchange fees established by Visa and Mastercard, and to certain network rules imposed on affiliated merchants. My task was to evaluate economic issues pertaining to the reasonableness of a proposed settlement in the litigation,² a settlement that has been described as the largest monetary settlement in antitrust history,³—with an initial monetary component (subject to opt outs) exceeding U.S. \$7 billion—along with changes in network rules that, most prominently, would allow merchants to surcharge credit card transactions. The settlement was approved by Judge John Gleeson and is now on appeal.⁴ My report to the court of August 28, 2013 is a matter of public record,⁵ and I draw on that report in what follows.

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Although it was not my task to adjudicate the dispute, an evaluation of the reasonableness of the settlement from an economic perspective inevitably entails a comparison between what the plaintiffs received in the proposed settlement and the expected returns to the plaintiffs of litigating the case to conclusion.⁶ The returns to litigation in turn depend on the prospects of establishing liability, the likely magnitude of damages and the nature of any injunctive relief conditional on liability, and of course the costs of litigation. In this

commentary, I will focus on the liability, damages, and injunctive relief issues because of their economic

novelty and broader implications for other antitrust cases. Readers interested in comments on other aspects of the proposed settlement may wish to consult my report to the Court.

The issues are complex and to a considerable degree novel, owing to several important characteristics of the Visa and Mastercard networks. First, the fact that each is a “network” immediately suggests the importance of network externalities in their operation. Second, each network for a time was administered as a joint venture among banks before initial public offerings (“IPOs”) established stand-alone companies. The policies at issue in the litigation were largely put in place while the two networks operated as joint ventures. Third, both networks operate as four-party payment mechanisms, in which thousands of banks that service merchants (“acquiring banks”) collect payments on behalf of the merchants from thousands of banks that issue cards to consumers (“issuing banks”) (thus the four-party merchant-acquirer-issuer-consumer payment chain). Finally, both networks involve two-sided markets, earning revenues from both merchants and card-carrying consumers indirectly through payments received from issuing and acquiring banks.

Against this backdrop, the plaintiffs challenged two sets of practices. The first—“default interchange”—consists of a default fee set by each network to be paid by acquiring banks to issuing banks for the service of collecting payment from consumers and bearing certain risks such as risks of fraud. Individual acquiring and issuing banks are free to negotiate a different fee between themselves, and sometimes do, but the default fee often prevails. The default interchange fee is not uniform, but varies with the type of card being used (as well as in other ways, such as the place of use and whether it is used in person). Premium cards (such as “signature cards”) that provide generous cash back or hotel or airline rewards, for example, have higher interchange fees.

Second, the plaintiffs challenged various “network rules” that merchants must accept to participate in the two networks. The “honor all cards” rule requires merchants to accept all cards carrying the Visa or Mastercard logo regardless of the attached interchange fee. Certain “anti-steering rules”—such as the “no surcharge” rule—further prohibit merchants from imposing surcharges on credit card transactions generally, or on high fee cards in particular, and from using certain other tactics to steer customers toward cheaper payment mechanisms. Elimination of the no surcharge rule is an important part of the proposed settlement. Certain “non-discrimination rules,” which likewise prevent merchants from discriminating in their treatment of payment options, were also challenged.

Because of the special characteristics of the credit card industry noted earlier, the application of familiar antitrust doctrines to these practices is complex and, in my view, raises substantial obstacles to the plaintiffs on both liability and damages. I will focus on those that are somewhat special for the credit card industry due to the industry characteristics noted above. Thus, I will not dwell on important issues in the litigation such as the propriety of class certification in the case, or the effects of a negotiated release in a prior related case (the “Visa check” litigation).

BECAUSE OF THE SPECIAL CHARACTERISTICS OF THE CREDIT CARD INDUSTRY NOTED EARLIER, THE APPLICATION OF FAMILIAR ANTITRUST DOCTRINES TO THESE PRACTICES IS COMPLEX AND, IN MY VIEW, RAISES SUBSTANTIAL OBSTACLES TO THE PLAINTIFFS ON BOTH LIABILITY AND DAMAGES.

The focus instead is on:

- the legal characterization of the challenged practices as “horizontal” or “vertical” and its significance,
- the question whether the defendants possess market power,
- the question whether the practices at issue are on balance anticompetitive under the rule of reason,
- the question whether plaintiffs can prove their damages with reference to an acceptable benchmark or counterfactual,
- the question whether a court would likely be willing to enjoin the network rules left in place by the proposed settlement, and
- the question whether plaintiff merchants are barred from recovering damages by the indirect purchaser principle of *Illinois Brick* and its progeny.⁷

II. *PER SE* ILLEGALITY OR RULE OF REASON?

The antitrust implications of default interchange and network rules can depend importantly on their legal characterization. Under well-settled principles of antitrust, certain “horizontal” practices (such as price-fixing) are deemed illegal *per se*, other horizontal practices as well as “vertical” practices are subject to a “rule of reason,” and certain unilateral practices of individual firms are beyond antitrust scrutiny unless the entity in question is a “monopoly” or engaged in an “attempt to monopolize” that would subject it to Section 2 of the Sherman Act. As an initial legal step in analyzing the antitrust implications of the challenged practices by Visa and Mastercard, it is appropriate to ascertain their proper characterization in this framework.

Both sides in the litigation devote considerable attention to the matter in their filings. With regard to default interchange, the plaintiffs argue that it represents price-setting, and was originally the product of decisions by the joint ventures controlling Visa and Mastercard, which were controlled by member banks. Accordingly, they contend, it should be seen as horizontal price-fixing and deemed illegal *per se*. Defendants have two key responses. First, they argue that the Visa and Mastercard IPOs, and their attendant conversions from joint ventures to stand-alone entities, eliminated any element of horizontal conduct. Second, they argue that default interchange economizes on the potentially high transaction costs of individual negotiations between thousands of acquiring and issuing banks, and eliminates a hold-up problem that acquirers would face in dealing with an issuer with which no prior interchange fee had been set. In their view, it considerably reduces the transaction costs of the four-party payment system and makes acquiring banks more willing to participate.

My own view is that the defendants have the stronger position, and there is serious doubt that the

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plaintiffs could succeed in securing *per se* condemnation of default interchange. In particular, even if default interchange can be characterized as “horizontal” because it predates the IPOs or because bank officials play some subsequent role

in running Visa and Mastercard as stand-alone entities, and even though it is price-related, default interchange

can receive rule of reason scrutiny if it is connected in an important way to the success of a joint venture or similar cooperative arrangement that delivers a valuable good or service that its members cannot easily produce on their own. Default interchange makes it possible for virtually any bank to enter the network and compete to serve merchants or consumers without having to incur the transaction costs of interchange fee negotiations with the other participating banks. The fact that banks are free to negotiate alternative bilateral interchange fees if they wish is also pertinent.

The decision by the Supreme Court to afford rule of reason treatment to the blanket licensing practices of ASCAP and BMI in the music industry affords a rough analogy.⁸ Blanket licensing of musical compositions economizes on the transaction costs of individual negotiations between composers and licensees just as default interchange economizes on negotiations between acquiring and issuing banks. An additional factor in the Supreme Court's reasoning in *BMI* was the ability of composers to negotiate individual licenses if they wish, much as acquiring and issuing banks are free here to reject default interchange and negotiate their own interchange fee.

With regard to the network rules in question, these are not the sorts of practices (such as price-fixing or market allocation) that are ordinarily candidates for *per se* condemnation. These rules can further be argued to have assisted importantly in building and maintaining the networks, by assuring consumers that their Visa and Mastercard logo cards will be accepted, and without penalty, by all merchants participating in the networks. Credit card networks become more valuable to participants (both merchants and consumers) as more participants join them—a conventional network externality. The assurance that each consumer's card will be accepted by all merchants participating in the network, without penalty or discrimination, makes participation in the network more attractive to consumers, leading to more consumer members and thus more merchant members seeking to secure their business.

In short, defendants have strong arguments that default interchange and the various network rules have played, and may continue to play, an important role in the growth and success of the Visa and Mastercard networks. Under these circumstances, a rule of reason analysis with respect to all practices is in order.

It is noteworthy that in prior litigation against Visa and Mastercard, the restrictions at issue there, although deemed to have horizontal dimensions, have been evaluated under the rule of reason.⁹ The recent Department of Justice action against Visa, Mastercard, and American Express concerning anti-steering merchant restraints proceeded on the premise that the restraints would be subject to rule of reason analysis.¹⁰ Visa and Mastercard settled that litigation, and it is now going to trial against American Express, with the government proceeding on a rule of reason theory. Network determined interchange rates were scrutinized under the rule of reason in *National Bancard Corp.*¹¹ Finally, notwithstanding its rule of reason challenges to anti-steering rules in recent litigation, the Justice Department has refrained from challenging default interchange altogether, let alone on grounds of *per se* illegality.

III. DEFAULT INTERCHANGE AND NETWORK RULES UNDER THE RULE OF REASON

Antitrust analysis pursuant to the rule of reason follows a standard template. The first question is whether the defendant(s) possesses market power, which is generally understood as the power to raise price above a competitive level (typically marginal cost). Market power can be proven by direct evidence or by inference, the latter generally based on a large enough “market share” in a relevant antitrust “market.” If market power is absent, the defendant(s) are presumed to lack the ability to harm competition through the challenged practices. If market power exists, the inquiry proceeds to consider whether the challenged practices harm competition. If they do, the defendant may offer a pro-competitive justification for them, which the plaintiff may then rebut or, if not rebutted successfully, may nevertheless overcome by a showing that the harm to competition outweighs the pro-competitive benefits.¹²

A. *Market Power*

Although some degree of uncertainty exists, the plaintiffs would likely prevail on the proposition that Visa and Mastercard possess market power. Visa and Mastercard were found to possess market power in prior

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litigation in the Second Circuit, in an opinion that was affirmed on appeal.¹³ In that case, the Court accepted the proposition that network services for general purpose credit charge cards constitute a relevant market (in relation to merchants and issuers as buyers), and determined that both

direct evidence and market share data (Visa 47 percent and Mastercard 26 percent) supported a finding of market power for both networks, especially in light of market concentration.¹⁴ New entry into the general purpose card market also appears difficult and uncommon.

Nevertheless, the economic experts in the interchange fee litigation devote a great deal attention to the market power question. A substantial portion of the debate focuses on the proper definition of the “relevant market” for antitrust purposes. Plaintiffs’ experts argue that the relevant market is no broader than general purpose credit and charge cards. This market definition was also put forward by the Justice Department in its recent case against Visa, Mastercard, and American Express (now going to trial against American Express). Three of plaintiffs’ experts go so far as to argue that Visa- and Mastercard-branded cards each constitute a relevant market from the perspective of merchants because of various network restrictions on merchants. (Strategically, of course, a finding that each credit card network was its own “monopoly” could trigger monopolization claims under Section 2 of the Sherman Act.)

In making their arguments, plaintiffs’ experts emphasize such factors as (i) the imperfect substitutability between credit/charge cards, debit cards, cash, and checks as payment mechanisms from the perspective of users, (ii) the fact that merchant acceptance of Mastercard and Visa cards does not decline significantly in response to increases in interchange fees by either network, (iii) the ostensible lock-in effects of the anti-steering rules that compel an all-or-nothing choice to accept or decline all cards from a particular network, (iv) the related collective action problem that merchants face in opting out of an important card network, and (v) the empirical claim that increases in interchange fees increase the profits of issuing banks. Plaintiffs further offer

evidence that Visa and Mastercard earn supra-competitive profits.

Defendants' experts dispute the market definition claims and market power inferences put forward by plaintiffs. Among many other points, they argue that card networks compete among each other and with other payment mechanisms for merchant acceptance, that "output" has increased rather than decreased—contrary to what one would expect from anticompetitive price increases—and that the plaintiffs' experts improperly account for the "two-sided" nature of the card market. Regarding the last point, they argue that that increases in interchange fees finance various benefits to cardholders, and that the total price of card usage (to both merchants and consumers) should be the focus of attention, not simply interchange or the merchant discount. They argue that this total price has declined. Defendants also dispute the claim that the Visa and Mastercard networks earn supra-competitive profits.

The defendants' experts are right to argue that the two-sided nature of the general purpose payment card business injects subtleties into the analysis that do not arise in a typical antitrust case, and that may call into question some of the reasoning in *United States v. Visa*.¹⁵ The market definition exercise in antitrust ordinarily asks whether a hypothetical monopolist in a candidate for a "relevant market" could impose a small but significant and non-transitory increase in price ("SSNIP").¹⁶ If so, the candidate market becomes a relevant market for antitrust analysis.

THE DEFENDANTS' EXPERTS ARE RIGHT TO ARGUE THAT THE TWO-SIDED NATURE OF THE GENERAL PURPOSE PAYMENT CARD BUSINESS INJECTS SUBTLETIES INTO THE ANALYSIS THAT DO NOT ARISE IN A TYPICAL ANTITRUST CASE,

When this framework is applied to the typical case, the prospect of a SSNIP represents an escalation of price above marginal cost, and is thus an indicator of the ability of a hypothetical monopolist to earn supra-competitive returns. In a two-sided market, however, the possibility arises that a price increase on one side of the market will be wholly or substantially offset by a price decrease on the other side of the market. With reference to the credit card market, if, hypothetically, any increase in interchange by the "hypothetical monopolist" were offset by a commensurate decrease in cardholder fees or an increase in cardholder benefits, supra-competitive returns would not follow.¹⁷

Accordingly, one must be careful applying the hypothetical SSNIP test in a two-sided market. In particular, one cannot draw an inference of market power simply from past increases in interchange rates relative to processing costs on the merchant side of the market, or the fact that such increases led few if any merchants to drop out of the Visa and Mastercard networks.¹⁸ In theory, merchants might accept increases in interchange not because of the lack of actual or potential competition from other payment mechanisms, but because interchange increases are accompanied by increased benefits to cardholders that make them more likely to use credit cards, so that higher merchant discounts are offset by increased sales.

That said, plaintiffs' experts marshal evidence that the total price to merchants and cardholders together increases as interchange rises, that higher interchange increases the profits of issuing banks, and that higher interchange passes through only partially to cardholders. They further contend that interchange revenue is

dissipated through rent-seeking expenditures that do not benefit cardholders (and thus confer no indirect benefits on merchants). Defendants contest these claims, but plaintiffs have a substantial set of arguments that, if accepted, answer the proposition that they have neglected the two-sided nature of the industry. Plaintiffs also develop rebuttal evidence with respect to the defendants' other economic arguments, such as the claim that output has increased.¹⁹

Taking all of the evidence together, and considering the outcome in *United States v. Visa*, plaintiffs have a substantial economic basis for claiming that a hypothetical monopolist of general purpose credit and charge card services could impose a SSNIP, based on a properly conceptualized two-sided or total price. Such a finding would support a definition of the market limited to such services, in which Visa's share is apparently over 40 percent and Mastercard's share is somewhat under 30 percent, and could in turn support a finding that both entities possess market power. Defendants raise significant issues, however, which call into question some of the reasoning in *United States v. Visa*, and create at least modest uncertainty about the market power issue.

DEFENDANTS RAISE SIGNIFICANT ISSUES, HOWEVER, WHICH CALL INTO QUESTION SOME OF THE REASONING IN UNITED STATES V. VISA, AND CREATE AT LEAST MODEST UNCERTAINTY ABOUT THE MARKET POWER ISSUE.

B. *The Net Economic Effects of Default Interchange, Honor All Cards, and Related Practices*

If the core practices at issue are subject to rule of reason analysis, the plaintiffs must prevail on the proposition that those practices are on balance anticompetitive. This task presents a considerably more formidable hurdle for the plaintiffs than the market power issue.

The practices challenged by plaintiffs at the outset of litigation include default interchange; merchant rules that prevented merchants from encouraging cardholders to use less expensive payment mechanisms through discounts, surcharges, and other means; non-discrimination rules; and rules that prevent merchants from declining to honor certain cards within the network altogether (honor all cards). During the pendency of litigation, Visa and Mastercard settled litigation brought by the Department of Justice with an agreement to permit discounting and related measures to encourage the use of less expensive payment mechanisms. And, as noted earlier, the proposed settlement approved by Judge Gleeson would, subject to certain constraints, eliminate the defendants' no-surcharge rules. Accordingly, the core practices that would remain in place after the proposed settlement include default interchange, the honor all cards rules (superimposed on what has been termed the "honor all paper" obligation), and non-discrimination rules.

These rules are interrelated both in their history and their rationale, which I summarize here in abbreviated form.²⁰ When Bank of America, for example, began to franchise other banks to issue cards or to provide services to merchants who accept cards (i.e., when it evolved toward a four-party network), it was essential to create an environment in which acquiring banks were willing to provide payment services to merchants, and issuing banks were willing to issue cards and pay the acquiring banks for transactions involving their affiliated merchants.

Further, BankAmericard had the ongoing objective of expanding its network of consumers and merchants, and it was important to induce broad acceptance of the card by merchants, including acceptance of the cards issued by franchised issuers. Honor all cards agreements with merchants evolved and did much to assure consumers that their cards would be accepted wherever the BankAmericard logo (later Visa logo) was displayed. This rule was important to the willingness of consumers to carry the card and the willingness of merchants to accept it—the so-called “chicken and egg” issue. Of course, merchants would not agree to honor all cards unless they were assured of payment by their acquiring banks, which in turn needed assurance of payment by issuing banks.

Issuers thus agreed to accept all transactions presented by acquiring banks (“honor all paper”). But this arrangement created some difficulties—how would the issuing banks be compensated? They bore costs of issuing cards, investigating the creditworthiness of cardholders, dealing with fraud and delinquency, and so on, which had to be covered. A simple honor all paper obligation on the part of issuing banks would give them no leverage to extract compensation from acquirers, and they would then have to cover all costs with cardholder fees.

Such an arrangement was perceived to be inadequate by members of the emerging BankAmericard system. An initial effort to require acquiring banks to compensate issuers provided that acquirers should pass the full merchant discount along to the issuing bank, with the expectation of reciprocity when the roles were reversed. This apparently proved unworkable due to dishonesty regarding the size of the merchant discount, and various other forms of opportunism. To solve this problem, default interchange was introduced, which sets an interchange rate that will prevail absent a bilateral negotiation to establish an alternative rate. The history of the Mastercard (formerly Interbank) system is broadly similar although different in some details.

In short, honor all cards rules and default interchange played an important role in making four-party systems attractive to all participants and in expanding their reach. Honor all cards rules assured consumers that they could easily and reliably determine where their cards will be accepted. The related honor all paper rules assured merchants and their acquiring banks that they would be paid, and default interchange provided revenue to issuing banks (in the absence of an alternative negotiated arrangement) that helped to cover not only their costs of processing transactions but the various benefits and incentives that their cards offered to consumers. It is conceivable that four-party systems might have evolved differently, but a powerful argument can be made that these rules did much to facilitate the growth and success of the Visa and Mastercard networks over time.

HONOR ALL CARDS RULES AND DEFAULT INTERCHANGE PLAYED AN IMPORTANT ROLE IN MAKING FOUR-PARTY SYSTEMS ATTRACTIVE TO ALL PARTICIPANTS AND IN EXPANDING THEIR REACH.

Various non-discrimination rules can also be understood as protecting the value of the network and its utility to card users. By prohibiting merchants from treating Visa and Mastercard holders less favorably than users of competing payment mechanisms, they help ensure that cardholders are not targeted by price

discrimination against them, and work to keep the competition between Mastercard and Visa and other payment networks on a “level playing field.”

Finally, there can be no doubt that the Mastercard and Visa networks provide substantial benefits to consumers and merchants. Consumers need not worry about acquiring cash in advance, and about the risk of loss or theft. Checks pose risks of fraud to merchants that they avoid by accepting cards within a network. Debit cards have advantages in these respects, but credit cards have further advantages—consumers can obtain goods and services on credit, enjoy float if they pay off their debts promptly, enjoy certain protections against problematic purchases, and benefit from various rewards and incentives. This list of benefits to consumers who use credit cards is not exhaustive. And because consumers find the cards attractive, merchants who accept cards can expect to make more sales to consumers who carry them.²¹

Given the role that default interchange, honor all cards, and non-discrimination rules played in the development and success of the Visa and Mastercard networks, and given the benefits to consumers and merchants of those networks, a strong argument can be made that such practices serve—or at least served—a pro-competitive function. Plaintiffs’ experts largely accept this proposition. Instead, they argue that practices such as default interchange have outlived their usefulness as the Visa and Mastercard networks have “matured” over time. As I understand this claim, the suggestion is either that the penetration of the Visa and Mastercard networks among merchants and consumers is now so great that the systems no longer require the measures at issue to promote merchant and cardholder acceptance or, as one expert suggests, that the challenge of expansion lies primarily on the merchant side rather than the consumer side of the market, and would be facilitated by lower interchange rates.

Defendants’ experts contest the characterization of the market as “mature,” observing that (i) growth in merchant acceptance and consumer use of cards has remained fairly rapid, (ii) competition from newly emerging technologies requires continued efforts by both networks to retain their market position (including by implication the practices at issue in this case), (iii) much room exists for networks to induce consumers to use their credit cards more often even if most consumers already carry the cards (presumably through interchange fees that finance greater incentives for card use), and (iv) the “maturation” of the market does not remove the need for interchange fees to balance the costs of payment systems between merchants and consumers.

I will not attempt to adjudicate this battle of experts over the existence and implications of industry “maturity,” and simply observe that the practices at issue lie historically at the core of the defendants’ highly successful business model. They were put in place many years ago, at a time when defendants can argue with considerable force that they lacked market power—even if they might be found to possess it today. In the face of such evidence, a court will likely be reluctant to declare that these practices have become antitrust violations

by virtue of industry maturation, especially given the uncertainties that would attend their abolition (discussed at greater length below).

A variety of other considerations raise further doubts about the ability of plaintiffs to establish that default interchange and accompanying network rules are on balance anticompetitive. First, an important body of theoretical work on two-sided markets suggests that it may be socially desirable for prices to be higher on the side of the market that is less price-sensitive.²² If merchants are less price-sensitive than consumers, this body of theory implies that economic welfare can be enhanced if merchants bear a substantial proportion of the total costs incurred by credit card issuers (through a mechanism such as interchange). A corollary is that socially desirable interchange fees need not be tied to the costs of processing merchant transactions.²³ To be sure, this fact does not establish that Mastercard and Visa set the socially optimal interchange fees, and indeed the literature suggests that privately determined interchange can and typically will deviate from the social optimum (potentially in either direction).²⁴

A VARIETY OF OTHER CONSIDERATIONS RAISE FURTHER DOUBTS ABOUT THE ABILITY OF PLAINTIFFS TO ESTABLISH THAT DEFAULT INTERCHANGE AND ACCOMPANYING NETWORK RULES ARE ON BALANCE ANTICOMPETITIVE.

If the theoretical literature offers one robust conclusion, however, it is that the determinants of socially optimal interchange rates are complex and dependent on a variety of subtle factors. Theoretical and empirical work on such matters is ongoing and at “an early stage.”²⁵ There is little basis for believing that socially optimal interchange rates are zero, for example, or some other amount that may have been chosen by any particular set of national regulators (such as those in Europe and Australia, to which the plaintiffs direct attention).

Second, the merchant fees charged by three-party networks (such as American Express and Discover, which serve as both issuer and acquirer) offer some reference point for assessing the total fees charged by Visa and Mastercard. To the best of my knowledge, no general purpose (non-debit) card network of any consequence has ever operated without significant interchange fees (or substantial merchant fees in a three-party network). Discover has somewhat lower fees than Visa and Mastercard historically, while American Express has somewhat higher fees. To be sure, plaintiffs argue that these fees are distorted by the anticompetitive pricing “umbrella” established by Visa and Mastercard, but the fact that American Express, Discover, and other smaller three-party general purpose card networks (e.g., Diner’s Club) have had substantial merchant fees for years raises additional doubts about the ability of plaintiffs to show that the fees in the Mastercard and Visa networks are anticompetitive.

Finally, a showing that default interchange and related network rules for the Visa and Mastercard systems are anticompetitive requires, in my estimation, a convincing description of a counterfactual world in which the purportedly anticompetitive practices of each network are eliminated, and in which the resulting

WHAT WOULD THAT COUNTERFACTUAL WORLD LOOK LIKE?

market equilibrium is demonstrably superior from an economic standpoint. What would that counterfactual world look like? In a garden variety antitrust case involving,

say, simple price-fixing, the counterfactual world is one in which the conspiracy to elevate prices disappears and prices decline toward their competitive level, with an attendant increase in economic welfare in accordance with standard price theoretic models in microeconomics.

If Mastercard and Visa did not set default interchange (and perhaps did not have certain network rules such as honor all cards), it is much more challenging to ascertain what would exist (or would have existed²⁶) as an alternative. The expert reports mention various possible scenarios and one can readily imagine others. If issuers were bound by an honor all paper requirement with no default interchange, they might find themselves at the mercy of acquiring banks who offered them no compensation for their services, and no revenue to put toward funding the cost of cardholder benefits and incentives. This scenario leads to a variety of questions:

- Would issuers drop out of the business, or be content to shift all costs to cardholders?
- How would that affect the value of the networks to their participants and the competition among issuers?
- Would honor all cards and paper rules be abandoned?
- Would issuers then negotiate bilateral interchange agreements with major acquirers?
- Would the transaction costs of those negotiations prove prohibitive as some defense experts argue?
- Could small issuers and acquirers effectively engage in such bilateral negotiations?
- Would some mechanism evolve to economize on the costs of bilateral negotiations (whereby small acquirers and issuers work through large banks with their own bilateral agreements to avoid the need for their bilateral negotiations involving small players)?
- Would new steering practices by merchants be so effective that interchange rates were competed down to the level of the rates on debit cards (as argued by two of the plaintiffs' experts)?
- Might Visa and Mastercard instead simply restructure their operations to avoid any lingering basis for antitrust liability (after all, their IPOs were motivated at least in substantial part by that purpose according to plaintiffs), eliminating any vestige of collaboration among issuer banks, and then proceed largely as in the past setting interchange fees as single entities?
- Might they somehow move away from the four-party model toward a three-party model without materially reducing merchant fees?
- Would large issuers such as Chase and Citibank break off on their own, creating new proprietary cards?

- And, to cut to the bottom line, what would be the costs of negotiating and implementing whatever changes might emerge? How would equilibrium interchange and/or merchant fees compare to current levels? How much would cardholders be affected, perhaps adversely, through changes in fees and incentives?

I would not suggest that any particular scenario is the most likely or plausible. Moreover, the construction of a proper counterfactual scenario requires one to identify precisely which practices represent antitrust violations and which do not, an exercise that gives rise to many possible permutations given the number of practices put in issue by the plaintiffs. The point here is simply that a great deal of uncertainty attends the question of what the proper counterfactual world would look like, stripped of whatever practices are alleged (or found) to be anticompetitive. And, if the counterfactual scenario is highly uncertain, it becomes exceedingly difficult to conclude that the market equilibrium stripped of the alleged anticompetitive practices would be superior from an economic standpoint—the essence of the inquiry under the rule of reason.

IF THE COUNTERFACTUAL SCENARIO IS HIGHLY UNCERTAIN, IT BECOMES EXCEEDINGLY DIFFICULT TO CONCLUDE THAT THE MARKET EQUILIBRIUM STRIPPED OF THE ALLEGED ANTICOMPETITIVE PRACTICES WOULD BE SUPERIOR FROM AN ECONOMIC STANDPOINT—THE ESSENCE OF THE INQUIRY UNDER THE RULE OF REASON.

Perhaps mindful of this problem, plaintiffs' experts at times finesse it. One expert for plaintiffs argues that Mastercard and Visa could survive in a world with zero interchange rates. He also points to the Australian experience, in which the Reserve Bank of Australia has regulated interchange rates without (he argued) reducing the size of the Mastercard and Visa networks there to any significant extent. Another expert offers damages counterfactuals based on a but-for world in which he claims that Visa and Mastercard could have survived despite considerably lower interchange fees. He notes that interchange fee regulation in places like Australia has not put either network out of business.

With all respect, however, the question for rule of reason purposes (as well as for damages calculation) is not whether the networks could survive (or could have survived in the past) with zero interchange by shifting all costs to cardholders, or whether they could survive at some positive but reduced interchange rate established by Australian or other national regulators. Rather, the question is what *market equilibrium* would emerge if the alleged anticompetitive practices were eliminated, and how that equilibrium would compare from an economic standpoint to the *status quo*. It is possible that an alternative market equilibrium might be economically superior, but without the capacity to identify it with any confidence, one can question whether the plaintiffs can succeed in establishing that the challenged practices—such as default interchange and honor all cards rules—are on balance anticompetitive (or, as discussed further below, whether the plaintiffs can establish their damages convincingly).

In this regard, it is noteworthy that U.S. Federal enforcement agencies have devoted considerable attention to practices in the general purpose credit and charge card industry. As noted, they challenged (successfully) rules that restricted Mastercard and Visa issuers from also issuing American Express and Discover

cards, and they achieved a successful settlement with the Visa and Mastercard defendants in litigation regarding certain network rules that discouraged discounting and certain other practices promoting the use of less expensive payment methods.

To my knowledge, however, the enforcement agencies have refrained thus far from bringing challenges to default interchange, honor all cards, and certain other network rules put in issue by plaintiffs. A plausible inference from the absence of enforcement actions regarding these practices is that Federal enforcers regard the economic issues with respect to these practices as complex, and the potential net benefits of any challenge to them as uncertain given the present state of economic knowledge.

IV. OTHER SOURCES OF LITIGATION UNCERTAINTY

A. *Damages*

Plaintiffs' experts submitted materials containing or suggesting quantitative damages analyses on behalf of class plaintiffs based on certain assumptions about the "but-for" world that would have arisen in the absence of the challenged practices. They consider some alternative possibilities, including the measurement of damages on the assumption that interchange would be zero absent the alleged anticompetitive practices, or the assumption that interchange would remain but at lower levels, perhaps approximating those set by regulation in certain countries. Another expert suggests a different counterfactual benchmark—a world in which merchants use steering mechanisms to such a degree and with such efficacy as to drive credit card interchange rates down to the level of interchange fees on debit cards.

These approaches to damages quantification are subject to substantial challenges. First, for the reasons suggested in the last section, it is not at all clear what the proper counterfactual should be. It seems speculative to suppose that the counterfactual market equilibrium in the absence of the challenged practices would involve zero interchange given all of the other ways that the market might evolve or have evolved, and the fact that to my knowledge no general purpose credit or charge card network of any consequence has ever evolved with zero interchange (or comparable merchant fees in a three-party network).

THESE APPROACHES TO DAMAGES
QUANTIFICATION ARE SUBJECT TO
SUBSTANTIAL CHALLENGES.

to suppose that the counterfactual market equilibrium in the absence of the challenged practices would involve zero interchange given all of the other ways that the market might

The notion that the counterfactual market equilibrium would involve interchange at a rate set by some set of foreign regulators seems equally speculative. Given the important differences to consumers between credit cards and debit cards, the substantially greater total costs to issuers of credit cards relative to debit cards, and all of the questions raised in the litigation about the likelihood and efficacy of merchant steering mechanisms, it also seems speculative to suppose that credit card interchange would be competed down to the level of debit card interchange.

Second, a question arises as to how damages should be conceptualized in a two-sided market. Assume, as plaintiffs argued, that the elimination of challenged practices would result in lower interchange rates by some amount, and that the challenged practices are indeed deemed anticompetitive. Assume further, however, as plaintiffs' experts concede at least up to a point, that lower interchange fees would result in higher fees and charges to cardholders, reduced awards, and a diminution in other incentives to use cards. Is it sensible to treat the entire reduction in interchange as "damages" due to an anticompetitive overcharge, or must one offset that amount by the detriment to cardholders from lower interchange? From an economic standpoint, a powerful argument can be made for focusing on the two-sided or total price as the better way to conceptualize any overcharge, as it captures the extent to which all affected parties in the aggregate have been harmed by any anticompetitive practices.²⁸

A POWERFUL ARGUMENT CAN BE MADE FOR FOCUSING ON THE TWO-SIDED OR TOTAL PRICE AS THE BETTER WAY TO CONCEPTUALIZE ANY OVERCHARGE

This issue in turn brings into play a debate among the experts—defendants argue that, at the margin, all increases in interchange are passed through to cardholders, although plaintiffs dispute the underlying empirics. To the degree that increases in interchange result in increased cardholder benefits, reductions in interchange may have the opposite effect, so that any benefits to merchants from reduced interchange fees might be offset in whole or in part by a loss to cardholders.

B. Injunctive Relief

In addition to damages, litigation might result in injunctive relief that goes beyond the increased opportunity to surcharge provided in the proposed settlement. For example, the Court might enjoin Visa and Mastercard from setting default interchange rates, enjoin the enforcement of the honor all cards rule, or enjoin the enforcement of some non-discrimination rule.

Just as the net economic impact of the challenged practices is difficult to identify for purposes of rule of reason analysis, however, and the proper counterfactual is difficult to identify for purposes of damages analysis, so too are the consequences for the general purpose card industry of any move to enjoin these long-time core business practices. The potential for serious unintended consequences is considerable.²⁹ These factors, in my view, would likely make a court hesitant to enjoin the core practices left standing by the proposed settlement.

A court will also likely be mindful of the fact that private antitrust litigation is not the only mechanism for addressing possibly anticompetitive practices. Federal antitrust enforcers can and have instituted actions to challenge certain network practices, resulting in favorable adjudication and settlement. Likewise, parties who believe themselves harmed by anticompetitive practices can and have secured legislative relief from Congress. The recent regulation of interchange rates for debit card transactions by the Federal Reserve, pursuant to the Dodd-Frank Act, is illustrative.

Federal enforcement actions have obvious advantages over private antitrust litigation in cases involving difficult economic issues, particularly if relief would involve changing the business models of successful U.S. companies.

FEDERAL ENFORCEMENT ACTIONS HAVE OBVIOUS ADVANTAGES OVER PRIVATE ANTITRUST LITIGATION IN CASES INVOLVING DIFFICULT ECONOMIC ISSUES, PARTICULARLY IF RELIEF WOULD INVOLVE CHANGING THE BUSINESS MODELS OF SUCCESSFUL U.S. COMPANIES.

well as investigative powers, that a court does not possess.

The Federal enforcement agencies have large economics staffs, typically headed by distinguished industrial organization economists. The availability of substantial economic input from a staff, employed by an entity with no direct monetary interest in the outcome of litigation, can reduce the risk of errors. The Congress also has access to a range of expertise, as

For all of these reasons, there is considerable doubt whether the plaintiffs could secure significant injunctive relief going beyond what the Federal enforcers have pursued in their own action, even if they were to establish liability. The business practices at issue lay at the heart of a decades-old and highly successful business model, and the potential for unintended consequences from interference with that business model is high.

C. *The Indirect Purchaser Issue*

Defendants argue that plaintiffs cannot recover damages in this action because merchants are indirect purchasers of the services provided by the defendants and their member issuers (following cases such as *Illinois Brick*).³⁰ Interchange fees are paid by acquiring banks to issuing banks, the argument runs, and are at most passed along to merchants as indirect purchasers. Plaintiffs argue that the indirect purchaser doctrine does not apply because interchange fees are effectively paid by merchants rather than acquirers, and because many acquirers are also members of the Mastercard and Visa networks as issuers, falling within a purported exception to the indirect purchaser doctrine.

THE QUESTION WHETHER THE INDIRECT PURCHASER DOCTRINE APPLIES TO MERCHANTS IN A FOUR-PARTY PAYMENT SYSTEM IS A SERIOUS ONE.

The question whether the indirect purchaser doctrine applies to merchants in a four-party payment system is a serious one. Other cases have invoked the indirect purchaser doctrine to bar damages claims by merchants or other bank customers in arguably analogous situations.³¹ Plaintiffs argue that these cases are distinguishable and/or incorrectly decided.

To the degree that economic analysis has any relevance the applicability of the indirect purchaser doctrine, one might bring it to bear in relation to the policy rationale behind *Illinois Brick* and related cases. My understanding of the indirect purchaser doctrine is that it stems initially from a concern about the possibility of multiple recoveries. If each purchaser at each point in a chain of transactions (e.g., wholesaler, retailer, consumer) could sue to recover the full monopoly overcharge (trebled under the antitrust laws), total damages would become excessive. To avoid this outcome, some manner of apportionment might be used—one

might attempt to compute the amount of harm borne by the wholesaler and separate it from the overcharges passed on to the retailer, do the same at the retail level, and so on. But this apportionment problem would be complex in many cases and subject to error.³² To avoid such issues, the indirect purchaser doctrine provides that the direct purchaser can recover the full overcharge with no deduction for amounts passed downstream, while indirect purchasers are barred from recovery.

If the rationale for the indirect purchaser doctrine is the avoidance of a costly and error prone apportionment problem, it has less force when apportionment is straightforward because contractual arrangements allow a court easily to ascertain what portion of a monopoly overcharge is passed along the chain of distribution (as in the possible “cost-plus” exception to *Illinois Brick*).³³ It also has less force when direct purchasers may be disinclined to sue, perhaps because they have an economic interest in maintaining the anticompetitive overcharge.

Plaintiffs in this litigation can perhaps appeal to these policy considerations, arguing that acquirer fees are easily separated from interchange fees that are paid to issuers and passed along to merchants (regardless of who “pays” interchange as a formal matter), and that some acquirers are also issuers and thus directly or indirectly benefit from any anticompetitive practices. Whether these considerations would be sufficient to overcome the tendency of courts to apply the indirect purchaser doctrine rather strictly, however, is unclear.³⁴

V. CONCLUSION

For the reasons developed above, the plaintiffs in the interchange fee litigation face a substantial and perhaps rather large probability of eventual failure both as to liability and as to the prospects of significant monetary and injunctive relief. A high probability exists that the issues will be analyzed under the rule of reason, and a review of the economic issues in the case suggests that the plaintiffs will have difficulty establishing that the intra-network practices are on balance anticompetitive.

The plaintiffs also face considerable difficulty in establishing a persuasive counterfactual for the computation of damages, assuming that they can overcome obstacles to liability, as well as significant potential risk under the indirect purchaser doctrine. Related considerations along with prudential factors raise further doubts about the likelihood of any injunctive relief going significantly beyond the terms of the proposed settlement.

GIVEN ALL OF THE ISSUES ON WHICH THE PLAINTIFFS CASE MIGHT FAIL, THE CUMULATIVE PROBABILITY OF FAILURE APPEARS TO BE QUITE SUBSTANTIAL.

Given all of the issues on which the plaintiffs case might fail, the cumulative probability of failure appears to be quite substantial. ▲

¹ Robert A. Kindler Professor of Law, New York University, and Visiting Professor of Law, Stanford University.

² In class actions, a question arises as to whether class plaintiffs’ and counsel represent the interests of the class as a whole adequately, and the court serves as an independent check on the wisdom of settlement under

Rule 23 of the Federal Rules of Civil Procedure.

³ <http://www.law360.com/articles/495780/7-25b-visa-mastercard-swipe-fee-deal-gets-approval>.

⁴ The full text of Judge Gleeson's order may be found at <http://www.scribd.com/doc/191371357/IN-RE-PAYMENT-CARD-INTERCHANGE-FEE-AND-MERCHANT-DISCOUNT-ANTITRUST-LITIGATION>.

⁵ <https://www.competitionpolicyinternational.com/assets/Uploads/opinion.pdf>. The expert reports in the case are confidential, although I do make reference to aspects of the expert reports in my own public report. In preparing this commentary, I make no references to confidential materials beyond those contained in my report to the Court, and I have deleted all references to specific expert reports.

⁶ See, e.g., Richard A. Posner, *Economic Analysis of Law* §21.5 (5th ed. 1998); Steven Shavell, *Foundations of Economic Analysis of Law* §17.2 (2004).

⁷ I also assume for purposes of analysis that initial allegations of inter-network conspiracy between Visa and Mastercard—an agreement between them to set interchange rates—are not supportable. An agreement between Visa and Mastercard on interchange fees would be a *per se* violation of Section I of the Sherman Act, and if proven would no doubt entitle plaintiffs to a finding of liability and potentially quite substantial damages.

⁸ *Broadcast Music, Inc. v. CBS, Inc.*, 441 U.S. 1 (1979).

⁹ *United States v. Visa U.S.A., Inc.*, 344 F.3d 229 (2d Cir. 2003) (prohibition on the issuance of Discover and American Express cards by member banks).

¹⁰ See *United States et. al. v. American Express et. al.*, Amended Complaint for Equitable Relief, Civil Action no. CV-10-4496, filed December 21, 2010 (discussing defendants' market power, alleging that defendants' practices unreasonably restrain trade and are not reasonably necessary to accomplish defendants' alleged pro-competitive goals).

¹¹ *National Bancard Corp. v. Visa U.S.A., Inc.*, 779 F.2d 592 (11th Cir. 1986)

¹² E.g., *United States v. Visa*, *supra* note 9; *United States v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir. 2001).

¹³ *United States v. Visa*, *supra* note 9.

¹⁴ *Id.*, 344 F.3d at 240.

¹⁵ *Id.*

¹⁶ See, e.g., U.S. Department of Justice and Federal Trade Commission 2010 Horizontal Merger Guidelines §4.1 (product market definition).

¹⁷ Dr. Frankel seems to acknowledge the point in one of his academic publications: “[T]he interchange fee might be used to cartelize an industry, as might occur if the interchange fee is set high and banks do not compete through rebates to consumers...” Dennis W. Carlton & Alan S. Frankel, *The Antitrust Economics of Credit Card Networks: Reply to Evans and Schmalansee Comment*, 63 ANTITRUST L.J. 903, 913 (1995).

¹⁸ See *United States v. Visa*, *supra* note 9, 344 F.3d at 240 (“despite recent increases in both networks’ interchange fees, no merchant had discontinued acceptance of their cards”).

¹⁹ In addition to the issues noted in the text, the expert reports contain discussion of the significance of “price discrimination” by the defendants in the setting of different interchange rates for different merchants or categories of merchants. At one time, it was widely thought that price discrimination was evidence of

market power. More recent economic learning undermines this view, suggesting that price discrimination is in fact quite common in markets that are highly competitive and in which firms do not earn supra-competitive returns. See Michael E. Levine, *Price Discrimination without Market Power*, 19 YALE J. REG. 19 (2002). I concur that price discrimination is not necessarily an indicator of market power.

²⁰ For additional detail, see, e.g., DAVID S. EVANS, INTERCHANGE FEES: THE REGULATION OF WHAT MERCHANTS PAY FOR CARDS (2011), available at <https://www.competitionpolicyinternational.com/assets/Hot-Tubs/Interchange-Fees-web.pdf>.

²¹ I recognize that some debate exists among the experts in the case as to the “social” versus “private” value of these additional sales by merchants who accept cards. To some degree, merchants who accept cards may simply increase their sales at the expense of merchants who do not.

²² For a relatively early, non-technical discussion, see Jean Charles Rochet & Jean Tirole, *An Economic Analysis of the Determinants of Interchange Fees in Payment Systems*, 2 REV. NETWORK ECON. 69 (2003).

²³ *Id.*

²⁴ See, *id.* §3.2 and sources cited therein; David Evans, *supra* note 20, chapter 1.

²⁵ *Id.* at 20.

²⁶ I recognize that for the purposes of computing past damages, the question is what would have happened absent the anticompetitive practices in the past, not what will happen without them in the future. In thinking about liability under the rule of reason, however, one can appropriately ask what the market would look like absent the challenged practices and, accordingly, I couch the text as a forward-looking discussion.

²⁷ United States v. Visa, *supra* note 9.

²⁸ I am mindful, however, of the point noted by one expert for plaintiffs—inefficiency in the market might arise not only because the “total price” is elevated above the competitive level, but also because the merchant price is “too high” and the cardholder price “too low” from the standpoint of social optimality. It is not at all clear to me, however, how this wrinkle might be factored into a quantitative analysis of antitrust damages.

²⁹ An independent commentary concluding that a court would not be likely to enjoin these practices is Steven Semeraro, *Taming Credit Card Fees by Requiring the Biggest Banks to Compete for Merchant Acceptance: An Interbank Competitive Model*, Thomas Jefferson School of Law Research Paper No. 2223518 (Feb. 2013).

³⁰ The indirect purchaser doctrine would not bar the plaintiffs from securing injunctive relief. Illinois Brick Co. v. Illinois, 431 U.S. 720 (1977).

³¹ Paycom Billing Svcs., Inc. v. Mastercard Int’l, Inc., 467 F.3d 283 (2d Cir. 2006); Kendall v. Visa USA, 518 F.3d 1042 (9th Cir. 2008); In Re ATM Fee Antitrust Litigation, 686 F.3d 741 (9th Cir. 2012).

³² See *Illinois Brick*, 431 U.S. at 737, *supra* note 30.

³³ *Id.* at 736

³⁴ See, e.g., Kansas v. Utilicorp United, Inc., 497 U.S. 199 (1990) (rejecting exception to indirect purchaser doctrine where overcharges allegedly passed on in full to utility customers).