

PRICELESS? THE ECONOMIC COSTS OF CREDIT CARD MERCHANT RESTRAINTS

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Merchants pay banks a fee on every credit card transaction. These credit card transactions cost American merchants an average of six times the total cost of cash transactions. The variation in fees among credit cards is also large, with some cards, such as rewards cards, costing merchants twice as much as others.

The largest component of the fee merchants pay goes to finance rewards programs, which in turn generate more credit card transactions. Although merchants finance the rewards programs, they derive no benefit from them. Rather than generating additional sales, rewards programs merely induce consumers to shift transactions from less expensive payment systems to more expensive rewards credit cards. Why, then, do all consumers pay the same price for purchases, regardless of the means of payment?

The answer lies in a set of credit card network rules known as merchant restraints. Merchant restraints prohibit merchants from accepting certain credit cards selectively and from pricing goods and services according to cost of payment. These restraints thus prevent merchants from signaling to consumers the costs of different payment methods. Accordingly, consumers never internalize the costs of their choice of payment system. Merchant restraints thus encourage more credit card transactions at a higher price than would occur in a perfectly efficient market. The restraints also permit card issuers to externalize the costs of rewards programs to merchants and, ultimately, to consumers who do not use rewards cards.

This Article argues that merchant restraints distort competition within the credit card industry and among payment systems in general. Further, merchant restraints' economic justifications are unfounded, and they should be banned as antitrust violations.

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INTRODUCTION.....	1322
I. THE STRUCTURE AND ECONOMICS OF CREDIT CARD NETWORKS	1326
A. Network Structure	1326
B. Costs of Credit Card Transactions.....	1329
C. Merchant Restraints	1334
D. Importance of Interchange Revenue for Card Networks.....	1338
II. THE EFFECTS OF MERCHANT RESTRAINTS.....	1342
A. Benefits and Costs of Credit Cards	1342
B. Merchants' Dilemma: The Rewards Card Externality	1345
C. Limited Utility of Discounting for Cash to Avoid the Rewards Card Externality.....	1350
1. Psychological Limitations.....	1350
2. Idiosyncratic Limitations.....	1352
3. Legal Limitations	1353
D. Effects on Consumers.....	1356
E. Effects on Payment System Competition	1356
III. ARE MERCHANT RESTRAINTS AN ECONOMIC NECESSITY FOR CREDIT CARD NETWORKS?.....	1363
A. The Network Effect and Two-Sided Networks	1363
B. The History of Merchant Restraints	1367
1. Honor-All-Cards Rules and No-Differentiation Rules	1367
2. No-Surcharge and No-Discount Rules	1369
3. Origins of Interchange.....	1376
4. History of the Cash Discount Act.....	1379
C. The Cash Discount Act as Consumer Protection?.....	1382
D. The Contemporary Relevance of Network Effects.....	1385
1. The No-Surcharge Rule.....	1385
2. The Honor-All-Cards Rule and Other Merchant Restraints	1390
IV. ANTITRUST ANALYSIS OF MERCHANT RESTRAINTS.....	1392
A. Defining the Relevant Market	1393
B. Tying	1399
C. Horizontal Price-Fixing	1400
D. Vertical Price-Fixing.....	1401
E. Hybrid Section 1 Violations?	1402
CONCLUSION	1404

INTRODUCTION

For nearly a decade, MasterCard has run a successful ad campaign that touts the benefits of its cards as “Priceless.”¹ But this is hardly the case. Merchants see the price tag for payment systems, and credit cards are expensive as payment systems go. On average, credit card transactions cost American

1. *Slate's Ad Report Card: The End of "Priceless"* (NPR radio broadcast Mar. 16, 2006).

merchants six times as much as cash transactions and twice as much as checks or PIN-based debit cards.²

TABLE 1: AVERAGE U.S. RETAILER'S COST PER TRANSACTION IN 2000³

	CREDIT CARDS	OFFLINE (SIGNATURE) DEBIT CARDS	CHECKS	ONLINE (PIN) DEBIT CARDS	CASH
Average Cost per Transaction	\$0.72	\$0.72	\$0.36	\$0.34	\$0.12

But these are only the average costs of credit cards. Some credit cards cost merchants much more than others. Merchants' costs of accepting credit cards vary tremendously among and within brands. Credit cards with rewards programs cost more for merchants to accept than cards without rewards. Similarly, corporate cards cost merchants more than consumer cards. A transaction on a rewards card or a corporate card can cost a merchant twice as much as the same transaction on a regular consumer card. Thus, merchants fund rewards and corporate card programs, but see no marginal benefit from having accepted a rewards card or corporate card instead of a regular nonrewards consumer credit card.

While the cost differences between payment systems are often a matter of cents per transaction, they are significant in absolute terms. In 2006, American merchants paid banks nearly \$57 billion in fees to accept payment cards⁴—more than the total size of the biotech industry, the music industry,

2. David Humphrey et al., *What Does It Cost to Make a Payment?*, 2 REV. NETWORK ECON. 159, 162–63 (2003). These numbers likely understate the cost discrepancies among payment systems because the U.S. data is from 2000 and the cost of accepting credit cards for merchants rose 23 percent just between 2000 and 2006, while other payment system costs have declined or remained static. See *infra* text accompanying notes 71–72.

3. Humphrey et al., *supra* note 2. These figures include fees paid by merchants to banks, as well as costs such as handling, theft, counterfeit, float, deposit preparation, insurance, armored cars, and labor. For different calculations, see Daniel D. Garcia-Swartz et al., *The Move Toward a Cashless Society: A Closer Look at Payment Instrument Economics*, 5 REV. NETWORK ECON. 175 (2006); Daniel D. Garcia-Swartz et al., *The Move Toward a Cashless Society: Calculating the Costs and Benefits*, 5 REV. NETWORK ECON. 199 (2006). Unfortunately, both the Humphrey et al. study and the Garcia-Swartz et al. studies are based on data at least a decade old. Cf. Allan Shampine, *Another Look at Payment Instrument Economics*, 6 REV. NETWORK ECON. 495 (2007) (critiquing Garcia-Swartz et al.'s methodology). But cf. Daniel D. Garcia-Swartz et al., *Further Thoughts on the Cashless Society: A Reply to Dr. Shampine*, 6 REV. NETWORK ECON. 509 (2007) (responding to Shampine's criticisms).

4. *Merchant Processing Fees*, NILSON REP., Apr. 2007, at 7.

the microchip industry, the electronic game industry, Hollywood box office sales, or worldwide venture capital investments.⁵

Payment costs—what a transaction costs—are the ultimate transaction cost, and credit card fees are merchants' most ubiquitous transaction cost. One would expect merchants to pass this cost on, at least in part, to consumers who use credit cards. Why, then, do all consumers pay the same for a purchase, regardless of whether they use cash, checks, debit, regular credit cards, or high-priced rewards or corporate cards?

The answer lies in a set of credit card network rules that leverage credit cards' market power to limit merchants' ability to steer consumers to cheaper payment systems through pricing. Credit card network rules are incorporated by reference in merchants' contracts with their banks. These rules restrict merchants' ability to choose which payment systems to accept and how to price them. They also force merchants to bundle the pricing of payment services with the underlying goods and services being sold. Further, these rules exploit consumers' cognitive bias of reacting differently to mathematically equivalent surcharges and discounts in order to prevent merchants from pricing according to payment system costs.⁶

These rules thus prevent merchants from signaling to consumers the costs of different payment methods. Accordingly, consumers never internalize the costs of their choice of payment system, which results in more credit card transactions at higher prices than would occur in a perfectly efficient market. Credit card network rules also prevent merchants from avoiding the cost externality created by rewards programs.

This Article argues that a set of credit card network rules, which it collectively refers to as "merchant restraints,"⁷ are antitrust violations that distort competition within the credit card industry and between payment systems in general. It shows how credit card networks have chosen to forgo interbrand competition in order to erect a barrier to entry against new, more cost-efficient payment systems. The Article demonstrates that the economic justifications proposed for merchant restraints are historically and logically flawed and suggests that merchant restraints represent a failure in the payment systems market that requires intervention.

5. Aneace's Blog, <http://aneace.blogspot.com> (May 12, 2006).

6. Cf. Paul Heidhues & Botond Köszegi, *Exploiting Naivete About Self-Control in the Credit Market* 1 (Feb. 23, 2008) (unpublished manuscript), available at <http://elsa.berkeley.edu/~botond/credit.pdf> (modeling exploitation of consumers' time-inconsistent tastes).

7. The term "merchant restraints" is not used by credit card networks. It is a shorthand term created by plaintiffs' attorneys in antitrust litigation against credit card networks. Credit card networks have hundreds of rules, only a handful of which create competitive problems. I adopt the term "merchant restraints" solely for the sake of convenience.

The Article proceeds in four Parts. Part I reviews the complex structure and economics of credit card networks, including merchant restraints. It shows how transaction-based revenue, which is protected from market discipline by merchant restraints, has increased in importance relative to interest-based revenue for credit card companies, making merchant restraints increasingly critical to credit card networks' profitability.

Part II then considers the problems created by merchant restraints. Credit card networks use merchant restraints to impose the cost externality created by rewards and corporate card programs upon merchants. Merchants are forced to fund rewards and corporate card programs from which they derive no benefit. Part II also shows how the externality of rewards programs is passed on to non-credit-card consumers and how card networks leverage their market power to forgo price-based competition in order to negate other payment systems' cost advantage. This leads to higher levels of credit card use at higher prices, the costs of which are again borne by merchants and non-credit-card consumers.

Part III examines the main argument in defense of merchant restraints—the assertion that merchant restraints are an economic necessity for credit card networks. Legal academics and economists contend that merchant restraints are necessary for networks to avoid what is known as a negative network effect or network externality—the phenomenon of a decrease in a network's size resulting in a decrease in the network's value for the network's remaining participants. These scholars argue that absent merchant restraints, merchants would accept credit cards on inconsistent terms, which would make credit cards less desirable to consumers. This in turn would make card acceptance less desirable for merchants, setting off a downward death spiral in the size of credit card networks that would decrease social welfare.

Part III also argues that the network effects claim and its subsidiary consumer protection claim are mistaken. It shows how the network effects argument is both historically inaccurate and inapplicable to the current competitive environment. The history of merchant restraints has been all but ignored by legal and economic scholarship, which has focused on theoretical arguments about the role of merchant restraints. The history of merchant restraints shows, however, that they were adopted because of regulatory and business reasons relating to branch banking regulations and usury laws, not because of network effects and consumer protection concerns. The regulatory and business factors behind the original adoption of merchant restraint rules, however, are no longer extant; branch banking

and usury restrictions have been largely abolished. Moreover, network effect concerns make little sense in the current competitive environment, where well-established networks compete against other established networks. Any negative network effect on one credit card network will be offset by a positive network effect on another credit card network or on another payment system. Indeed, the ability of credit card networks to thrive in Europe and in Australia absent certain merchant restraints calls into question the importance of network effects.

Likewise, consumer protection concerns about inconsistent credit card acceptance originated in the context of 1960s banking regulation, which inhibited interstate branch banking. Because banks operated in only one state, there was a serious concern that merchants would not honor cards issued by unfamiliar out-of-state banks. Regulatory changes, however, have since allowed the creation of interstate branch banking, and most credit cards are issued by banks with national operations, obviating the original reason for concerns about inconsistent card acceptance. Today, consumer protection concerns about inconsistent credit card acceptance make sense only so long as there is significant price variation among credit cards. Absent merchant restraint rules, however, there would only be de minimis variation in credit card fees, so merchants would have no reason to distinguish between cards.

Part IV conducts an antitrust analysis of merchant restraints, and explores the difficulties of defining the proper market for merchant restraints and of fitting merchant restraints into existing categories of Sherman Act section 1 violations. This Article concludes that merchant restraints distort competition within the credit card industry and among payment systems in general. Because merchant restraints are restraints on trade lacking a procompetitive justification, they should be banned as antitrust violations.

I. THE STRUCTURE AND ECONOMICS OF CREDIT CARD NETWORKS

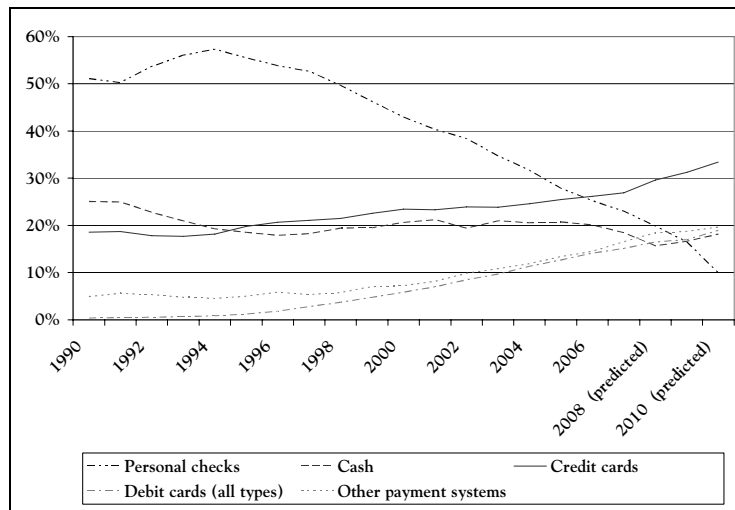
A. Network Structure

The payments industry is increasingly dominated by electronic payment systems, particularly credit cards. The percentage of dollar volume of goods and services purchased using credit cards has risen from 6 percent in 1984,⁸ the first year when such statistics were compiled, to 26 percent

8. DAVID S. EVANS & RICHARD SCHMALENSEE, *PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING* 25 (1999).

in 2006.⁹ Credit cards are predicted to account for over one-third of total U.S. purchase volume by 2010.¹⁰

CHART 1: PAYMENT SYSTEMS' MARKET SHARE BY DOLLAR VOLUME
(1990–2010)¹¹



Most credit cards in the United States are run on the following bank-controlled networks: MasterCard, Visa, American Express, and Discover. In 2006, Visa had a 53 percent market share of U.S. combined consumer and commercial payment card purchase volume, followed by MasterCard with 30 percent, American Express with 13 percent, and Discover with 4 percent.¹²

Historically, MasterCard and Visa were nonstock corporations owned by their member banks—essentially joint ventures. Since 2006 and 2008, respectively, MasterCard and Visa have been publicly traded corporations with complex, multi-class stock ownership structures combining public and

9. *Consumer Payment Systems*, NILSON REP., Oct. 2007, at 10.

10. *Consumer Payment Systems*, NILSON REP., Dec. 2006, at 1, 9.

11. *Consumer Payment Systems*, NILSON REP., Oct. 2007, at 9 (2006 and 2001 data); *Consumer Payment Systems*, NILSON REP., Dec. 2006, at 7 (2000 and 2005 data, as well as the 2010 prediction); *Consumer Payment Systems*, NILSON REP., Dec. 2005, at 6 (2004 data); *Consumer Payment Systems*, NILSON REP., Dec. 2004, at 6 (2003 data); *Consumer Payment Systems*, NILSON REP., Nov. 2003, at 6 (2002 data); *The Future of Consumer Payment Systems in the United States*, NILSON REP., Apr. 2002, at 6 (1990–1999 data).

12. CardData, U.S. Quarterly Payment Card Charge Volume by Brand—2006, <http://www.cardweb.com/carddata/charts/quartervolume/2006.html> (last visited Jan. 31, 2008). This data includes network credit cards and offline debit cards. It does not include PIN-based debit cards, prepaid cards, or private label credit cards.

bank ownership and, in the case of MasterCard, also charitable foundation ownership.¹³ MasterCard's and Visa's networks consist of three parties that link the transaction between the consumer and the merchant (Figure 1). First, there are the banks that issue cards to consumers called the issuer banks. Second, there are the banks at which merchants maintain their accounts. These are called the acquirer banks because they functionally purchase merchants' accounts receivable created by consumers' card transactions with merchants.¹⁴ Issuers and acquirers typically belong to MasterCard and Visa networks.¹⁵ Intermediating between issuers and acquirers is the network association, which performs authorization, clearing, and settlement (ACS) services. Before their IPOs, voting on governance issues was in proportion to annual sales volumes, so MasterCard and Visa have traditionally been dominated by the large issuers.¹⁶

American Express and Discover are freestanding financial institutions with public ownership. Historically, American Express and Discover each performed all the functions of the issuer, acquirer, and network itself. Recently, American Express and Discover have contracted with MasterCard and Visa member banks to issue cards on their networks' brands, although they continue to serve as the acquirer and ACS network (Figure 2).

13. See Adam J. Levitin, *Payment Wars: The Merchant-Bank Struggle for Control of Payment Systems*, 12 STAN. J.L. BUS. & FIN. 425, 463–67 (2007), for an analysis of MasterCard's new ownership structure. Visa's IPO was the largest in U.S. history. See Anuj Gangahar, *Visa Stages Largest Ever US IPO*, FIN. TIMES (London), Mar. 18, 2008.

14. In all networks there is often an additional party, the merchant service provider or independent sales organization, which links the merchant and the acquirer. Acquirers frequently outsource all but the financing element of their operations to merchant service providers. See Ramon P. DeGennaro, *Merchant Acquirers and Payment Card Processors: A Look Inside the Black Box*, 91 FED. RES. BANK ATLANTA ECON. REV. 27, 31 (2006). A separate processor and/or gateway provider may also be involved in linking the merchant and the acquirer.

15. *In re Visa Check/MasterMoney Antitrust Litig.*, 280 F.3d 124, 130 (2d Cir. 2001) (citing a 95 percent overlap in membership).

16. E.g., *Visa USA Changes Board*, NILSON REP., Nov. 2005, at 1, 10 (Visa voting).

FIGURE 1: PARTIES TO MASTERCARD AND VISA NETWORKS

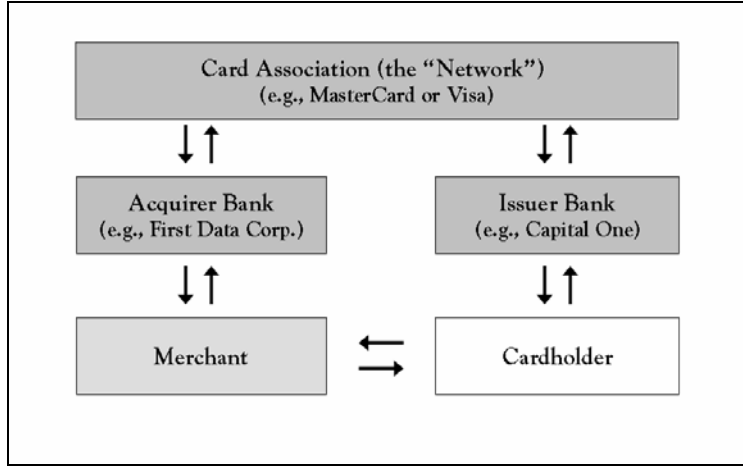
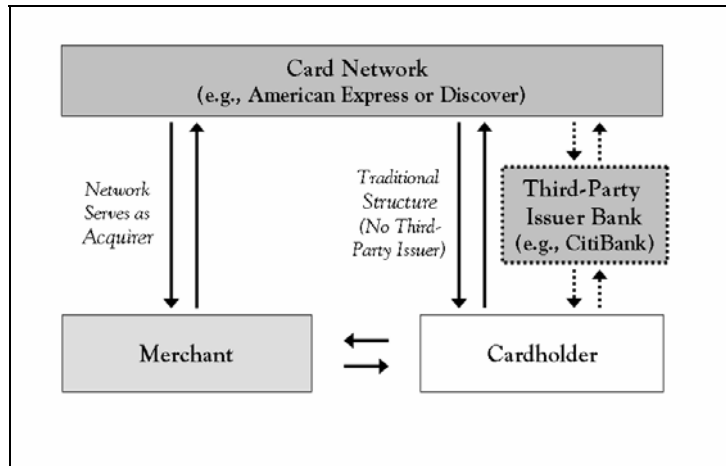


FIGURE 2: PARTIES TO AMERICAN EXPRESS AND DISCOVER NETWORKS

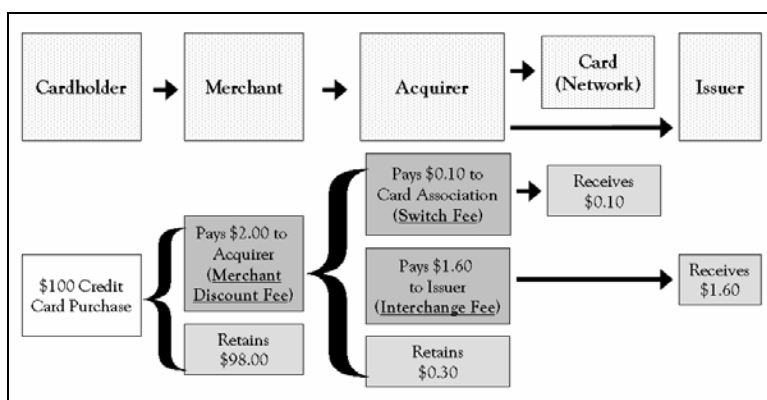


B. Costs of Credit Card Transactions

Credit card transactions have several cost components, the manipulation of which affects demand for the product from both types of consumers—merchants and cardholders (Figure 3). When a consumer makes a purchase with a card, the merchant’s account at the acquiring bank is credited with the purchase amount, less an amount known as the merchant discount fee. The merchant discount fee typically consists of both a flat rate amount, ranging from a few cents to a dollar, and a percentage

amount. The total merchant discount fee usually amounts to 2 to 3 percent, but tends to be higher, in the range of 3 to 4 percent for non-U.S. merchants and for mail-order, Internet, or telephone-order merchants.¹⁷ Rates can even be as high as 15 percent for merchants who present a particularly high risk because of low transaction volume, limited credit history, or the nature of their business.¹⁸

FIGURE 3: NETWORK'S FEE DIVISION ILLUSTRATED WITH A \$100 CREDIT CARD PURCHASE, A 2 PERCENT MERCHANT DISCOUNT RATE, AND A 1.6 PERCENT INTERCHANGE RATE



Of the merchant discount fee, part is retained by the acquirer bank and part is remitted to the network association.¹⁹ The network association keeps a

17. MerchantSeek, Merchant Account Rates, http://www.merchantseek.com/merchant_accounts_rates.htm (last visited Feb. 4, 2008).

18. See Adult Card Processing.com, <https://secure.goweb.com/adultcardprocessing/index.html> (last visited Feb. 4, 2008); Guardian Financial Services, Inc., http://www.guardianfinance.com/high_risk_merchant_account.htm (last visited Feb. 4, 2008).

19. This description of credit card network economics differs from the Ninth Circuit's recent confused (and incorrect) description in *Kendall v. Visa U.S.A., Inc.*, 518 F.3d 1042, at 1045–46 (9th Cir. 2008). The Ninth Circuit incorrectly believed that the network, rather than the issuer, retained the interchange fee. See *id.* In fairness to the Ninth Circuit, a 12(b)(6) motion is based on the assumption that all facts pled by the plaintiff are true, and the plaintiffs' complaint never explained who received the interchange fee. Still, given the existence of the Eleventh Circuit's ruling in *National Bancard Corp. (NaBanco) v. VISA U.S.A., Inc.*, 779 F.2d 592, 594 (11th Cir. 1986), and the district court's finding that interchange is paid to the issuer, *Kendall*, 518 F.3d at 1046, it is unclear why the Ninth Circuit would reach a different conclusion.

The Ninth Circuit's inability to master the economic structure of credit card networks makes its cursory antitrust analysis suspect. In *Kendall*, the plaintiffs alleged that the defendant banks and networks had conspired to fix the interchange fee. *Id.* at 1048–49. The Ninth Circuit held that the plaintiffs in *Kendall* had failed to plead sufficient facts against the banks to overcome the rule that allegations of parallel conduct and a bare assertion of conspiracy alone are insufficient to

small part of this remittance (known as the network assessment, or switch fee)²⁰ to cover the costs of clearing the transaction²¹ and remits most of it, in turn, to the issuing bank. The remittance to the issuer is called the interchange fee, although this term is often misapplied to all the fees involved in the network, including the merchant discount fee. At some point after the transaction has been completed, the issuer will bill the cardholder for the full purchase amount. Typically there will be an interest-free grace period (the float period) before the cardholder has to pay the bill; if the cardholder pays late, the issuer will assess interest and fees.

The purpose of the interchange fee is a matter of debate; it might well have changed over time.²² The interchange fee's original purpose might have

overcome a 12(b)(6) motion to dismiss. See *id.* at 1046–47 (citing *Bell Atl. Corp. v. Twombly*, 127 S. Ct. 1955, 1964 (2007)); *id.* at 1051–52.

Notably, *Twombly* dealt with a situation involving only parallel pricing; no mechanism for the conspiracy to set prices was alleged. See 127 S. Ct. at 1962. *Kendall*, however, alleged such a mechanism—the card associations. 518 F.3d at 1048. The Ninth Circuit greatly overread *Twombly* to support the proposition that “merely charging, adopting or following the fees set by a Consortium is insufficient as a matter of law to constitute a violation of Section 1 of the Sherman Act.” *Id.* Simply put, *Twombly* does not support such a proposition. *Twombly* dealt with parallelism without a consortium; *Twombly* had nothing to say about parallel pricing by members of a consortium or cartel.

The Ninth Circuit also relied on one of its own precedents, *Kline v. Coldwell, Banker & Co.*, 508 F.2d 226 (9th Cir. 1974), for the point that “membership in an association does not render an association's members automatically liable for antitrust violations committed by the association.” *Kendall*, 518 F.3d at 1048. Notably, *Kline* involved a suggested fee schedule for Los Angeles area realtors. 508 F.2d at 228. It is not clear from *Kline* if these were inter-broker fees or fees charged to clients. If the latter, it is quite different from interchange; most consortiums do not set the fees paid by one member to another. Consortium membership (and serving on the board) is quite different when one is setting the consortium's own fees (which in the credit card context would be the network's authorization, clearing, and settlement fees, about which the Ninth Circuit did not know in *Kendall*) versus when one is setting the fees to be paid to members of the consortium (like interchange actually is). Thus, the Ninth Circuit's misunderstanding of the interchange fee might well have impacted the outcome of *Kendall* despite the Ninth Circuit's insistence that the economics of the fee were irrelevant to the ruling.

20. Visa's switch fee was 0.0925 percent of the transaction value in August 2007; MasterCard's was 0.0950 percent of the transaction value.

21. MasterCard's ACS costs appear to be around 13 cents per transaction. Dennis W. Carlton & Alan S. Frankel, *Transaction Costs, Externalities, and “Two-Sided” Payment Markets*, 2005 COLUM. BUS. L. REV. 617, 633.

22. William W. Shaw, *A Question of Integrity*, CREDIT CARD MGMT., Feb. 2005, at 48. The earliest court decision on interchange found that it was a fee for the costs of transferring transactional paper from the acquirer to the issuer. *Nat'l Bancard Corp. (NaBanco) v. VISA U.S.A., Inc.*, 596 F. Supp. 1231, 1238 (S.D. Fla. 1984). Some commentators argue that the interchange fee is a function of credit card networks' need to allocate costs between merchants and consumers in order to maximize the size and value of the network and that it is necessary for a credit card system with multiple issuers and acquirers “to operate effectively in the presence of an ‘honor-all-cards’ rule.” Benjamin Klein et al., *Competition in Two-Sided Markets: The Antitrust Economics of Payment Card*

been to cover the costs of issuing cards, fraud, and funds during the float period.²³ Alternatively, it might have been a way to allow issuers to evade usury laws.²⁴ Regardless, the interchange fee is not a clearing fee. Whatever its original purpose, 44 percent of the interchange fee now goes to fund rewards programs,²⁵ and interchange fee rates are not set based on the networks' costs. Instead they are set based on the value provided to merchants—that is, whatever price the network thinks the market will bear.

Networks set their interchange rates annually or semiannually. For pre-IPO Visa and MasterCard, this meant that the member banks, through their representatives on the association's board, set a rate schedule for all transactions between all member banks. Post-IPO, the rate is now set by a board comprised of a majority of independent, publicly elected directors. For third-party-issued American Express and Discover cards there is no universal interchange fee schedule. Instead, these networks contract with individual third-party issuers regarding the per transaction fee the third-party issuer will receive. For self-issued American Express and Discover cards, there is only a merchant discount fee; there is no interchange rate because the same party serves as both issuer and acquirer.

Interchange Fees, 73 ANTITRUST L.J. 571, 574 (2006); see also *Hearing on Credit Card Interchange Fees*, *Hearing before the H. Comm. on the Judiciary Antitrust Task Force*, 110th Cong. 11 (July 19, 2007) (statement of Timothy J. Muris, Professor, George Mason University School of Law); DAVID S. EVANS & RICHARD L. SCHMALENSEE, *PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING* 153 (2d ed., 2005).

There are several problems with this argument. First, the interchange fee is a clumsy tool for price allocation between merchants and cardholders because it is not charged directly to merchants. Both Visa and MasterCard permit acquirers to establish their own merchant discount fee. Thus, it is theoretically possible for an acquirer to have a merchant discount fee less than the interchange rate, and many acquirers offer blend flat rates for smaller businesses. While interchange is a major component of the merchant discount fee, it is not a sophisticated tool for balancing consumer demands and places MasterCard and Visa at a disadvantage vis-à-vis American Express and Discover in that regard. At best, then, the network effects argument explains the necessity of a merchant discount fee.

Second, the network effects argument fails to explain the absence of standardized interchange fees during the initial years of the MasterCard's and Visa's networks. See Timothy J. Muris, *Payment Card Regulation and the (Mis)application of the Economics of Two-Sided Markets*, 2005 COLUM. BUS. L. REV. 515, 531 (2005). Third, the network effects argument cannot explain why issuers account for the costs of rewards programs in their publicly filed financials as reductions in interchange income. *E.g.*, Capital One Fin. Corp., Annual Report (Form 10-K), at 32, 79 (Mar. 2, 2006); MBNA Corp., Annual Report (Ex-13), at 42 (Mar. 15, 2005). Whatever underlying theoretical basis now might be concocted in defense of the interchange fee, the credit card issuers themselves see it as a method of funding rewards programs (and other costs), as well as an independent profit center.

23. AMY DAWSON & CARL HUGENER, *A NEW BUSINESS MODEL FOR CARD PAYMENTS* 9 (Oct. 19, 2006); see also EVANS & SCHMALENSEE, *supra* note 22, at 154, for a discussion of the first formal methodology of setting the interchange fee.

24. See *infra* text accompanying notes 180–186.

25. DAWSON & HUGENER, *supra* note 23.

Interchange rates are classified by the merchant's line of business, sales volume, and the level of bundled rewards on the consumer's card. Interchange rates typically include both a flat fee of 5 cents to 25 cents and a fee of 1 to 3 percent of the total transaction amount (including taxes and tips). The average Visa interchange rate percentage fee in the U.S. was 1.77 percent as of April 2007,²⁶ with a range from 1.15 to 2.7 percent.²⁷ In April 2008, the top MasterCard interchange percentage fee rose to 3.25 percent for certain MasterCard World Elite transactions.²⁸

Because the interchange fee is an arrangement between the acquirer and the issuer, merchants cannot negotiate the interchange rate or the network rules, discussed in the following section, that insulate the interchange rate from market discipline. They can only negotiate on the merchant discount fee.²⁹

The interchange fee sets the floor for the merchant discount fee.³⁰ The merchant discount fee is always the interchange fee plus an additional percentage taken by the acquirer bank. Many acquirers explicitly price their services as interchange plus a particular percentage fee.³¹ The merchant discount fee will vary above and beyond the interchange fee based on the merchant's risk profile and the acquirers' profit component.³² Thus, merchant discount fees are low in stable, high-volume, but low-margin industries like groceries, but extremely high for fraud-prone businesses like low-volume, adult Internet sites.

The acquiring market is extremely concentrated,³³ but very competitive on price.³⁴ It is a low-margin, high-volume business, and acquirers have high turnover rates in their portfolios.³⁵ Acquirers have little leeway in which to

26. Press Release, Visa USA, Visa USA Updates Interchange Rates (Apr. 12, 2007), <http://corporate.visa.com/md/nf/press695.jsp>.

27. Visa U.S.A. Interchange Reimbursement Fees (Rates Effective Apr. 2007) (on file with author).

28. MasterCard, MasterCard US and Interregional Interchange Rate Programs, April 2008, at 44, available at <http://www.mastercard.com/us/wce/PDF/MasterCard%20Interchange%20Rates%20and%20Criteria%20-%20April%202008.pdf>.

29. Some very large merchants are able to negotiate their own interchange fee categories or rebates on interchange from the networks.

30. EVANS & SCHMALENSEE, *supra* note 8, at 199.

31. See, e.g., North American Credit Card Association, Our Rates, <http://www.naccadirect.com/nacca/rates.aspx?id=2> (last visited Mar. 24, 2008).

32. DeGennaro, *supra* note 14, at 37. Major factors detailed in a merchant's risk profile are its past volume of transactions, fraud rate, chargeback rate, and industry. *What's at Stake in the Interchange Wars*, GREEN SHEET, Nov. 28, 2005, at 70; *New Interchange Rate Highlights*, GREEN SHEET, Mar. 27, 2006, at 56.

33. See Levitin, *supra* note 13, at 470–71.

34. See Howard H. Chang, *Payment Card Industry Primer*, 2 PAYMENT CARD ECON. REV. 29, 45–46 (2004).

35. See *id.*

set their prices, because the interchange rate floor is the major component of their costs. There is increasingly little room for variation in the merchant discount fee based on the individual merchant's profile because the spread acquirers charge has declined sharply in the last decade.³⁶ Therefore, merchant discount fees are largely a function of the card associations' interchange rates, and the interchange fee accounts for the vast majority of the fees merchants pay to accept credit card transactions.

Even though interchange is technically a fee paid by acquirers to issuers, the economic reality, and indeed the pricing structure, of interchange fees belies this formality and shows interchange to really be a pass-thru fee imposed on merchants. Interchange fees are scheduled according to merchants' business profiles. If interchange were really only a fee paid by acquirers to issuers, merchants' business profiles would be irrelevant, only the acquirers' own risk profiles should matter for pricing. Moreover, some interchange categories are clearly designed to cover only one or two large merchants. For example, MasterCard has an interchange fee category that is limited to warehouse clubs doing over \$4 billion in MasterCard credit transactions per year.³⁷ There are only two merchants that might fit this category—Sam's Club and BJ's Wholesale Club. The only other U.S. merchant that might have over \$4 billion in MasterCard transactions is Costco, but Costco doesn't accept MasterCard, only American Express. Given that some interchange fee categories are specifically crafted to cover only one or two merchants, the economic reality of interchange is that it is a pass-thru fee imposed by issuers on merchants, not on acquirers.

C. Merchant Restraints

Merchants who accept payment cards agree in their contracts with their acquirer banks to be bound by the card networks' rules, although until very recently the rules are available to merchants only in abridged form, if at all.³⁸

36. EVANS & SCHMALENSEE, *supra* note 22, at 261–63.

37. MasterCard, *supra* note 28, at 20.

38. See *Credit Card Interchange Fees: Antitrust Concerns? Hearing Before the S. Comm. on the Judiciary*, 109th Cong. 118–20 (2006) (statement of Bill Douglass, CEO, Douglass Distributing). An abbreviated version of MasterCard's rules are available online. In response to merchant criticism, Visa has made an abbreviated version of its merchant rules available to large merchants who sign a nondisclosure agreement. *Visa to Disclose Regs, With Strings Attached*, GREEN SHEET, Aug. 14, 2006, at 57. On May 15, 2008, the date of the first House Judiciary Committee hearing on the Credit Card Fair Fee Act, which proposes to regulate interchange fees and merchant restraints, see *infra* note 291, Visa finally made its operating regulations available online, at Visa Rules, <http://corporate.visa.com/pd/rules/main.jsp> (last visited May 15, 2008).

The networks employ a number of rules (referred to here collectively for convenience as merchant restraints) to increase card usage at the expense of other payment systems and to limit price competition within the credit card industry in order to maintain higher interchange rates. Each network has its own set of rules, but all are substantially similar.³⁹

Merchant restraints can be classified into two broad categories of interconnected rules. The first category consists of rules that restrict the way in which merchants can price credit cards. There are three rules in this category: no-surcharge rules, no-differentiation rules (also known as the all-products rule), and no-discrimination rules.⁴⁰ No-surcharge rules forbid merchants to impose a surcharge for the use of credit (or debit) cards, thus linking the price consumers are charged for using credit cards with the price charged for using other payment systems. In effect, this means that consumers almost never see an explicit price for using a particular payment system. Instead, the price of payment is bundled in with that of the goods or services being purchased.

Whereas no-surcharge rules link credit card prices with other payment systems' prices, no-differentiation rules link the prices of different types of credit cards within a brand. No-differentiation rules prohibit merchants from charging different prices for particular types of cards within a brand, even though costs to merchants vary significantly within brands.⁴¹ Consumers pay the same price to transact with all types of MasterCard, Visa cards, American Express cards, and Discover cards. Likewise, transactions on rewards cards and corporate cards do not cost cardholders more than transactions on regular consumer cards, even though the use of these cards can cost merchants twice as much.

As a catchall, merchants are forbidden from discriminating against the card association's cards in any way.⁴² Thus, merchants may not discourage the use of brands' cards through nonpricing methods. No-surcharge rules, no-differentiation rules, and no-discrimination rules prevent merchants from passing on the marginal cost of a consumer's choice of payment system to that

39. None of the rules have official names and the terminology used to reference particular rules is not standardized.

40. Originally, there was an additional merchant restraint on pricing, the no-discount rule, which prohibited merchants from offering discounts for non-credit-card payments. See *infra* Part III.B.2.

41. See MASTERCARD INT'L, MERCHANT RULES MANUAL 2-4 (2006), available at http://www.mastercard.com/us/wce/PDF/MERC_Entire_Manual.pdf. No-surcharge rules are sometimes also referred to as no-discrimination rules.

42. See *id.* at 2-15, 2-22; DISCOVER NETWORK, DISCOVER NETWORK MERCHANT OPERATING REGULATIONS 4 (2004) (on file with the author).

consumer.⁴³ Thus, consumers are not forced to internalize the full costs of their choice of payment system. Instead, at the point of sale, all payment systems, as well as all card brands and all card types within card brands, have the same costs to consumers. Therefore, consumers choose among payment systems without factoring in point-of-sale costs.

The second category of merchant restraints consists of rules that restrict merchants' ability to selectively accept particular credit cards or to selectively accept credit cards for particular transactions. These rules are the honor-all-cards rule (also known as the all-banks or all-issuers rule), the all-outlets rule, and the no-minimum- and no-maximum-amount rule. The honor-all-cards rule requires merchants to accept all credit cards bearing the card association's brand,⁴⁴ while the all-outlets rule requires merchants to accept cards at

43. MASTERCARD INT'L, *supra* note 41, at 2-22 ("A merchant must not directly or indirectly require any MasterCard cardholder to pay a surcharge or any part of any merchant discount or any contemporaneous finance charge in connection with a MasterCard card transaction. A merchant may provide a discount to its customers for cash payments. A merchant is permitted to charge a fee (such as a bona fide commission, postage, expedited service or convenience fees, and the like) if the fee is imposed on all like transactions regardless of the form of payment used. A surcharge is any fee charged in connection with a MasterCard transaction that is not charged if another payment method is used."); *id.* at 6-16 ("Unless permitted by local laws or regulations, Acquirers must ensure that their Merchants do not require Cardholders to pay a surcharge or any part of any Merchant discount, or any contemporaneous finance charge in connection with a Transaction. A Merchant may provide a discount fee to its customers for cash payments."); VISA, RULES OF VISA MERCHANTS 10 (2007), available at http://usa.visa.com/download/merchants/rules_for_visa_merchants.pdf; Visa, Operating Regulation 5.2.F (May 15, 2008) [hereinafter Visa Operating Reg.], available at <http://corporate.visa.com/pd/rules/pdf/visa-usa-operating-regulations1.pdf> (forbidding surcharges); *id.* at 5.2.D (requiring that any discount given to cardholders of other brands be given to Visa cardholders).

American Express has a piggy-back no-surcharge rule that requires that its card be treated like a MasterCard or Visa. The absence of an explicit no-surcharge rule appears to stem from a legal settlement. See *infra* text accompanying notes 197-198. AMERICAN EXPRESS, TERMS AND CONDITIONS FOR AMERICAN EXPRESS CARD ACCEPTANCE § 1 (2001) ("You will honour the Card, and will not attempt to . . . persuade the Cardmember to use any other credit, charge, debit or smart card, account access device or service or impose any restrictions or conditions on the use or acceptance of the Card that are not imposed equally on the use or acceptance of other cards.").

See also DISCOVER NETWORK, *supra* note 42, at 4 ("Unless otherwise agreed upon by us in writing, you may not impose any surcharge, levy or fee of any kind for any transaction where a Cardmember desires to use a Card for any purchase of goods or services.").

Discover has agreed to drop its no-surcharge rule as part of a settlement in merchant-initiated lawsuits. *Interchange/Surcharge Litigation Update*, NILSON REP., Feb. 2006, at 6. It appears, though, that Discover has dropped its no-surcharge rule in name only, as it has agreed to allow merchants to surcharge, only if they surcharge for other brands of cards. *Id.* Thus, Discover has only changed its no-surcharge rule from a direct one to one like American Express that piggy-backs on those of MasterCard and Visa. Regardless, because Discover cards are the least expensive for merchants to accept, merchants are unlikely to surcharge for Discover, as doing so would push transactions to more expensive brands.

44. MASTERCARD INT'L, *supra* note 41, at 2-21; Visa Operating Reg., *supra* note 43, at 5.2.B.3. MasterCard and Visa originally applied the honor-all-cards rule to both their credit and

all their locations, regardless of different business models (for example, Internet store, main-line retail, and discount outlet).⁴⁵

The no-minimum- and no-maximum-amount rule forbids merchants from imposing either a minimum or maximum charge amount,⁴⁶ although this rule is widely flouted. The no-minimum-and no-maximum-amount rule prevents merchants from steering transactions on which card payments are particularly costly to noncard payment systems. Small transactions are less profitable for merchants when paid on a bank payment card because the flat fee part of the interchange fee schedule. On a small transaction, the flat fee amount can consume a significant amount of a merchant's profit margin.

For large transactions, merchants are less keen on surrendering a percentage cut to the banks. A merchant receives the same essential service of fund transmission from its acquirer on a \$50 credit card payment as on a \$5,000 credit card payment, but a merchant will pay the acquirer 100 times as much for the \$5,000 transaction. In contrast, cash, checks, automated clearing house (ACH) transactions,⁴⁷ and most PIN-debit transactions, cost a flat amount to accept.⁴⁸ Thus, a merchant will pay approximately 5 cents to accept either a \$50 or a \$5,000 ACH transaction or 45 cents to accept either a \$50 or a \$5,000 PIN-debit transaction. For payment systems other than credit cards (and offline debit cards that use credit card ACS networks), the marginal cost increase based on the size of transactions is minimal.

Honor-all-cards, all-outlets, and no-minimum- and no-maximum-amount rules prevent merchants from picking and choosing what sort of cards they will accept within a card brand and for which transactions they

debit products. Thus, a merchant who accepted MasterCard or Visa credit cards would also have to accept MasterCard or Visa debit cards. In the United States, MasterCard and Visa now apply the honor-all-cards rule to credit cards and debit cards separately as the result of a settlement with Wal-Mart, Sears, and other retailers in 2003. *In re Visa Check/Mastermoney Antitrust Litig.*, 297 F. Supp. 2d 503 (E.D.N.Y. 2003), *settlement aff'd sub nom. Wal-Mart Stores, Inc. v. Visa U.S.A. Inc.*, 396 F.3d 96 (2d Cir. 2005); *MASTERCARD INT'L*, *supra* note 41, at 2-33. Now a merchant may choose to honor all credit cards of the brand, all debit cards of the brand, or both. *Id.* at 2-34.

Connecticut also has enacted the honor-all-cards rule in its state code. CONN. GEN. STAT. ANN. § 42-133ff(b) (West 2007).

45. See *MASTERCARD INT'L*, *supra* note 41, at 2-15; *DISCOVER NETWORK*, *supra* note 42, at 28.

46. *MASTERCARD INT'L*, *supra* note 41, at 2-22; *VISA*, *supra* note 43, at 10; *Visa Operating Reg.*, *supra* note 43, at 5.2.F; *DISCOVER NETWORK*, *supra* note 42, at 4.

47. Automated Clearing House (ACH) transactions electronically debit or credit particular deposit accounts.

48. See Terri Bradford, *Payment Types at the Point of Sale: Merchant Considerations*, PAYMENT SYSTEMS RESEARCH BRIEFING, FED. RES. BANK OF KAN. CITY, Dec. 2004, at 2. PIN-debit transaction fees are not a flat rate, but they are capped, depending on network, at between 45 cents and 65 cents, which makes them flat rate for most transactions over \$20. See *id.*

will accept credit cards. Card acceptance is an all-or-none proposition within a brand, even though the costs to merchants of card acceptance vary enormously among cards within a brand and by transaction size.

The net effects of the card associations' rules are: (1) to force merchants to charge the same price for goods or services, regardless of a consumer's payment method; (2) to prevent merchants from steering consumers to cheaper payment options; and (3) to increase the number of credit card transactions, which as a result increases the interchange fees and ultimately interest income for issuers.⁴⁹

Merchant restraints also prevent consumers from accounting for the cost of payment systems when deciding which one to use. Instead, consumers decide based solely on factors such as convenience, bundled rewards, image, and float. These factors tend to favor credit card transactions over other payment systems. Higher purchase volume increases issuers' income on the front-end in terms of interchange fees and on the back-end in terms of more interest, late fees, and penalties.

D. Importance of Interchange Revenue for Card Networks

Income from interchange fees (or merchant discount for self-acquiring American Express and Discover) are the economic engine of credit card networks. Historically, it accounts for nearly one-half of American Express's revenue.⁵⁰ For MasterCard, Visa, and Discover issuers, interchange accounts for about one-fifth of revenue,⁵¹ but it is still the key to the entire enterprise because interchange combines with the card networks' merchant restraint rules to increase the number and volume of card transactions, thus increasing not only interchange revenue, but also interest revenue and late fees.

Interchange income has become increasingly important to the card industry in recent years. Because of low interest rates on home lending, consumers shifted their borrowing from credit cards to home equity loans and lines of credit and borrowed against their home equity to pay off credit card

49. Even if these merchant restraint rules did not exist, card design currently blurs the distinction between more and less expensive cards, making it difficult for merchants to screen out pricier cards before entering a transaction.

50. Am. Express Co., Annual Report (Form 10-K), at 70 (2006).

51. Jeffrey Green, *Bank Card Profitability 2007*, CARDS & PAYMENTS, May 2007, at 27; DISCOVER BANK, CONSOLIDATED FINANCIAL STATEMENT FOR THE YEARS ENDED NOVEMBER 30, 2006 AND 2005, at 6 (2006).

balances.⁵² Although consumers use credit cards with ever-greater frequency, the ratio of balances outstanding to purchase volume (the turn rate) has decreased dramatically over the last decade. In 1996, there were roughly two dollars in purchases for every dollar of balance outstanding and producing interest income. By 2006, the purchase-to-outstanding ratio had become closer to three to one (Chart 2).⁵³ Accordingly, the income of credit card issuers is coming increasingly from interchange fee and less from interest income. From 1999 to 2006, MasterCard and Visa issuers' interchange revenue increased 116 percent, from 14 percent of revenue to 20 percent (Chart 3).⁵⁴

52. Kenneth A. Posner, Morgan Stanley, Keynote Address at the FMI 2006 Retail Electronic Payments Conference: Clash of Titans: Retailers, Card Issuers, and Interchange (Feb. 1, 2006), at 15 (slides available at http://www.fmi.org/elect_pay_sys/2006conference/Posner.pdf).

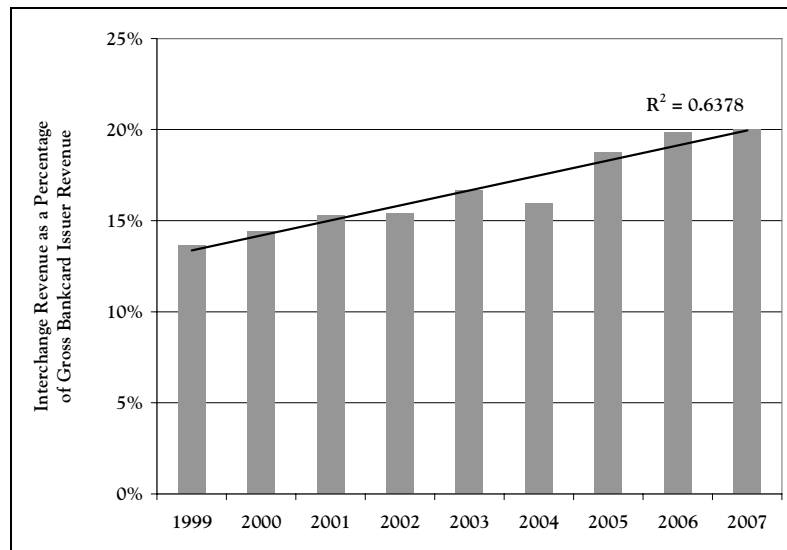
53. CardData, Bank Credit Card Annual Charge Volume, http://www.cardweb.com/carddata/charts-gold/annual_credit_charge_volume.asp (last visited Apr. 18, 2008); CardData, U.S. End-of-Year Outstandings by Brand-Current & Historical, <http://www.cardweb.com/carddata/charts-gold/receivables.html> (last visited April 18, 2008).

54. Green, *supra* note 51, at 28; Jeffrey Green, *Bank Card Profitability 2008*, CARDS & PAYMENTS, May 2008, at 37; Jeffrey Green, *Bank Card Profitability 2006*, CARDS & PAYMENTS, May 2006, at 32; Burney Simpson, *Bank Card Profitability 2005*, CARDS & PAYMENTS, May 2005, at 28.

CHART 2: MASTERCARD AND VISA CREDIT CARD TURN RATES (1989–2006)⁵⁵



CHART 3: RATIO OF BANKCARD ISSUER'S INTERCHANGE REVENUE TO GROSS REVENUE (1999–2006)⁵⁶



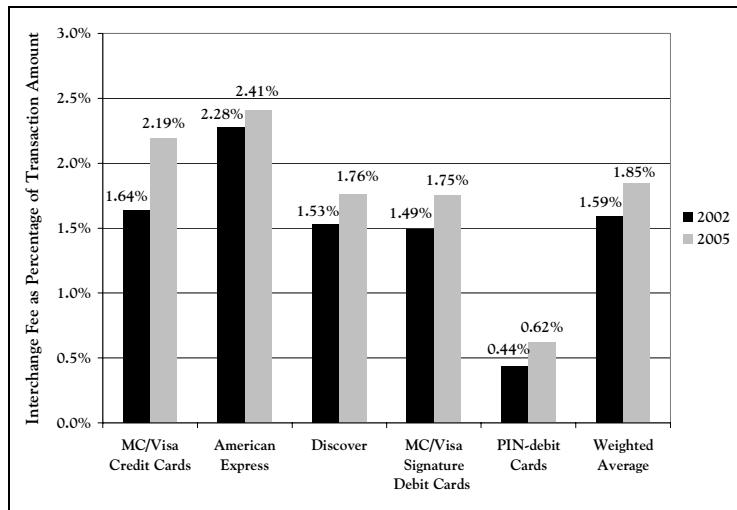
55. See sources cited *supra* note 54.

56. See sources cited *supra* note 54.

Slowed growth in interest income has placed pressure on card issuers to increase their interchange income. Card issuers have responded by issuing more higher interchange rate cards.

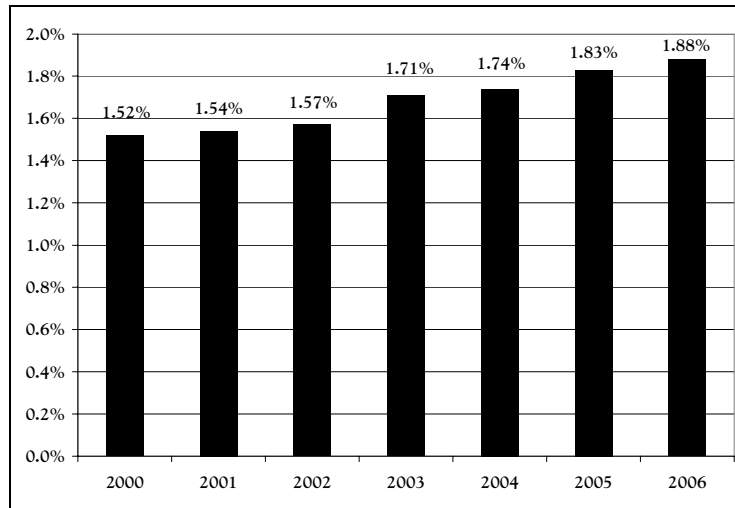
Similarly, competition between networks for issuers has also pushed up interchange rates. In 2003, the United States Court of Appeals for the Second Circuit ruled that MasterCard and Visa could not prevent their member banks from issuing American Express cards too.⁵⁷ The end of this so-called dual exclusivity permitted American Express and Discover to compete with MasterCard and Visa for issuers. American Express offers third-party issuers individually negotiated per transaction fee structures that are often higher than the interchange rates offered by MasterCard and Visa. MasterCard and Visa have had to raise their interchange rates to compete with American Express for issuers, creating a race to the top in credit card pricing, the direct costs of which are borne by merchants (Charts 4 and 5).

CHART 4: COMPARISON OF AVERAGE INTERCHANGE RATES IN 2002 AND 2005⁵⁸



57. United States v. Visa U.S.A., Inc., 2001 U.S. Dist. LEXIS 20222 (S.D.N.Y. Nov. 26, 2001), *aff'd* 344 F.3d 229 (2d Cir. 2003), *cert. denied sub nom.* Visa U.S.A., Inc. v. United States 543 U.S. 811 (2004).

58. *Merchant Discount Fees*, NILSON REP., Aug. 2006, at 11; *U.S. Interchange Fees*, NILSON REP., May 2003, at 10.

CHART 5: WEIGHTED AVERAGE MERCHANT DISCOUNT RATES, 2000–2006⁵⁹

II. THE EFFECTS OF MERCHANT RESTRAINTS

A. Benefits and Costs of Credit Cards

Merchants decide whether or not to accept credit cards as a general proposition based on their own idiosyncratic cost-benefit analysis (or at least an analysis of perceived costs and benefits). Merchant discount fees (and thus interchange fees) constitute the cost of accepting credit cards. There are many potential benefits to merchants from accepting credit cards that are unmatched by other payment systems. Credit cards, unlike other payment systems, enable consumers to spend beyond both their cash on hand and the funds in their bank accounts. Thus, merchants who accept credit cards often see their average purchase amount increase.⁶⁰ Credit cards (and all electronic payment systems) facilitate bookkeeping and currency conversion and decrease the merchants' theft and credit risks. They also often improve checkout speed.

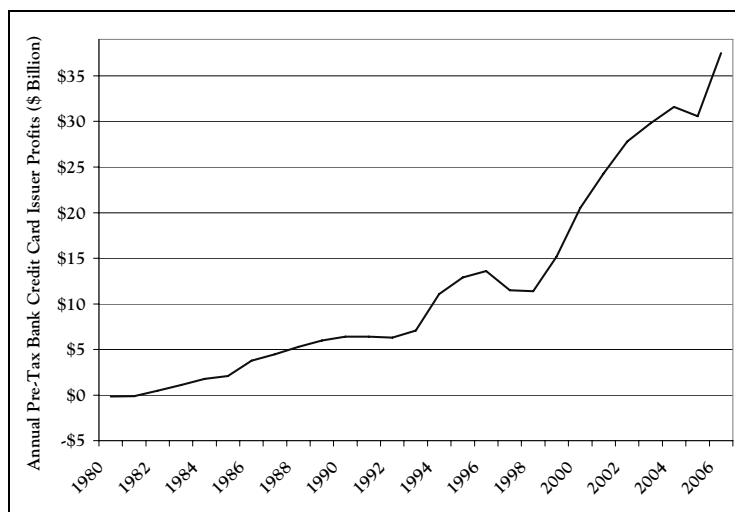
These benefits explain why credit cards should generally cost merchants more to accept than other payment systems. They do not, however, explain why merchants should pay even more for certain types of credit cards, such as rewards or corporate cards. Nor do they explain why merchants'

59. *Merchant Processing Fees*, *supra* note 4.

60. Levitin, *supra* note 13, at 483.

costs of accepting credit cards—principally a function of the interchange fee—have steadily increased. Interchange rates are a percentage of transaction value (excluding a small flat fee), not an absolute value cost, so they should be immune to inflation and changes in transaction volume. Moreover, many costs of credit card issuers, such as fraud, have declined,⁶¹ and card issuer profits have soared (Chart 6).⁶²

CHART 6: CREDIT CARD ISSUER ANNUAL PRE-TAX PROFITS
(1980–2006)⁶³



As interchange rates have risen, so too has the percentage of cards in force that carry higher-end interchange rates. Different types of cards of the same brand have different costs to merchants because they are in different interchange tiers based on rewards points and because a significant percentage of interchange fees goes to fund increasingly generous rewards programs.⁶⁴ The higher the level of rewards points on a card, the more expensive the card is for merchants to accept.

61. CardData, U.S. Fraud Losses/Gross Volume Monthly Averages—Historical, http://www.cardweb.com/carddata/charts-gold/fraudlosses_volume.amp (last visited Apr. 17, 2008); CardData, U.S. Fraud Losses/Gross Outstandings Monthly Averages—Historical, http://www.cardweb.com/carddata/charts-gold/fraudlosses_receivables.amp (last visited Apr. 17, 2008).

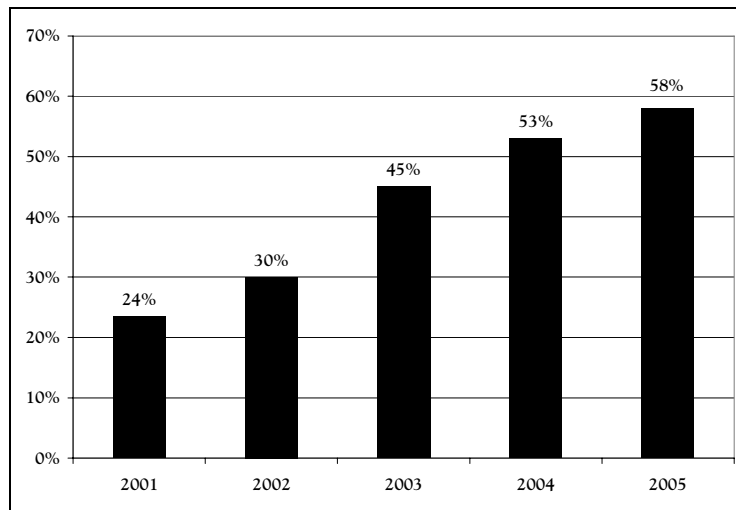
62. CardData, Bank Credit Card Annual Pre-Tax Profits, http://www.cardweb.com/carddata/charts-gold/annual_credit_pre-tax_profits.amp (last visited Apr. 17, 2008).

63. *Id.*

64. Dawson & Hugener, *supra* note 23, at 9.

Rewards cards have risen from less than 25 percent of new card offers in 2001 to nearly 60 percent in 2005 (Chart 7).⁶⁵ Two-thirds of all cardholders now have a rewards card, up from half in 2002.⁶⁶ More and more transactions are now charged by consumers to costlier cards.

CHART 7: REWARDS CARDS AS PERCENTAGE OF NEW CREDIT CARDS OFFERED (2001–2005)⁶⁷



Rewards cards also make up a disproportionate amount of credit card spending. Eighty percent of credit card transactions in 2005 were made on rewards cards (Chart 8).⁶⁸ Indeed, some card issuers account for the cost of rewards programs in their financials as reductions in interchange income.⁶⁹ Because rewards programs are a major component of interchange costs, as rewards programs have grown, so too have interchange fees and hence merchant discount fees.

65. Binyamin Appelbaum, *Gimmicks Galore in Glut of Credit Cards: Rewards Designed to Woo Fickle Customers*, CHARLOTTE OBSERVER, June 4, 2006, at 10; CardTrak.com, Card Debt (April, 2004), <http://www.cardweb.com/cardtrak/pastissues/april2004.html> (last visited Jan. 27, 2008).

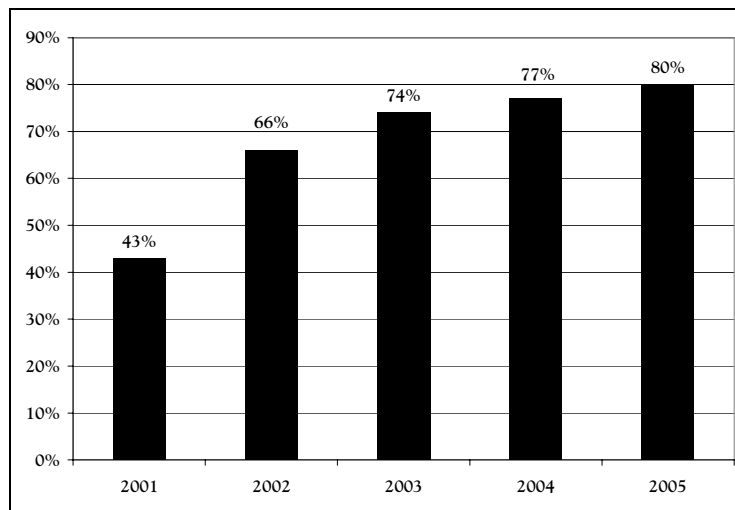
66. Damon Darlin, *Gift Horses To Consider: Credit Cards That Reward*, N.Y. TIMES, Dec. 31, 2005, at C1.

67. Appelbaum, *supra* note 65; CardTrak.com, *supra* note 65.

68. H. Michael Jalili, *Rewarding Volume*, AM. BANKER, Dec. 14, 2006, at 11.

69. E.g., Capital One Fin. Corp., Annual Report (Form 10-K), at 32, 79 (Mar. 2, 2006); MBNA Corp., Annual Report (Ex-13), at 42 (Mar. 15, 2005).

CHART 8: PERCENTAGE OF CREDIT CARD TRANSACTIONS ON REWARDS CARDS
(2001–2005)⁷⁰



The weighted average merchant discount rate for all payment cards increased 23 percent from 2000 to 2006 (Chart 4).⁷¹ Merchants' absolute cost of accepting payment cards has increased by 139 percent over the same time period, however.⁷² This is because the absolute number and percentage of transactions made on credit cards has increased along with the percentage of those transactions made on rewards cards and on premium rewards cards with increasingly generous rewards programs. Credit cards are also starting to penetrate areas of the economy previously dominated by checks and cash: micropayments (such as, fast food and vending machines), health care, rent, tax, insurance, and utility bills.

B. Merchants' Dilemma: The Rewards Card Externality

For many merchants, credit card acceptance has become the fastest growing cost of doing business.⁷³ This has placed increased financial pressure on merchants because of their restricted ability to use pricing to influence consumers' choice of payment system. The general increase in interchange rates,

70. Jalili, *supra* note 68.

71. *Merchant Processing Fees*, *supra* note 4.

72. *Id.*

73. *Financial Services Issues: A Consumer's Perspective*, Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Institutions, 108th Cong. 115 (2004) (statement of John J. Motley III, Sr. Vice President, Food Marketing Institute).

as well as issuers' shift to higher interchange cards, be they rewards and corporate cards or American Express cards, has exacerbated the rising cost of accepting card payments for merchants.

Rewards cards are driving the increase in credit card usage. When credit cards first became widely available a quarter century ago, they provided merchants a significant boon by enabling greater spending by masses of credit-constrained consumers. Now, however, growth in credit card usage is fueled by affluent, non-credit-constrained consumers, seeking rewards points and frequent flier miles, rather than by credit-constrained consumers, seeking the benefits of paying later for goods and services received now.⁷⁴ As Steve Mott observed in 2005, “[c]onsumer use of credit cards for [borrowing] has been flat for a decade, while spending continues to rise.”⁷⁵

Growth in rewards card use is fueled by increased marketing of rewards cards (Chart 7) and by consumer demand for the rewards programs. As Brian Gantert, first vice president of marketing at Chase Card Services, has remarked, “We have found that rewards are obviously a key determinant in customers’ use of the credit cards, so the behavior of the customers that have rewards is that they tend to spend more and use the card more frequently.”⁷⁶ Rewards drive the growth in rewards cards and all credit card usage.

74. See Posner, *supra* note 52, at 5–6; see also Brian Johnston & Greg Kelly, *Reinvigorating Customer Rewards Programs*, AM. BANKER, June 2007, at 2 (noting that in 2004, “more than 60% of affluent customers reported using reward cards as their primary credit cards”).

75. Steve Mott, *The Challenge of Bank Card Interchange* (Dec. 2005), at 18, http://www.betterbuydesign.com/articles/The_Challenge_of_Interchange—Mott-Dec-2005.ppt.

76. H. Michael Jalili, *New Approaches Advised to Cure ‘Rewards Fatigue,’* AM. BANKER, May 21, 2007, at 8. Growth in rewards card use does not appear to be driven by other features of rewards cards, such as interest rates and credit limits. *Id.* Interest rates (APRs) do not correlate with reward levels. Gold cards have higher APRs than standard cards, which have, in turn, higher APRs than Platinum cards, and there is currently less than a 1 percent spread in APRs among all card types. CardData, U.S. Gold Card Weighted, Monthly Pricing Averages—Historical, http://www.cardweb.com/carddata/charts_gold/gold_weighted_price.amp (last visited Sept. 28, 2007); CardData, U.S. Platinum Card Weighted, Monthly Pricing Averages—Historical, http://www.cardweb.com/carddata/charts_gold/platinum_weighted_price.amp (last visited Sept. 28, 2007). Therefore, consumers are not purchasing more on rewards cards due to lower interest rates.

It is possible that rewards cards have higher credit limits than regular cards, but the higher credit limits are unlikely to correlate with greater creditworthiness of rewards card holders, simply because almost anyone who wants a rewards card can get one. If there are higher credit limits for rewards cards, it is solely as an impetus for encouraging greater consumer spending and could just as easily be applied to regular cards.

The most likely explanation for the disproportionate purchase volume on rewards cards is that rewards cards tend to be held by more-affluent consumers than regular cards. This might be the result of targeted card issuer marketing. See, e.g., Burney Simpson, *Merchants Tackle Credit Card Fee Policies*, CARDS & PAYMENTS, Jan. 2006, at 32 (noting that “Visa and MasterCard have added richer rewards for cards targeting the valued high-earning household demographic”). Nevertheless, it is also because more affluent consumers tend to be more financially sophisticated and realize that all things being equal, a rewards card is a better deal for them economically than a

If increased rewards card usage led to more and larger purchases for merchants, it would be reasonable for rewards cards to cost merchants more to accept. It appears, however, that rather than inducing consumers to make more and larger purchases, rewards merely induce consumers to shift their consumption from non-credit-card payment systems and nonrewards credit cards to rewards cards.⁷⁷ In other words, rewards induce consumers to shift from low-cost to high-cost payment systems.

Rewards credit card-holding consumers use credit cards more often and more exclusively than those without rewards credit cards.⁷⁸ But if a consumer also has a rewards debit card (which have less generous rewards programs than credit cards), he or she will use the rewards debit card more often than consumers who only have rewards credit cards.⁷⁹ This phenomenon suggests that while rewards are generating increased card usage, they are not generating many additional or larger transactions.⁸⁰ Indeed, the low level of rewards (typically in the range of 1 percent of purchase value, but capped at \$300 annually) creates only a limited rational incentive for increased purchasing. Rather than generating new transactions, rewards cards are simply shifting transactions to more expensive payment systems for merchants.

nonrewards card. Thus, the higher purchase volume on rewards cards seems to be largely a reflection of the relatively greater purchasing power of rewards card consumers over regular card consumers rather than other features of the cards).

77. See Andrew Ching & Fumiko Hayashi, *Payment Card Rewards Programs and Consumer Payment Choice 4* (Fed. Reserve Bank of Kansas City, Working Paper No. 06-02, 2006), available at http://www.kansascityfed.org/PUBLICAT/PSR/RWP/Ching_Hayashi_Paper.pdf.

78. *Id.*

79. *Id.*

80. Perhaps the most vivid illustration of the problem comes from merchant categories other than retailers. Insurance companies, utilities, landlords, and educational institutions have begun to accept credit cards in recent years. To wit, if I only have \$80 in my wallet, I will be careful not to purchase more than \$80 of goods at the grocery store. But if I have a card with a \$5000 credit limit, I am less likely to be so careful about the particular amount I purchase at the grocery store. I might well spend \$84 or \$90 because I am not liquidity constrained. A similar story might emerge if I go out to a restaurant.

But unlike groceries or a restaurant meal or gas or clothes, a consumer cannot purchase more tuition or more rent because of a credit card. The decision of whether to take out a particular insurance policy for a certain coverage level, to attend a university, or to rent a particular apartment is almost assuredly made *before* the consumer ever knows what payment options are available. And even if the consumer knew of the payment options in advance, how many people are going to purchase additional auto insurance coverage (which is typically done in large dollar increments) because they can get some more frequent flier miles? Likewise, how many consumers decide to leave the lights on longer or run the AC higher or keep the house warmer in winter because they can put the payment on a card? Or decide to attend a particular college based on its acceptance of credit cards for tuition payments? There may be other benefits to these types of merchants from accepting cards, but increased sales is assuredly not one of them, which means rewards cards offer no benefits to these types of merchants.

Rewards programs fuel an expensive cycle of increased card usage funded by merchants who receive no marginal benefit from the rewards cards. Merchants pay the price of accepting rewards credit cards but see no benefit from doing so and can neither opt out of accepting rewards cards nor charge rewards card holders more.⁸¹

Rewards cards also divide into regular, premium, and superpremium rewards rates. These rewards rates are matched by tiered interchange rates.⁸² Average annual purchases are higher on rewards cards than on regular cards⁸³ and increase for each level of rewards. For example, Visa offers Visa Signature Preferred, Visa Signature, and Visa Rewards cards, all of which have different interchange rates from traditional Visa credit cards.⁸⁴ Visa Signature cards, which carry a high level of rewards and are marketed specifically to affluent consumers, comprise only 3.5 percent of all Visa cards but have accounted in recent quarters for 22.2 percent of all Visa purchases.⁸⁵

In April 2007, Visa introduced an additional ultra-premium card, the Visa Signature Preferred card, aimed at wealthy consumers who spend over \$50,000 per year on their cards.⁸⁶ Signature Preferred cards carry interchange rates that are, on average, 14 percent higher than those for regular Visa Signature cards.⁸⁷ The October 2007 interchange rate for Visa Signature Preferred cards at large supermarkets was 2.20 percent plus \$0.10, whereas the rate for the regular Visa Signature card was 1.65 percent plus \$0.10. The rate at large supermarkets for both regular Visa rewards cards and nonrewards cards was 1.15 percent plus \$0.05, almost half of the Signature Preferred card rate.⁸⁸

Assuming the merchant discount rate on these transactions is basically proportional to the interchange rate, what has the merchant gained by paying the marginal cost of a Visa Signature Preferred transaction or Visa Signature card transaction? Unlike accepting credit cards in the first place, the

81. Whereas higher cost brands—which typically began as so-called travel and entertainment cards—like American Express, Diners Club, and Carte Blanche, arguably add value to merchants through advertising establishments that accept American Express, see Gerald P. O'Driscoll, Jr., *The American Express Case: Public Good or Monopoly?*, 19 J.L. & ECON. 163, 166–67 (1976), this value relates to the brand, not to level of rewards within a brand.

82. See, e.g., *Visa 2006 Interchange Rates*, GREEN SHEET, Mar. 27, 2006, at 58.

83. Darlin, *supra* note 66, at C1.

84. *Id.*

85. Elizabeth Olson, *Holding Liev Schriber's Tony Award? Priceless*, N.Y. TIMES, Aug. 13, 2006, at BU7.

86. Robin Sidel, *Moving the Market: New Tier on Visa Card to Lift Fees on Merchants*, WALL ST. J., Mar. 15, 2007, at C3.

87. *Id.*

88. Visa U.S.A. Consumer Credit Interchange Reimbursement Fees, *supra* note 27.

merchant has not enabled a transaction that would not otherwise have occurred because of the consumer's liquidity constraints. Liquidity of credit cards is a function of credit limits, not interchange tiers (which they do not necessarily map). In any case, Signature and Signature Preferred cardholders are affluent, negating most liquidity concerns. Moreover, it is unlikely that the merchant would lose transactions by refusing to accept Signature or Signature Preferred cards (if this were allowed). How many consumers would really refuse to make a transaction if they could only use a regular credit card, not a rewards card? By accepting the traditional credit card, in this scenario a regular Visa card, the merchant already enabled purchases from liquidity-constrained consumers.⁸⁹

There is no marginal benefit to the merchant from accepting premium cards. She has merely funded the affluent Visa Signature and Signature Preferred card consumers' first-class upgrades or cash rebates. Visa Signature and Signature Preferred cardholders pay the same price at point of sale as holders of regular Visa cards or basic rewards cards. But the Signature and Signature Preferred cards rewards programs are much more generous. Whereas the regular rewards card might offer 1 percent cashback, the Signature Preferred card might offer 5 percent cashback and/or fewer cashback restrictions. Thus, the net purchase price for the Signature Preferred cardholder is 4 percent less than for the cardholder with a regular rewards card and 5 percent less than for the cardholder of a plain vanilla nonrewards Visa. Functionally, the affluent Visa Signature Preferred cardholder receives a 4 to 5 percent discount that is unavailable to the regular cardholder.

The problem, then, is that while the costs of credit card acceptance have been rising due to rewards and corporate cards, the benefits to merchants of card acceptance have remained static or declined. Credit card acceptance is, overall, generally in the interest of merchants, so merchants continue to accept credit cards. But the acceptance of particular types of credit cards is not in the interest of merchants. Because of merchant restraint rules, merchants are unable to either opt out of accepting the high-cost rewards and corporate cards or to pass along the marginal cost to those consumers who choose to use rewards or corporate cards.

89. Arguably, the merchant has avoided a purchase made with an even more expensive American Express card, but this just proves the point: The merchant has no marginal gain from accepting the premium bank card, just as it has no marginal gain from accepting the Amex card.

C. Limited Utility of Discounting for Cash to Avoid the Rewards
Card Externality

While merchant restraints generally control merchants' ability to charge different prices for different payment methods (or in economics jargon, to price discriminate), there is an important exception. A 1981 federal law called the Cash Discount Act⁹⁰ gives merchants the right to offer a discount to induce cardholders to pay "by cash, check or similar means."⁹¹

Cash or other discounts are rare, however, and are largely confined to the retail gasoline industry.⁹² Why don't more merchants offer discounts for cash and other less expensive payment systems than credit cards? The answer lies in a variety of factors—psychological, idiosyncratic, and legal—that make cash discounting ineffective. Moreover, cash discounting only permits limited price discrimination among payment systems, but what merchants really want is to be able to price discriminate among credit cards and charge more for higher cost credit cards.

1. Psychological Limitations

There is a well-established body of psychological and economic literature on cognitive biases⁹³—the manner in which the typical human mind will routinely misjudge a situation—and there is a growing body of legal work that incorporates the insights from this literature,⁹⁴ including in the

90. Cash Discount Act, Pub. L. No. 97-25, 95 Stat. 144 (1981), codified at 15 U.S.C. §§ 1602, 1666f(a) (2000).

91. *Id.* § 102. Several states have similar laws as well. See CAL. CIV. CODE § 1748.1(a) (Deering 2005); FLA. STAT. ANN. § 501.0117(1) (West 2006); MD CODE ANN., COM. LAW § 12-509 (LexisNexis 2005). California, Maine, and Washington also duplicate federal provisions banning card companies from restricting cash discounts. See CAL. CIV. CODE § 1748.1(a) (Deering 2005); ME. REV. STAT. ANN. TIT. 9A § 8-30(a) (2007); WASH. CODE REV. § 19.52.130 (West 1999).

92. See Elizabeth Douglass, *Cash Rules at Some Pumps*, L.A. TIMES, Aug. 21, 2007, at C1; see also Adam J. Levitin, *The Antitrust Super Bowl: America's Payment Systems, No-Surcharge Rules, and the Hidden Costs of Credit*, 3 BERKELEY BUS. L.J. 265, 302 (2005).

93. See, e.g., Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCI. 453 (1981); Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. 251 (1986).

94. See, e.g., Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 HARV. L. REV. 1420 (1999); Samuel Issacharoff, *Can There Be a Behavioral Law and Economics?*, 51 VAND. L. REV. 1729 (1998); Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998); Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551 (1998); Jennifer Arlen, Comment, *The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765, 1768–69 (1998).

area of payment systems.⁹⁵ Among the cognitive biases that have been identified is the framing effect, or framing bias. As Jon D. Hanson and Douglas A. Kysar have explained, “the frame within which information is presented can significantly alter one’s perception of that information, especially when one can perceive the information as a gain or a loss.”⁹⁶ The classic example of a framing bias is the glass “half full” or “half empty.” There is the same amount of liquid in glass, but it is perceived differently depending on how it is presented. The difference in perception is crucial because consumers do not have equivalent reactions to gains and loss.

Surcharges and discounts are different frames for presenting the same price information—a price difference between two things. There is no mathematic difference between a surcharge and a discount. A merchant can achieve the same price differentiation either way, simply by altering which of two price points is set as the baseline.

Consumers react differently to surcharges and discounts, however, as the language of pricing frames the information conveyed to the consumer. People have stronger reactions to losses than to gains because of another cognitive bias known as the endowment effect. The endowment effect means that people place greater value on an item that they already possess than on an identical one that they do not.⁹⁷ In the credit card context this means, as Richard Thaler has explained, “consumers would view the cash discount as an opportunity cost of using the credit card, but the surcharge as an out-of-pocket cost.”⁹⁸ Surcharges are perceived as a loss, but discounts are perceived as a gain.

Thus, in a survey of Dutch consumers’ opinions on credit card surcharges and cash discounts, 48 percent of consumers had a negative reaction to surcharges, and an additional 26 percent had a strongly negative reaction.⁹⁹

95. See, e.g., RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS (2006); Bar-Gill, *supra* note 94 (identifying a systemic tendency of consumers to overestimate their ability to repay their credit card bills in full and on time); Adam J. Levitin, *Priceless? The Social Costs of Credit Card Merchant Restraints*, 45 HARV. J. ON LEGIS. 1 (2008); Levitin, *supra* note 92, at 280 (discussing framing biases).

96. Hanson & Kysar, *supra* note 94, at 1441.

97. Russell Korobkin, *The Endowment Effect and Legal Analysis*, 97 NW. U. L. REV. 1227, 1228 (2003).

98. Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 45 (1980). But see Charles Plott & Kathryn Zeiler, *The Willingness to Pay-Willingness to Accept Gap, the “Endowment Effect,” Subject Misconceptions, and Experimental Procedures for Eliciting Valuations*, 95 AM. ECON. REV. 530 (2005).

99. See E. VIS & J. TOOTH, THE ABOLITION OF THE NO-DISCRIMINATION RULE, REPORT FOR EUROPEAN COMMISSION DIRECTORATE GENERAL COMPETITION 12 (2000), available at <http://ec.europa.ec/comm/competition/antitrust/cases/2973/studies/netherlands/report.pdf>.

Only 19 percent had positive reactions to cash discounts, and a mere 3 percent had a strong positive reaction to cash discounts.¹⁰⁰ Attitudes were substantially more negative towards surcharges than towards discounts, in spite of the economic equivalence. Because of the framing effect, surcharges are far more effective than discounts at signaling to consumers the relative costs of a payment system, so it would take a larger noncredit discount to have the same effect on consumer behavior as a smaller credit surcharge.

2. Idiosyncratic Limitations

Although a surcharge has a greater effect on consumer behavior than a discount, cognitive biases do not fully explain the rarity of discounts for cheaper payment systems. Why do merchants so rarely offer discounts to encourage the use of less expensive payment systems?

Many idiosyncratic factors contribute to the rarity of discounts. First, some merchants have unusual costs from accepting certain payment systems. For example, some merchants have particularly high theft risks for cash, and merchants who do not have a steady repeat clientele have a higher hot check risk. Second, many merchants simply do not know they are allowed to discount.¹⁰¹ Third, larger, more sophisticated merchants often have lesser incentives to discount for other payment systems than smaller merchants because they can get lower merchant discount rates and have more options to minimize the costs of credit cards.¹⁰²

Fourth, discounts are less likely to influence consumer behavior for both small and large transactions. For small transactions, the absolute size of the discount is too small for consumers to care, while for large transactions, the discount is offset for consumers by the convenience and safety of credit cards.¹⁰³ In many transactions, discounting may not be worthwhile because it would have a negligible effect on consumer behavior.

Fifth, merchants' ability to discount is limited by the spread between the credit price and the merchandise cost to the merchant. If the merchant offers discounts by more than that spread, the merchant will lose money on the transaction. Merchants might need to increase the credit price to create a sufficient spread to profitably offer a discount that affects consumer behavior.

100. *Id.*

101. See Levitin, *supra* note 95, at 310.

102. See Levitin, *supra* note 13, at 449–51, 458–59.

103. Of course, the issue of transaction size applies to surcharges as well. Credit card rebates escape this logic because they aggregate small transactions and are already the preferred payment method for large transactions.

This poses a dilemma for the merchant. If the merchant raises his baseline (credit) price in order to offer a sufficient noncredit discount to influence consumer behavior, his advertised sticker price—the credit price—will be higher than that of nondiscounting competitors, which is a disadvantage for the discounter, who may lose casual comparison customers.¹⁰⁴

3. Legal Limitations

The most important factor, however, behind the paucity of discounting is that within the legally permitted parameters, discounting is inefficient for many merchants. The federal Cash Discount Act gives merchants a right to discount only for cash, checks, and similar means, not for lower cost credit cards, and no-differentiation rules prevent merchants from discounting for certain credit card brands or cards within a brand.

Although cash is the cheapest payment system for merchants to accept, merchants generally do not want to encourage cash payments. Credit card payments offer merchants a variety of benefits that paper payments do not. For most merchants, the net cost of cash and checks is higher than that of plastic.

Credit card payments have a number of benefits such as easier accounting and cash management. Plastic's biggest benefit for merchants, though, is that consumers spend significantly more when purchasing with plastic than with paper.¹⁰⁵ Although consumer price elasticity correlates with payment method, it is unclear whether people spend more because they are purchasing with credit or if people prefer to use credit cards for larger purchases. Relative to paper, though, it appears that plastic may increase consumers' willingness to pay for goods and services and to make purchases that they otherwise would not.¹⁰⁶

Since merchants want to receive the benefits of greater consumer spending induced by plastic, they are willing to pay a price for it. Although cash and checks are cheaper on average for merchants, the net benefits of cash and check acceptance are lower than those of credit acceptance for most merchants because of the increased spending that goes with plastic.

104. This limitation is specific to discounts and does not apply to surcharges.

105. See Levitin, *supra* note 95, at 37. It is not clear whether consumer spend more when they purchase with credit cards than when they purchase with debit cards. While the credit limit on a card is not constrained by the funds in the consumers' bank account at time of purchase, some consumers might shy away from making large purchases on credit cards if they know or fear that they will end up paying interest on the purchase amount. Query, though, why merchants do not discount for PIN-debit.

106. See *id.* at 45–49.

The right provided by the Cash Discount Act, then, is of little use to most merchants, who want to encourage the use of plastic, rather than the use of cash and checks. Most merchants do not want to differentiate between paper and plastic prices. Instead, merchants want to differentiate between high-priced cards (rewards and corporate) and regular-priced cards (nonrewards consumer cards) and between credit cards and debit cards to encourage the use of payment systems with the lowest net costs.¹⁰⁷ But merchants' most basic lever for steering consumer payment system usage—price discrimination—is constrained by merchant restraints, and the right provided by the Cash Discount Act is largely irrelevant for merchants who want to avoid the cost externality of high interchange rate cards.

Merchants do not have an option of discounting for the payment systems they want to encourage—no-rewards credit cards. Instead, because of merchant restraints, if merchants want to accept credit cards, they must accept all credit cards of a brand and at the same price as all other payments, except cash (which merchants often do not want). As a result, merchants are unable to avoid funding credit card rewards programs from which they derive no benefit. And as rewards programs become more common, the size of the externality imposed on merchants through merchant restraints increases.

While the ability to grant cash and check discounts is of little use for most merchants, it is clear that many merchants in the United States would surcharge for certain types of credit cards if they could. Merchants are willing to switch acquirers to get prices mere hundredths of a percentage point better.¹⁰⁸ Since surcharging would have an impact hundreds of times larger, it stands to reason that merchants would surcharge. Some merchants already surcharge for credit, albeit in a disguised way. Automobile dealers will typically only allow customers to pay a small amount (\$1000 to \$4000) of the purchase price via credit card because they do not want to incur the merchant discount fees. This is, of course, a violation of the no-maximum amount rule. If a customer insists on paying for the entire transaction via credit card, the dealer will raise the price on the car by saying that he is no

107. Robin Sidel, *As Card Fees Climb, Merchants Push PINs*, WALL ST. J., Jan. 16, 2007, at A1; see Card Forum, *PIN-Debit is Second Only to Cash in Wal-Mart Stores* (May 26, 2005), <http://www.cardforum.com/printarticle.html?id=20050531NJAMQ30>; see also Levitin, *supra* note 13, at 447–51 (detailing merchant strategies for reducing payment costs, while still accepting credit cards).

108. EVANS & SCHMALANSEE, *supra* note 22, at 261.

longer able to provide a particular rebate or incentive. Moreover, some U.S. merchants already surcharge for debit cards.¹⁰⁹

Examples from Western Europe and Australia also tell us that some merchants will surcharge, when permitted to do so by law. Since merchant discount fees in Western Europe and Australia are significantly lower than in the United States, there is less incentive for merchants to surcharge.¹¹⁰ Moreover, European and Australia merchants are still not permitted to charge differently for different types of cards within brands; no-differentiation rules remain in effect worldwide, so merchants lack the ability to price precisely according to the costs imposed by consumers' choice of payment device. Nonetheless, 10 percent of Dutch merchants and 11 percent of Australian merchants surcharge for credit.¹¹¹

Ultimately, though, whether merchants would actually surcharge is irrelevant. The ability to surcharge would give merchants negotiating leverage to gain lower fees, and with lower fees, there would be no need to surcharge. The level and frequency of surcharging would vary according to the market, but by subjecting the interchange rate to market discipline, the mere ability to surcharge would lead to a market equilibrium at lower prices.

109. Offline (signature) debit cards, which are operated by MasterCard and Visa have no-surcharge rules, but some independent online (PIN-based) debit card networks do not have no-surcharge rules. Often, the same physical card can access multiple debit networks. ARCO gasoline stations do not accept credit cards or offline debit cards, but they accept PIN-based debit cards on networks that allow surcharges. ARCO surcharges 45 cents per transaction on debit cards. See Herb Weisbaum, *How to Avoid Getting Socked With Extra Fees*, MSNBC (July 17, 2006), <http://www.msnbc.msn.com/id/13905579> (last visited Jan. 27, 2008). Likewise, many Sacramento area fast food restaurants surcharge for debit. *Id.*

110. As of December 2007, merchant discount fees in Australia averaged 0.85 percent for MasterCard and Visa and 2.17 percent for American Express. Reserve Bank of Australia, Statistical Release C3, Merchant Fees for Credit and Charge Cards, <http://www.rba.gov.au/Statistics/Bulletin/C03hist.xls> (last visited Mar. 19, 2008).

111. Levitin, *supra* note 95, at 310; *Business Plan Credit Card Surcharges*, SYDNEY MORNING HERALD, Mar. 21, 2006, available at <http://www.smh.com.au/news/Business/Businesses-plan-credit-card-surcharges/2006/03/21/1142703336796.html>; InfoChoice, Credit Card Surcharging More Common, Sept. 4, 2006, <http://www.infochoice.com.au/banking/news/creditcards/06/09/article15501.asp> (last visited Jan. 27, 2008); Press Release, East & Partners, Ltd., Almost One Half of Australian Merchants Set to Surcharge (Aug. 1, 2005). Nearly half of all Australian merchants surveyed plan to institute surcharges within six months of the survey date. *Id.* In Denmark, nearly a fifth of merchants surcharge for debit cards. David S. Evans & Richard Schmalensee, *The Economics of Interchange Fees and Their Regulation: An Overview*, in INTERCHANGE FEES IN CREDIT AND DEBIT CARD INDUSTRIES: WHAT ROLE FOR PUBLIC AUTHORITIES? PROCEEDINGS OF THE 2005 FEDERAL RESERVE BANK OF KANSAS CITY CONFERENCE 93 (2005). It seems that merchants will surcharge either when there is little competition within the merchant's industry or when an industry leader sets the pace and surcharging becomes standard practice.

D. Effects on Consumers

Merchant restraint rules impose the externality of rewards program costs on merchants and prevent merchants from making rewards card users pay their own way. Merchants are able, however, to pass on the costs of credit card rewards to all consumers, and empirical evidence shows that they do so by raising prices across the board.¹¹² This creates a cross-subsidy of credit card consumers by non-credit-card consumers, and of rewards card consumers by all consumers not using rewards cards.

The cross-subsidy is highly regressive. The poorest Americans do not have access to credit cards, much less super-premium rewards and corporate cards.¹¹³ In its worst form, food stamp consumers are subsidizing first-class frequent flier upgrades.¹¹⁴

Moreover, by making credit cards appear relatively cheaper to other payment systems, merchant restraints encourage higher usage of credit cards than would otherwise occur.¹¹⁵ This in turn leads to more credit card consumers paying interest and penalty fees, which contributes to consumer bankruptcies, low savings rates, decreased purchasing power, and inflation.¹¹⁶ Merchant restraints also alter the focus of credit card competition because interchange income increases the value of consumers who only transact and do not borrow relative to those who borrow on their cards. This in turn decreases card issuers' incentives to compete for the revolving customers on the basis of lower price.¹¹⁷ Merchant restraints have far-reaching effects on consumers and society.

E. Effects on Payment System Competition

The effects of merchant restraint rules are not limited simply to merchants. They also have profound effects on competition among payment systems and among credit card networks because they block the ability of merchants to signal payment system price to consumers. Consumers "are quite sensitive to explicit pricing of payment services," and they "respond

112. Levitin, *supra* note 95, at 34–42.

113. *Id.* at 43–44.

114. *Id.* at 44–45.

115. *Id.* at 22.

116. *Id.* at 55–61.

117. See Alan S. Frankel, *Toward a Competitive Card Payments Marketplace*, PAYMENTS SYSTEM REVIEW CONFERENCE 27, 64, (Nov. 29, 2007), http://www.rba.gov.au/PaymentsSystem/Publications/PaymentsInAustralia/PaymentsSystemReviewConference/2007/psr_conference_volume_2007.pdf.

significantly to variations in payment prices.”¹¹⁸ Merchant restraints, however, prevent merchants from signaling the costs of different payment systems to consumers. As a result, consumers do not factor in costs when making their consumption decisions. Instead, they only weigh the relative benefits of different payment systems, a calculus in which credit card rewards play an outsized role. Accordingly, consumers make more credit card transactions than they would if they had to factor in the costs of credit cards as a transacting system (not as a borrowing system) at the point of sale.¹¹⁹

Credit card networks thus use merchant restraints to leverage their market power by forcing more card transactions than is efficient. This results in greater front-end (interchange) and back-end (interest) revenue for the networks. By inhibiting merchants from signaling the costs of payment systems to consumers, merchant restraints insulate interchange fees from market discipline, and thus limit competition. By preventing cost signaling, merchant restraints limit price-based competition in three dimensions: (1) between payment systems; (2) between different brands in the same payment system; and (3) between different products in the same payment system within the same brand. The effect of limited price competition is to avoid commoditization by shifting the basis of competition from price to other bundled products and brand image.

Honor-all-cards rules, all-outlets rules, and no-minimum- and no-maximum-amount rules make credit card acceptance an all-or-none proposition for merchants. Merchants cannot exclude specific cards within a brand or refuse to accept cards for particular transactions. These rules pave the way for the merchant restraints that limit merchants’ ability to price payment services for consumers.

No-differentiation and no-discrimination rules prevent merchants from discouraging consumers from using particular cards within a brand through pricing and other methods. These rules make it impossible for merchants to avoid the externality of rewards programs and other perks offered to card users from which merchants derive no benefit. No-surcharge rules exacerbate this situation by linking the price of all credit card transactions to all other transactions.

118. David B. Humphrey et al., *Realizing the Gains From Electronic Payments: Costs, Pricing, and Payment Choice*, 33 J. MONEY, CREDIT, & BANKING 216, 217, 231 (2001) (studying Norwegian consumers).

119. Forcing consumers to bear the costs of credit cards as a transacting system might have the benefit of serving as a proxy for alerting consumers to the costs of credit cards as a borrowing system. *Id.* at 25–28.

No-surcharge rules equalize the price at the point of sale between all payment systems. This equalization accrues to the benefit of costlier payment systems, particularly credit cards, because they are able to impose a cost externality on the merchant who either absorbs it or passes it along to the consumers of other payment systems. Essentially, no-surcharge rules increase the price of all other payment systems to match the price of credit cards.¹²⁰

No-surcharge rules are thus a barrier to entry for new payment systems because they negate any cost advantage that other non-credit card payment systems might have. It is very costly to enter the consumer payment systems market because payment systems involve expensive ACS and security technology, have high regulatory costs (especially for bank-run systems), have costs for funds if the system offers any float, and need flawless initial nationwide deployment. Merchant restraints add a further layer to the barricade in an industry with already high entry costs.

For example, for consumers who use credit cards only to transact, and not for their credit function (including float), PIN-based debit cards offer the same convenience, but are cheaper and securer. For pure transacting, PIN-debit is a superior payment system. The use of PIN-debit, however, may well be limited by the no-surcharge rule advantages given to credit cards.

The corollary of increasing other payment systems' point-of-sale costs relative to credit cards' is that credit cards' point-of-sale costs are relatively reduced, which results in an increase in credit card usage. This increased usage translates into higher interchange revenue and is amplified into higher interest revenue because of the tendency of consumers who intend to use credit cards solely for transacting to overestimate their ability to pay off their balances in full and on time.¹²¹

Merchant restraints also make costlier cards within a brand competitive with cheaper cards. No-differentiation rules, no-discrimination rules, and honor-all-card rules allow card issuers to shift their portfolios to include greater percentages of more profitable, high interchange rate rewards cards without experiencing a decline in card usage.¹²² Indeed, by offering more rewards cards, card issuers actually encourage greater card usage.

120. See Joseph Farrell, *Efficiency and Competition Between Payment Instruments*, 5 REV. NETWORK ECON. 26, 31 (2006).

121. See Bar-Gill, *supra* note 94.

122. See Jean Charles Rochet & Jean Tirole, *Tying in Two-Sided Markets and the Honor All Cards Rule* (Institut d'Economie Industrielle, Working Paper No. 440, 2006), available at <http://idei.fr/doc/by/tirole/2sided.pdf>.

No-surcharge rules equalize the price at the point of sale between all credit card brands. No-surcharge rules thus insulate the card networks from having to compete with each other on point-of-sale price to consumers.

Most of this benefit accrues to American Express, the card brand with the highest interchange rate. It is limited, however, by merchants' ability to refuse all American Express cards; no-surcharge rules do not restrict merchants' ability to opt out of a brand altogether. If American Express were to be too aggressive in exploiting its competitive advantage from no-surcharge rules, it would lose business.

So why hasn't one of the card networks attempted to gain a competitive advantage on the others by dropping its merchant restraints? Why hasn't the market provided a solution? First, permitting surcharging only makes competitive sense for the lower-cost networks; the most expensive brands have nothing to gain from it. Cheaper brands would gain only if all networks permitted surcharging, because merchants will not surcharge for cheaper brands, lest they push consumers to use the more expensive brands. If merchants surcharged only for the brands with lower merchant discount fees, it would make the brands with the higher merchant discount fees cheaper for consumers, who would then switch their consumption to the brands that are the most costly for merchants. As long as the higher cost networks have no-surcharge rules, merchants do not care whether the lower-cost networks permit surcharging.

Second, the three dimensions of credit card competition also explain why a market solution to no-surcharge rules has not emerged. As long as the competitive advantages of no-surcharge rules vis-à-vis other payment systems and in-brand outweigh the interbrand competitive disadvantage (for brands other than American Express), card networks will not voluntarily compete with each other based on merchant restraints. As long as merchant restraints continue to grow credit cards' slice of the total payments pie and let them foist more high cost products on the market, the networks will not abandon merchant restraints in order to gain a larger share of the credit card slice of the pie.

Moreover, many of the ten large issuers that comprise over 87 percent of the bankcard market¹²³ issue cards on as many as three networks. Shifting portfolios from brand to brand is expensive, and issuer contracts with networks often include long-term lock-ins. Interbrand competition would be robbing Peter to pay Paul. Credit card issuers have limited ability to shift existing

123. See *Top 10 U.S. Merchant Portfolios*, NILSON REP., Mar. 2008, at 12.

card portfolios en masse, only to move to new cards. Thus, none of the networks will try to gain a competitive advantage by rescinding merchant restraint rules.

Credit card networks are also content with the lack of interbrand competition based on point-of-sale price because it helps issuers avoid commoditization. Commoditization is a major concern for the card industry. Commoditized industries—where sellers compete solely on the basis of price for the sale of identical products—have low profit margins, and commoditized products sell on a cost-plus basis.

Credit cards are virtually identical products on all nonprice points. In this regard, they are no different than checking accounts, ACH transfers, or cash. Credit cards should function like these payment systems, as commodities with cost-plus pricing.

They do not because the card industry's pricing is structured to avoid commoditization. Credit cards have a bewildering array of explicit price points to consumers, including: annual fees, teaser interest rates, base interest rates, balance transfer interest rates, cash advance interest rates, overdraft advance interest rates, default interest rates, late fees, overlimit fees, balance transfer fees, cash advance fees, international transaction fees, and telephone payment fees. Card issuers do not compete on most of these price points. Instead, they compete on selectively highlighted price points, such as teaser interest rates or bundled benefits, like frequent flier miles. As a result, they are not competing on net price, but on selected facets of costs and benefits to consumers.¹²⁴ Card pricing has been increasingly shifted to back-end, contingent fees that a consumer cannot easily evaluate. Few cards now have annual fees,¹²⁵ which is an easy way for consumers to distinguish between cards based on a definite, up-front price point. Annual fees also alert consumers to the price difference between credit cards and other payment systems. Interest rates should be comparable using Truth-in-Lending Act¹²⁶ (TILA) disclosure forms, but in practice TILA forms are of little use because inscrutable cardholder agreements with universal cross-default clauses make it impossible for a consumer to understand the true interest rate on a card.¹²⁷ Teaser introductory APR offers, often of 0 percent, mask the true interest rate.¹²⁸ Because penalty interest rates are nearly uniform, cross-default clauses make

124. See *Hearing on The Credit Cardholders' Bill of Rights: Providing New Protections for Consumers Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Financial Services Comm.*, 110th Cong. (Mar. 13, 2008) (testimony of Adam J. Levitin).

125. Bar-Gill, *supra* note 94, at 1391.

126. 15 U.S.C. §§ 1601–1667f (2000).

127. Ronald J. Mann, "Contracting" for Credit, 104 MICH. L. REV. 899, 924–26 (2006).

128. Bar-Gill, *supra* note 94, at 1392.

an individual consumer's credit card interest rates uniform by moving them all to the penalty rate upon a default. Finally, it seems that consumer demand is highly price inelastic to interest rates.¹²⁹ The result is that interest rates are not the basis of competition in the card industry.¹³⁰ Merchant restraints mask the final price-point on which cards could be commoditized—point-of-sale pricing. The card industry's complex pricing structure is crafted to avoid commoditization.

Card issuers instead divert competition from commoditizable price points to bundled rewards¹³¹ and other features like identity theft protection, which are difficult to value and thus less prone to commoditization. Rewards are hard to commoditize. Calculating the bundled pricing of credit and affinity programs is far too complex for consumers, and because of the private nature of financial transactions, there is only limited interconsumer signaling. Consumers cannot rationally choose between credit cards-based net cost and benefit; instead, they choose based solely on perceived benefit.

Consumers eagerly pursue bundled intangibles, such as frequent flyer miles and rewards points; a 2002 survey found that half of consumers with rewards cards said that rewards points influenced their decision to use the credit card instead of another payment method.¹³² Accordingly, card companies market themselves based on bundled rewards.

Rewards programs like frequent flyer miles and cash-back rebates have the effect of reducing the net cost to consumers of transactions made with a credit card. A consumer who purchases goods using cash for the same sticker price as a consumer who purchases the good with a cash-back (or other rewards scrip) rebate card will have paid more in net terms for the goods.

Rewards programs arguably increase consumer welfare, however, by catering to consumer preferences. As a general matter, brand and product

129. See Christine Chandran et al., *Competition in the New Zealand Credit Card Market From the Consumer Perspective*, 6 J. ASIA-PAC. BUS. 59, 63 (2005); see also Peter Pae, *Credit Card Rates Keep Rising Despite the Competition*, WALL ST. J., Sept. 6, 1991, at B1. Consumer price inelasticity toward interest rates may be partially explained by the inability of consumers to meaningfully gauge true interest rates and by hyperbolic discounting of interest rates (or more precisely, underestimating the likelihood of paying interest) when they choose cards.

130. See Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79, 104–09 (2000). Zywicki argues, however, that credit card users who have large revolving balances do shop around based on interest rates. See *id.*; see also Chandran et al., *supra* note 129, at 59.

131. See Press Release, Vertis, Bonus Points and Other Incentives Attract Consumers to Credit Cards (July 20, 2005) (“Obtaining Points and Getting Money Back Are Most Appealing Reasons to Select a Credit Card”).

132. See Allen C. Grommet, *Economic Analysis*, CAMBRIDGE CONSUMER CREDIT INDEX 2 (May 7, 2002).

differentiation is a way of offering consumers levels of service and price that more closely match their preferences, thereby increasing consumer welfare.

There are two problems, however, with the application of this principle to the credit card market. First, there are offsetting types of product variation and homogenization in this market as a result of merchant restraints. Merchant restraints foster brand and product differentiation in terms of consumer benefits, but limit differentiation among cards in terms of consumer point-of-sale price and acceptance.

Second, the major brand and product differentiation in the credit card market is in terms of bundled rewards, not in terms of price (annual fees, APR, late fees) or service, given that many issuers issue cards on two or even three networks. Service differentiation is in terms of Chase or Bank of America Card Services, not MasterCard versus Visa. American Express has a reputation for superior service, but only with respect to cards for which American Express is the issuer, and these cards have higher annual fees and are generally charge cards (not credit cards) that have to be paid in full each month and require better creditworthiness. Is this the type of product differentiation consumers actually want?

What a focus on brand and product differentiation misses is that credit cards are at core payment and borrowing devices, and these are the services in which consumers want competition and variation, not the bells and whistles. Credit cards' primary function is to provide payment and lending services, not to serve as a source of rebated income paid in the form of the consumer's choice. Yet, that is not the impression one gets based on credit card advertising. American Express, for example, uses the slogan "My Card. My Rewards." Likewise, a Citigroup advertisement proclaims: "Points for banking. Points for credit cards. Points for Mortgages. Points, Points, Points!" One starts to wonder whether Citigroup is in the banking business or the rewards business. Is American Express selling rewards or payment services? Is the tail wagging the dog? Why don't we see ad campaigns like "American Express, the lowest APR available"? Rewards programs have perverted the credit card market both for consumers and for merchants, who unwillingly bear the cost of the rewards programs.

Merchant restraints insulate the interchange rate from market discipline, which makes credit cards more competitive with other payment systems, limits competition within the credit card industry, and allows card issuers to shift their portfolios toward increasingly expensive cards. Merchant restraints also let card issuers shift the basis of competition in the card industry from price to bundled intangibles, thereby helping them to avoid

commoditization and to maintain higher prices. Merchant restraints encourage more credit card usage and at higher prices. Credit card networks benefit tremendously from merchant restraints' limitations on competition.

III. ARE MERCHANT RESTRAINTS AN ECONOMIC NECESSITY FOR CREDIT CARD NETWORKS?

A. The Network Effect and Two-Sided Networks

Merchant restraints would appear to be naked restraints on trade. Yet most scholarship on merchant restraint rules contends that the rules are necessary for the functioning of credit card networks.¹³³ Credit card networks, along with numerous economists and legal academics, contend that merchant restraints are necessary for credit card networks to exist because of what is known as the network effect, or network externality.¹³⁴

133. E.g., Klein et al., *supra* note 22, at 574–75, 619 n.106; Jean-Charles Rochet & Jean Tirole, *An Economic Analysis of the Determination of Interchange Fees in Payment Card Systems*, 2 REV. NETWORK ECON. 69, 70–76 (2003) [hereinafter *Economic Analysis*]; Jean-Charles Rochet & Jean Tirole, *Cooperation Among Competitors: Some Economics of Payment Card Associations*, 33 RAND J. ECON. 549 (2002) [hereinafter *Cooperation*]; Joshua S. Gans & Stephen P. King, *A Theoretical Analysis of Credit Card Regulation* (Melbourne Bus. Sch. Working Paper No. 2002-11, 2002).

134. See, e.g., EVANS & SCHMALENSEE, *supra* note 8, at 137; Richard Schmalensee, *Payment Systems and Interchange Fees*, 50 J. INDUS. ECON. 103, 105 (2002); MASTERCARD INT'L, SUBMISSION TO THE RESERVE BANK OF AUSTRALIA 7, 11, 36 (2001); William F. Baxter, *Bank Interchange of Transactional Paper: Legal and Economic Perspectives*, 26 J.L. & ECON. 541 (1983); Howard H. Chang & David S. Evans, *The Competitive Effects of the Collective Setting of Interchange Fees by Payment Card Systems*, 45 ANTITRUST BULL. 641, 649–51 (2000); David S. Evans & Richard Schmalensee, *Economic Aspects of Payment Card Systems and Antitrust Policy Toward Joint Ventures*, 63 ANTITRUST L.J. 861, 887 (1995); Joshua S. Gans & Stephen P. King, *Approaches to Regulating Interchange Fees in Payment Systems*, 2 REV. NETWORK ECON. 125 (2003); Klein et al., *supra* note 22, at 572–74; Muris, *supra* note 22, at 532–34; *Cooperation*, *supra* note 133; Jean-Charles Rochet, *The Theory of Interchange Fees: A Synthesis of Recent Contributions*, 2 REV. NETWORK ECON. 97, 98 (2003); *Economic Analysis*, *supra* note 133, at 70–76; NETWORK ECON. CONSULTING GROUP FOR VISA INT'L SERV. ASS'N, CREDIT CARD SCHEMES IN AUSTRALIA: A RESPONSE TO THE RESERVE BANK OF AUSTRALIA AND THE AUSTRALIAN COMPETITION AND CONSUMER COMMISSION JOINT STUDY 7–12, 30 (2001); see also Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479, 512 (1998) (discussing the impact of network effects on credit card network competition).

Richard Epstein has presented an additional justification for the no-surcharge rule: It is needed to prevent cash-only consumers from free-riding on credit cards' signaling of merchant reputability. Richard A. Epstein, *The Regulation of Interchange Fees: Australian Fine-Tuning Gone Awry*, 2005 COLUM. BUS. L. REV. 551, 583–84 (2005). Epstein is concerned that cash-only consumers will capture some of the reputational signaling value conveyed by the display of credit card logos at merchant locations. According to Epstein, these logos inform consumer of “the scope and reliability of the business' full range of operations.” *Id.* at 583.

Epstein's argument is a red herring, disconnected from the realities of modern payment systems. It takes very little for a merchant to accept credit cards—a bank account and telephone or Internet access are the basic requirements. Card networks want merchants to accept their cards. Given that

The network effect is the phenomenon in which the value of the network product depends on the number of users of the product.¹³⁵ Put another way, a network's value to its participants depends on the network's size. For example, a single telephone is of no value because it cannot be used to communicate with anyone else. The more telephones there are in the world, however, the more valuable it is to have a telephone. Conversely a reduction in the number of telephones reduces the value of owning a telephone.

The network effect means that the utility in which the network for participants increases when the size of the network increases, and decreases when the size of the network decreases. Thus, a participant joining the network has a positive externality on all other network participants, and a participant leaving the network has a negative externality on all other network participants. Any event that affects the size of a network also affects the network's value for its users.

Certain networked industries, like auction houses, brokerages, newspapers, heterosexual dating services, and all payment systems, including credit

fly-by-night Internet companies and corner delis accept credit cards (and the networks make their logos freely downloadable over the Internet), the idea that credit card logos impart significant reputational signaling value is preposterous. Compared to the signaling imparted by a merchant's operative lease, the reputational signaling of credit card acceptance is minimal at best. Thus, Epstein's free-riding scenario is unconvincing.

Another potential concern about permitting surcharging is that it could lead to double-marginalization. See Marius Schwartz & Daniel R. Vincent, *The No Surcharge Rule and Card User Rebates: Vertical Control by a Payment Network*, 5 REV. NETWORK ECON. 72, 75 (2006). Double-marginalization is the problem that occurs from the presence of two monopolists in a product supply chain, such as two independent toll booths on a bridge. Double-marginalization results in a larger deadweight loss than a single monopoly. Arguably if a merchant is a local monopoly (for example, the only bar in a small airport), that merchant would use the ability to surcharge and to overcharge consumers who used credit cards, thus resulting in an inefficiently low level of card usage.

Several factors limit the double marginalization concern. First, the problem of double marginalization is really a problem of the existence of the local monopoly—the local monopoly will exist regardless of the ability to surcharge and most of the excess rents extracted by the local monopolist will be from the good or service being sold because that is the vast bulk of the purchase price. Moreover, there wouldn't be a double marginalization problem if surcharging was allowed because there would only be one monopolist—the local one. Surcharging would effectively eliminate the monopolist position in the card network. Additionally, the merchant's fear of limiting sales (not all consumers might have sufficient cash on hand or in a bank account) would weigh against overcharging credit consumers, and there is no reason that surcharges could not be limited to a cost-based formula that allows pass-thru pricing. Finally, even if a double-marginalization problem existed, the harm from local monopolists overcharging for credit is likely outweighed by that of the current system in which all merchants undercharge for credit.

135. But see William H. Page & John E. Lopatka, *Network Externalities*, ENCYCLOPEDIA L. & ECON. 952, 956 (1999) (discussing the lack of agreed definitions of "network effect" and "network externality").

cards, are two-sided networks.¹³⁶ Two-sided networks have two distinct types of customers. For auction houses and brokerages the customer types are buyers and sellers. For newspapers, the customer types are advertisers and readers. For heterosexual dating services, the two customer types are men and women. And in the case of credit card networks, the two types of customers are cardholders and merchants.

In a two-sided network, the value of participating in the network to either type of customer depends on the number of the other type of customer participating. For example, the value of a dating service to men depends on the number of women in the service and vice versa. Often, one type of consumer will be more willing to pay for the network's services than the other. Thus, heterosexual dating services will frequently charge men a different rate than women to participate. Likewise, night clubs host "ladies' nights," when discounts are given to women, who are presumed to be less willing to pay for the social network services of night clubs than men. Because each type of consumer likely has a different price elasticity—willingness to pay—two-sided networks can maximize their size, and hence value to participants, by allocating their costs between the two types of customers according to price elasticities.

New two-sided networks also have a chicken-and-egg problem—it is impossible to attract one type of customer without having first attracted the other. Merchants will not accept a card unless consumers demand to use the card, and consumers will not carry a card unless merchants accept it. The ability to maximize on different price elasticities through cost allocation between the two types of customers in a two-sided network is a significant tool for getting such a network off the ground.

Payment networks are able to allocate costs between the two types of participants through the fees they charge each type of customer. Merchant discount rates determine the costs for merchants, while annual fees, interest rates, and back-end or transaction fees determine the costs for consumers.¹³⁷ For American Express and Discover, the network controls all of these price points. In multiparty networks like MasterCard and Visa, the network does not control these direct price points—issuers set the fees and interest rates,

136. *But see* Carlton & Frankel, *supra* note 21, at 626–31 (arguing that the concept of two-sided markets is insufficiently defined and that most markets can be described as two-sided because consumers benefit from the supply created in response to the demand of other consumers).

137. Theoretically, an additional price point could be added for consumers—a per transaction fee. A transaction fee could be taken at the point of sale or billed later. Credit card networks have avoided transaction fees, especially at the point of sale, because such fees have a much stronger impact on consumers' choice of payment method than the other, more temporally removed fees because of hyperbolic discounting.

and acquirers set the merchant discount fees. The network, however, can affect the relative cost allocation through the interchange fee, which in turn sets a base for the merchant discount fee. As Joshua Peirez, MasterCard Group Executive of Global Public Policy, has explained, “When setting interchange rates, we are looking at maximizing the output of the MasterCard system.”¹³⁸

For payment systems, cost allocation between the two customer types is complicated by the constant and direct financial transactions between the two customer types—merchants and cardholders. The direct merchant-customer transaction provides the customers with an opportunity to reallocate the costs among themselves. This cost reallocation could potentially price some participants away from using the network’s product and thus impose a negative externality on the remaining network participants.

Avoidance of negative network effects is the primary argument that has been put forth in defense of both interchange fees and merchant restraint rules, particularly no-surcharge rules.¹³⁹ As the argument goes, by passing on the marginal cost of credit card transactions to cardholders, merchants would destroy the network’s careful balancing of price elasticities. Consumers are less willing to bear the cost of credit cards than merchants, and would shift to other payment systems if the costs of credit card transacting become too high. If consumers shifted away from credit cards, card acceptance would be less attractive to merchants, which would make the card less attractive to consumers, setting off a downward “death spiral” for the network.¹⁴⁰

Similarly, honor-all-cards, no-differentiation, all-outlets, and no-minimum- and no-maximum amount rules are necessary so that cardholders always receive consistent treatment. Participation in a credit card network is much less desirable for a cardholder if the cardholder is uncertain whether his card will be accepted by a merchant or on what terms. Absent these merchant restraints, credit cards would be less attractive to consumers, again starting the network’s downward spiral.

The network effect concern is quite convincing on the surface as an economic argument. It is historically inaccurate, however, as an explanation for merchant restraint rules, and while it makes sense in a stand-alone economic model, it makes little sense in the current competitive environment, as the following discussion demonstrates.

138. Digital Transactions, MasterCard Raises Some Rates, Lowers Others for Web Retailers, (Feb. 28, 2007), <http://www.digitaltransactions.net/newsstory.cfm?newsid=1270>.

139. See sources cited *supra* note 134.

140. MASTERCARD INT’L, *supra* note 134, at 11, 36.

B. The History of Merchant Restraints

The history of merchant restraints has been all but ignored by legal and economic scholarship, which has focused on theoretical modeling arguments about the role of merchant restraints. The history of merchant restraints shows, however, that they were adopted because of regulatory and business reasons, not because of network effects and consumer protection concerns identified in the theoretical literature.

1. Honor-All-Cards Rules and No-Differentiation Rules

It is not clear when particular networks adopted various merchant restraints. Credit cards have been around in various forms for some time, but started to take off in 1958 with go-it-alone travel and entertainment (T&E) networks in which one entity served as issuer, acquirer, and network, like American Express, Diners Club, and Carte Blanche. There was no reason at the time for T&E networks to have honor-all-cards rules because they offered only one type of card from one issuer.

The financial institutions that issued T&E cards did not operate retail branch banks. Before 1994, federal banking regulations prevented the formation of banks with national retail operations. The McFadden Act of 1927¹⁴¹ prohibited interstate branching by allowing national banks to branch only within the state in which it was situated, so there were no banks in the United States with national presences. Thus, for retail banks to get into the credit card business on a national scale, multi-issuer networks were necessary. Banks in multiple states banded together in card associations or as franchisees of card brands in order to offer nationally accepted card payment products. Two dominant multi-issuer networks arose in the 1960s: BankAmericard (now Visa) and InterBank (now MasterCard).¹⁴²

The absence of national bank brands meant that merchants did not know the reliability and reputation of banks from outside of their state and were hesitant to rely on them for payment. Yet a credit card would be of limited utility if it could not be used nationally, especially in locations where the cardholder's bank was not located. Thus, for multi-issuer networks, an honor-all-cards rule and a no-differentiation rule were necessary to ensure that a card issued by a member bank in California would be honored by a merchant in Maine and treated the same as a card issued by a member bank

141. McFadden Act (Branch Banks), ch. 191, sec. 8, 35190, 44 Stat. 1229 (codified as amended at 12 U.S.C. § 81).

142. See EVANS & SCHMALENSEE, *supra* note 22, at 61–85 for a concise history of the industry.

in Maine, the same way the Federal Reserve mandates that all checks clear at par.¹⁴³ Honor-all-cards and no-differentiation rules have been around for multi-issuer networks since the birth of the BankAmericard network in 1966.¹⁴⁴

Single-issuer networks like American Express, Diners Club, Carte Blanche, and (later) Discover originally had no need for such rules, because all of their cards were the same. Only with the creation of different types of cards all bearing the same brand, did it become necessary for single-issuer networks to adopt honor-all-cards and no-differentiation rules. In 1975, Diners Club offered the first corporate card.¹⁴⁵ In 1984, Diners Club created the first rewards program, and American Express created the first platinum card.¹⁴⁶ As single-issuer networks began to introduce more expensive products, they needed honor-all-cards and no-differentiation rules to assure that new products would be accepted.

Likewise, during the 1990s, MasterCard and Visa issuers began to expand their rewards and corporate card programs as well as creating different interchange tiers; when the interchange fee was first introduced in 1971, there was a single rate for all transactions at all merchants.¹⁴⁷ Honor-all-cards and no-differentiation rules took on a new function for multi-issuer networks with the diffusion of higher-end MasterCard and Visa cards.

The change in the role of the honor-all-cards and no-differentiation rules occurred during the 1990s, at the same time that the Riegle-Neal Act¹⁴⁸ and the Gramm-Leach-Bliley Act¹⁴⁹ rescinded the interstate branch banking restrictions that necessitated their creation and their multi-issuer networks. With the end of restrictions on interstate branch banking, banks with national retail presences began to emerge, vitiating the need for multi-issuer

143. See *The Impact of Credit Cards on Small Business: Hearing on H.R. Res. 66 Before the Subcomm. on Special Small Business Problems*, 91st Cong. 115, 119 (1970) [hereinafter *Hearing*] (statement and testimony of Karl Hinke, Chairman of the Board of Directors, InterBank Card Association).

144. See EVANS & SCHMALENSEE, *supra* note 22, at 65.

145. Diners Club Int'l, Company History, http://www.dinersclub.com/dce_content/aboutdinersclub/companyhistory (follow "1970" hyperlink; then follow "1975" hyperlink) (last visited Jan. 21, 2008).

146. David Breitkopf, *New 'Pay for Play' Perks From MC for the Wealthy*, AM. BANKER, Apr. 12, 2007, at 9. Platinum cards were introduced on MasterCard and Visa networks in 1996. Lisa Fickenscher, *Amex Sues First USA for Using 'Platinum Card' Name*, AM. BANKER, Sept. 23, 1996, at 27.

147. See EVANS & SCHMALENSEE, *supra* note 22, at 76-77.

148. Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (1994) (codified as amended in scattered sections of 12 U.S.C.) (permitting federally chartered banks to open deposit-taking branches across state lines by merging with other banks).

149. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 and 15 U.S.C.).

networks.¹⁵⁰ Likewise, the concern about inconsistent card acceptance within brands faded away as merchants became familiar with the brands, and realized that payment did not depend on the identity of the issuer, but was guaranteed by the system.

Honor-all-cards and no-differentiation rules were not originally adopted to counter negative network externalities. Instead, they were originally a reaction to the organizational problems for multi-issuer networks created by banking regulation in the 1960s. While these regulatory problems have ceased to exist, honor-all-card and no-differentiation rules have morphed into a new role, which has nothing to do with network effects. Instead, these rules now allow all credit card networks to lever new, more expensive product lines onto their existing merchant base.

2. No-Surcharge and No-Discount Rules

There was formerly an additional merchant restraint, the no-discount rule. The no-discount rule mirrored the no-surcharge rule. Just as the no-surcharge rule prohibits merchants from surcharging for credit card transactions, the no-discount rule prohibited merchants from offering discounts for transactions made on other payment systems.

Mathematically, of course, a surcharge for credit is indistinguishable from a discount for other payments. Yet in the current legal landscape, merchants are prohibited from surcharging for credit, but permitted to discount, although usually only for cash. The history of this peculiar situation illustrates the importance of consumer perception of the cost of payment systems and underscores the powerful effect that price differentiation could have on consumers' choice of payment instrument.

While surcharges and discounts are mathematically equivalent, there is a crucial economic distinction between them. Consumers react much stronger to credit surcharges than to cash discounts due to the framing effect and the endowment effect.¹⁵¹ Thus, no-surcharge rules are more important than no-discount rules for credit card networks.

The origins of no-surcharge and no-discount rules are murky. The earliest information comes from a February 1970 survey taken by the House Select Committee on Small Business. The Select Committee set the survey to three single-issuer T&E card brands (American Express, Carte Blanche, and Diners Club); twenty-seven oil companies that issued gasoline cards;

150. See Levitin, *supra* note 13, at 467–76.

151. VIS & TOTH, *supra* note 99, at 11–12.

thirty-two banks that currently issued cards either through BankAmericard (Visa), InterBank (MasterCard), or their own brand; and the InterBank Card Association. The survey had a 100 percent response rate.¹⁵² Among the survey's questions were the range of merchant discount rates charged, as well as "Does your merchant credit card contract contain a provision precluding the merchant from granting discounts to customers on non-credit card sales?"¹⁵³

All of the T&E cards reported in the survey that they had both no-surcharge and no-discount rules.¹⁵⁴ They reported merchant discount rates between 3 and 10 percent.¹⁵⁵ The oil companies did not have merchant discount rates because the transactions were essentially considered "on us." When oil companies entered into mutual acceptance arrangements with other card brands, however, some oil companies applied merchant discount fees, ranging from 1 percent to 6 percent, while others absorbed the cost themselves.¹⁵⁶

Half of the banks surveyed prohibited merchants from surcharging or discounting.¹⁵⁷ The other half, though, had no such restriction.¹⁵⁸ Merchant discount fees at the banks ranged from 0 percent to 6 percent.¹⁵⁹ In terms of the range of merchant discount fees offered by these banks, there was no statistically significant difference between those that had no-surcharge and no-discount rules and those that did not.¹⁶⁰ None of the oil companies precluded merchants from differential pricing for cardholders.¹⁶¹

The InterBank (MasterCard) network did not have no-surcharge or no-discount rules itself. Instead it required that acquirer agreements with merchants contain some form of a no-discrimination clause, but interpreted this no-discrimination clause to be more like an honor-all-cards or no-differentiation clause than a no-surcharge clause.¹⁶² The precise form of such a clause was a negotiated contractual term between member acquirer

152. THE IMPACT OF CREDIT CARDS ON SMALL BUSINESS, SUBCOMM. NO. 5, SELECT COMM. ON SMALL BUS., H.R. REP. NO. 91-1500, at 3 (1970).

153. *Hearing, supra* note 143, at 218.

154. *Id.* at 223.

155. *Id.*

156. *Id.* at 238-46.

157. *Id.* at 224-37. While the question was phrased in terms of discounts, many of the responses were phrased in terms of surcharges. It is possible, however, that some respondent banks had only no-surcharge rules, not no-discount rules or vice versa.

158. *Id.*

159. *Id.*

160. Author's calculations based on *Hearing, supra* note 143, at app.

161. *Id.* at 238-46.

162. *Id.* at 119.

banks and individual merchants,¹⁶³ and nearly half of the banks issuing InterBank cards in the survey did not apply this rule to prevent surcharges or discounts.¹⁶⁴

It is unclear whether BankAmericard (Visa) had such rules. In 1970, BankAmericards were issued under franchise and license agreements with Bank of America. For cards issued by Bank of America, there were no-surcharge and no-discount rules, but some franchised and licensed banks that issued BankAmericards did not report having no-surcharge and no-discount rules.¹⁶⁵ The situation was likely the same as InterBank's.

From the survey responses we learn that by 1970, all the T&E networks had no-surcharge and no-discount rules in place. The multi-issuer bankcard networks—MasterCard and Visa—however, did not originally have no-surcharge and no-discount rules. Instead, they were adopted on an individual basis by member banks. MasterCard and Visa only adopted network-wide no-surcharge and no-discount rules at some point after 1970.

Network effects were not a concern that animated the creation of no-surcharge and no-discount rules. Network effects were not identified in economics literature until 1974, and there was little study of them until the mid-1980s.¹⁶⁶ Accordingly, a network effects concern (even without that terminology) is strikingly absent from testimony at Congressional hearings on credit card network rules in 1970.¹⁶⁷ Indeed, it would have been remarkable if such an unknown concept led to the creation of the rules.

Because in 1970 no-surcharge and no-discount rules were individual acquirers' rules, rather than network rules, the rules were clearly not designed to protect the network. An individual acquirer's no-surcharge or no-discount rule could not counteract surcharging or discounting by a merchant of another acquirer who did not have such contractual rules. Clearly concerns other than control over the size of the network animated early no-surcharge and no-discount rules.

Further, given the economic structure of card networks before 1971, there was little economic (as opposed to legal) need for no-surcharge and no-discount rules. Before 1971, there were no interchange fees in multi-issuer networks; acquirers remitted the entire merchant discount fee to the issuer.¹⁶⁸

163. *Id.* at 232.

164. *Id.* at 224–37.

165. *Id.* at 227, 234.

166. Network effects as such were first identified in Jeffrey Rohlfs, *A Theory of Interdependent Demand for a Communications Service*, 5 BELL J. ECON. & MGMT. SCI. 16 (1974).

167. *Hearing, supra* note 143.

168. Muris, *supra* note 22, at 531; see also EVANS & SCHMALENSEE, *supra* note 22, at 155. Other sources indicate that from 1966 to 1971, there was not a uniform interchange fee schedule, but

The discount rate was set by negotiations between individual merchants and acquirers, and not by the network.¹⁶⁹ Because there was only one type of card in the brand, merchant discount rates varied only by acquirers, not by card type within the brand. Accordingly, the full amount of credit card networks' fees to merchants were subject to normal market pressure because of competition between acquirers to sign up merchants and because of merchants' greater ability in the 1970s to refuse to take cards. Merchants had more room to negotiate their fees, so there was less reason for merchants to surcharge. Accordingly, half of the banks responding to the 1970 House Select Committee survey had no-surcharge rules. In such circumstances, concerns about negative network effects, as anachronistic as they would be, would have made little sense.

Why then, did half of the individual bankcard issuers and all three T&E card brands adopt no-surcharge and no-discount rules? Three reasons emerge from testimony given in June 1970 by credit card industry executives to the Subcommittee on Special Small Business Problems of the Select Committee on Small Business of the House of Representatives.

First, Joseph N. Tilem, vice president and general counsel of Carte Blanche, testified that he drafted the first no-surcharge/no-discount rule.¹⁷⁰ He did not specify a date, although he explained that the rule was drafted in reaction to a problem that began in the 1950s, when merchants advertised that they would give a discount to anyone who presented a Diners Club card, but paid in cash.¹⁷¹ The first no-surcharge/no-discount rule was not meant to address merchants offering a generally available cash discount, but only a cash discount being offered solely to Diners Club cardholders.

Tilem explained that unlike bankcards, T&E cards relied on merchant discount fees, not interest, for revenue. Therefore, T&E cards could not survive if cardholders had to bear the full cost of using them:

Now, in the case of the T. & E. credit card, the only way the company can remain viable, can keep going, is, of course, to have the credit card worth something. If the credit card is a device which is going to, in effect, make you pay 7 percent more than your neighbor who is getting

a fee schedule for payments from acquirer to issuer that varied by issuer and acquirer that was eventually replaced with a uniform fee schedule because individual negotiations were too cumbersome as the number of banks in networks grew and because of concerns that acquirers were not remitting the agreed-upon fee to issuers. See *Nat'l Bancard Corp. (NaBanco) v. VISA U.S.A., Inc.*, 596 F. Supp. 1231, 1238 (S.D. Fla. 1984), *aff'd*, 779 F.2d 592, 595 (11th Cir. 1986).

169. *Hearing, supra* note 143, at 224, 232; Muris, *supra* note 22, at 531.

170. *Hearing, supra* note 143, at 200 (statement of Joseph N. Tilem, Vice President and General Counsel of Carte Blanche).

171. *Id.* at 200-01.

the same piece of merchandise for a 7-percent cash discount, obviously there would be no desire to continue with the credit card In fact, I think clearly it might put the T. & E. companies out of business.¹⁷²

The benefit of T&E cards—convenience, safety, and float—was not worthwhile to consumers if they had to pay both the annual fee and the 7 percent merchant discount fee. If consumers were required to pay 7 percent to transact with their Carte Blanche card, assuming a thirty-day grace period, it would be the same as if they had taken out a thirty-day loan at an 84 percent APR.¹⁷³ As an American Express executive put it, if the consumer had to pay the merchant discount fee, it would be “tantamount to almost assessing a finance charge.”¹⁷⁴ The merchant discount fee is really no different than “points”—interest paid up front.¹⁷⁵ Thus, there is no real float on credit cards. All cardholders, transactors and revolvers alike, actually pay interest.

Not only would an 84 percent APR have violated usury laws before 1978,¹⁷⁶ but it is hard to believe that anyone would knowingly pay 84 percent interest for the transacting benefits of credit cards, if the economics of the transaction were presented to them in this way. If consumers directly paid the full cost of credit cards, no one would use them solely to transact.

Tilem’s statement is a frank admission that consumers would not use T&E cards if they had to bear the full cost of using them. It is only through merchant restraint rules that credit card networks are able to disguise the fact that there is no real float and to impose an externality on merchants (and thus on all other consumers), so that the benefits of T&E cards are perceived as outweighing their costs to cardholders.

T&E cards had (and continue to have) the highest merchant discount rates among networks. Accordingly, T&E cards would have been the cards for which merchants would have been most likely to surcharge—why should

172. *Id.* at 201–02.

173. Realistically, the APR is actually higher because consumers would rarely use the full float. If only half the float were used, the effective APR would be 168 percent!

174. *Hearing, supra* note 143, at 193.

175. See *Smiley v. Citibank (S.D.)*, N.A. 517 U.S. 735, 744–47 (1996) (equating fees and interest).

176. State usury laws were not eviscerated until the U.S. Supreme Court’s 1978 decision in *Marquette Nat’l Bank of Minneapolis v. First of Omaha Serv. Corp.*, 439 U.S. 299, 308–10 (1978), which held that the applicable interest rate for a national bank is that of the state in which it is located, as determined by its certificate of organization. *Marquette* started a regulatory race to the bottom, with most national banks moving their credit card operations to states like Delaware or South Dakota with either no or minimal usury laws. Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 685–86 (1987).

a merchant pay 6 percent for a sale made using an American Express card, when the same sale could be consummated for 3 percent using a Visa? Thus, all three T&E networks had no-surcharge and no-discount rules in 1970. Gasoline cards, by contrast, had the lowest merchant discount rates and did not have any no-surcharge or no-discount rules. Higher cost networks need no-surcharge rules to remain competitive with lower cost networks and other payment systems.

A second reason for no-surcharge and no-discount rules is found in the testimony of John Murray, assistant general counsel of American Express:

We see the card as supplying for [the merchant] a financial service [of consumer credit] which he would otherwise have to supply himself and pay the cost of. The discount rate is well within his means and what it would cost him to provide the service. Therefore, he should not assess an extra charge on our cardholders. Basically, it is a protection to the cardholder.¹⁷⁷

Murray claimed that the service provided by credit cards to merchants is somehow different than merchants' other costs of doing business, such as labor, financing, shipping, or overhead, which are expected to be passed on to the consumer. Obviously, there is no basis for such a distinction—credit card fees are just another cost of doing business.

The real import of Murray's explanation is in the claim that it is a "protection to the cardholder," which is no different than the explanation offered by Tilem.¹⁷⁸ Perhaps in these explanations can we discern a poorly articulated cry of consumer protection of cardholders. A similar rationale was put forth by Kenneth V. Larkin, senior vice president of marketing at Bank of America. He stated that BankAmericard's no-surcharge rule was to prevent "abuse from the public in that regard . . . We do not want [merchants] dumping [the] discount rate on the cardholder . . ." ¹⁷⁹ The consumer protection rationale for the no-surcharge and no-discount rules is protecting credit card consumers from recognizing the costs of their transactions and for being required to pay their own way.

A third rationale was put forth by the representatives of the Marine Midland Bank.¹⁸⁰ Unlike T&E cards, which did not charge interest, other than a minimal late fee (in the range of 1.5 percent), and had no credit

177. *Hearing, supra* note 143, at 193.

178. *See supra* note 170.

179. *Id.* at 108.

180. *Id.* at 49 (statements of Donald E. Cielewich, senior vice president, Marine Midland Trust Co. of Western New York and William J. O'Connor, Jr., attorney for the Marine Midland Trust Co. of Western New York).

limits, bankcards charged significant interest on revolving accounts. Thus, the Marine Midland Bank representatives explained that their bank had adopted a no-surcharge (but not a no-discount) rule in order to comply with Regulation Z under the Truth-in-Lending Act.¹⁸¹ The Truth-in-Lending Act (TILA) of 1968¹⁸² required lenders, including credit card issuers, to disclose the cost of credit ex ante through two uniform components: the finance charge and the annual percentage rate (APR). TILA deemed any difference between the price of a cash transaction and a credit transaction, whether by cash discount or credit surcharge, to be part of the cost of credit, which had to be included in mandatory ex ante disclosures.¹⁸³ If the merchant discount fee were passed on to consumers, it would be as the American Express executive noted, tantamount to a finance charge.¹⁸⁴ Absent no-surcharge and no-discount rules, credit card issuers risked violating TILA's disclosure requirements because they could not control the APR if merchants surcharged or discounted.

Two-tiered pricing made adequate TILA disclosures impossible for card issuers because credit card networks could not calculate and disclose ex ante what the APR would be for every single good or service at every merchant.¹⁸⁵ Moreover, TILA regulations required the conversion of surcharges and discounts into an APR based on the assumption that the surcharge or discount was for a thirty-day extension of credit. This meant that a 5 percent surcharge would increase the APR by an immense 60 percent, which would scare potential credit consumers and, at least before 1978, violate state usury ceilings.¹⁸⁶

181. *Id.* at 49–50; see 12 C.F.R. § 226.4(a) (2007).

182. Truth in Lending Act, Pub. L. No. 90-321, § 101-09, 82 Stat. 146–150 (1968) (codified at 15 U.S.C. §§ 1601–1667f (2000)).

183. It is odd, therefore, that Marine Midland Bank only had a no-surcharge, not a no-discount rule. See 15 U.S.C. § 1605(a) (excluding “charges of a type payable in a comparable cash transaction” from the definition of finance charge).

184. *Hearing, supra* note 143, at 193 (statement of John Murray, Assistant General Counsel of American Express). Of course, given that merchants raise their prices to all consumers, including credit card consumers, as a result of accepting credit cards, there is still a disguised finance charge, arguably in violation of the Truth-in-Lending Act.

185. COMM. ON BANKING, HOUS., & URBAN AFFAIRS, CASH DISCOUNT ACT, S. REP. NO. 97-23, at 1 (1981).

186. See S. REP. NO. 97-23, at 1 (1981); Edmund W. Kitch, *The Framing Hypothesis: Is It Supported by Credit Card Issuer Opposition to a Surcharge on a Cash Price?*, 6 J.L. ECON. & ORG. 217, 221 (1990); Carl D. Lobell & Joseph W. Gelb, *The Cash Discount Act*, N.Y.L.J., Dec. 31, 1981, at 1 (expressing concerns over the usury ceiling).

3. Origins of Interchange

The usury problems created by surcharging historically point to an explanation of the original function of the interchange fee: It was designed to increase issuer compensation at a time when issuers could not charge higher interest rates because of usury laws. Interchange was devised to evade state usury laws, and TILA's inclusion of indirect charges on consumers as finance charges¹⁸⁷ threatened the system, necessitating no-surcharge and no-discount rules. Thus it seems likely that both no-surcharge and no-discount rules, the centerpieces of merchant restraints, were devised to avoid legal and marketing problems that threatened the fundamental economics of early credit card issuance.

The two-sided nature of credit card networks provides the starting point for understanding the original function of interchange as a mechanism to avoid usury violations while still providing issuers with a sufficient return so that they would participate in networks. A common account of interchange fees purpose is that they are needed to maximize the size of the network by playing on different price elasticities for merchants and consumers.¹⁸⁸ But interchange fees are technically fees paid by acquirer banks to issuer banks; they are not direct transfers from merchants to consumers.

The fact that interchange fees are technically a transfer among banks (even if they are ultimately passed on to the merchants and thus consumers) is significant. Why would one set up a system in which banks were transferring fees to each other, and why would the fee go from the acquirer to the issuer instead of vice-versa? If the interchange fee is really to cover the costs of processing transactional paper, as one court has stated,¹⁸⁹ then why is it paid from the acquirer to the issuer? Both parties have costs in handling the transaction. Yet all U.S. credit card systems have acquirers paying issuers. This tells us something quite important about the origins of the interchange fee, namely that it was necessary in order to make credit card issuance economically viable when usury restrictions were still applicable to all banks and card pricing and underwriting models were quite primitive.

187. 15 U.S.C. § 1605(a) (2000) (“[T]he amount of the finance charge in connection with any consumer credit transaction shall be determined as the sum of all charges, payable directly or indirectly by the person to whom the credit is extended, and imposed directly or indirectly by the creditor as an incident to the extension of credit. The finance charge does not include charges of a type payable in a comparable cash transaction.”).

188. See *supra* note 22.

189. Nat'l Bancard Corp. (NaBanco) v. VISA U.S.A., Inc., 596 F. Supp. 1231, 1238 (S.D. Fla. 1984).

In order to be viable, a network needed to sign up a sufficient number of merchants and consumers. Some banks (acquirers) specialized in signing up merchants, while others (issuers) specialized in signing up consumers. It seems that it was relatively easy to find acquirers, in part because of the limited risk assumed by an acquirer, which is typically protected by a balance against which it can set-off debts. Issuers, on the other hand, faced a serious credit risk in making unsecured loans to consumers. In the early days of card networks, credit scoring was non-existent and underwriting technology and techniques were primitive; card issuers lacked their current ability to undertake sophisticated computer analysis of reams of consumer data to find pricing strategies that would maximize revenues by targeting products to consumer behavior patterns. Accordingly, card lending was a riskier business than today, and card issuers issued far fewer cards, only issued them to people deemed to be highly creditworthy, and relied heavily on credit limits to control credit risk by limiting the size of their exposure for any individual.

To the extent that issuers wished to compensate for this risk by charging higher interest rates, they were limited, before 1978, by state usury laws. Other potential income sources for issuers, such as fee income, were also limited. In the early years credit card pricing was much simpler than today—typically cards had an annual fee and a single flat rate. The contingent, back-end weighted fee structure had not yet been devised. This meant that absent other revenue sources, credit card issuance might not be a profitable undertaking—the risks outweighed the returns—and it would be hard for a network to recruit issuers and thus cardholders.

The difficulties in making credit card issuance profitable in the early years can be seen from a comparison to proprietary non-network credit cards issued by merchants (gas stations and department stores being the most notable examples). These cards, which did not have interchange fees (because all transactions were “on us”), were generally break-even or even money-losing affairs.¹⁹⁰ Instead of serving as an independent profit center, cards were loyalty devices to encourage consumers to frequent a particular merchant, much like free parking.¹⁹¹

Before the advent of multi-bank networks, individual banks had their own card programs in which they served as both issuer and acquirer, like American Express and Discover. In these early single-bank card programs, the majority of income was from merchant fees, not from interest, in part

190. Timothy Wolters, “Carry Your Credit in Your Pocket”: *An Early History of the Credit Card at Bank of America and Chase Manhattan*, 1 ENTERP. & SOC’Y 315, 321 (2000).

191. *Id.*

because relatively few card users were revolvers so issuers had major float expenses.¹⁹² This meant that if the functions of issuer and acquirer were split between separate banks, the major source of revenue would be with the acquirer bank. Accordingly, without the interchange fee, stand-alone issuers economics would resemble those of proprietary cards—break-even or money-losing ventures, but without even the redeeming benefit of customer loyalty. Not surprisingly, most of the pre-interchange fee general purpose cards were unsuccessful.¹⁹³

The creation of uniform interchange fees in 1971 (and with predecessor fees dating back to 1966) offered a solution to the economic quandary of early card networks.¹⁹⁴ Given the limitations imposed by usury laws and the primitive pricing and underwriting models of early credit card programs, it might not have been possible to recruit issuer-only banks to card networks absent interchange revenue (or some other proxy for it). The interchange fee offered a way to make card issuance sufficiently profitable for banks such that they would go out and solicit consumers to become cardholders. To wit, say that usury laws capped the interest rate that could be charged at 20 percent annually. But with a 3 percent interchange fee on a 30-day extension of credit, the issuer would be able to make an effective return of 36 percent annually for purchases paid off at the end of the float period and 56 percent annually for revolving balances. The interchange fee changed the economics of early card issuance and helped cement it as a profitable undertaking by allowing issuers to get far higher returns than they could with usury restrictions. Interchange allowed card networks to wire around the economic constraint of usury laws. But this could only work if merchants were forbidden from passing the fee (as included in the merchant discount fee) on to card users. Otherwise, interchange would appear to be an indirect charge on consumers by issuers that might trigger state usury law violations.

In 1978, the U.S. Supreme Court's *Marquette* decision gutted state usury laws,¹⁹⁵ but interchange didn't go away. Instead, it became gravy for card issuers, who were able to raise their interest rates while maintaining steady interchange revenue. From 1966 to 1978, merchants and consumers got used to interchange fees (and merchant discount fees) as part of the standard card

192. See *id.* at 331, 342.

193. *Id.* at 324, 346.

194. Cf. Steven Semeraro, *Credit Card Interchange Fees: Debunking Six Myths*, BANKING AND FIN. SERV. POL'Y REP. (forthcoming 2008) (arguing that the interchange fee might have been "a hedge against the risks attendant to an entirely new form of unsecured lending," and, if so, that the need for this hedge has been outgrown) (draft on file with the author).

195. See *supra* note 176.

pricing structure. To be sure, cards still had limited market penetration, but once the economic foundation was laid in the 1970s, there was no one pushing to change cards' economic model post-*Marquette*, even though its original *raison d'être* had ceased to exist. Consumers and merchants didn't understand the economic model, and banks had no incentive to change, especially as change would have meant confronting consumers with even higher interest rates, which would put issuers belonging to the first mover network at a huge competitive disadvantage.

Notably, neither network effects nor anything resembling the concept received any mention when credit card executives testified regarding no-surcharge and no-discount rules to Congress in 1970. There would be a dramatic decrease in credit card use if consumers perceived and internalized the full costs of cards. But is this a legitimate concern? It is not the network effect to which card networks refer in defense of their rules. Instead, in 1970, the card industry executives articulated three reasons for no-surcharge and no-discount rules: (1) a legal problem created by TILA (implicit within being a usury problem); (2) a consumer protection issue; (3) and the necessity of imposing an externality on merchants and noncardholders in order to make cards attractive to cardholders.¹⁹⁶ The history of no-surcharge and no-discount rules shows they were created not to protect credit card networks from negative network externalities, but instead as a response to a specific regulatory and economic environment and the need to mask the high cost of cards to evade usury laws and the marketing problems of explicitly priced loans. The following discussion shows how the legal compliance rationale for no-surcharge and no-discount rules has ceased to be an issue and how consumer protection concerns about surcharging and discounting are misplaced.

4. History of the Cash Discount Act

Consumer advocacy groups saw no-surcharge and no-discount rules as negatively affecting cash consumers, and, in February 1974, Consumers Union sued American Express and BankAmericard on the grounds that their no-surcharge and no-discount rules were restraints on trade constituting an antitrust violation.¹⁹⁷ American Express settled the suit two months later by agreeing to rescind its no-discount rule and to allow merchants to offer cash

196. See *supra* text accompanying notes 170–187.

197. Complaint at 1, *Blitz v. Am. Express Co.*, No. 74-314 (D.D.C. Feb. 20, 1974).

discounts.¹⁹⁸ Despite their mathematic equivalence, no-discount rules were perceived as harming cash consumers, while no-surcharge rules were perceived as protecting credit card consumers.¹⁹⁹ Consumers Union reportedly reached subsequent settlements with other card networks.²⁰⁰ Merchants, however, were unable to take advantage of the settlement because they too were defined as “creditors” under TILA and subject to disclosure requirements that they could not meet without knowing individual cardholders APRs.²⁰¹

Consumer groups thus pressed Congress to amend TILA to allow for cash discounts by not including the discount in the APR.²⁰² When it appeared a bill would pass allowing surcharges and discounts, the credit card industry lobbied heavily for preserving surcharge restrictions.²⁰³ The result was that Congress amended TILA in 1974 to exempt cash discounts from the APR, but of no more than 5 percent, subject to proper disclosure by the merchant.²⁰⁴ Congress also instructed the Federal Reserve Board (FRB) to draft TILA disclosure regulations.²⁰⁵

While working on the regulations, the FRB was unsure if Congress intended the 5 percent discount limitation to apply to surcharges too, given their mathematic equivalence.²⁰⁶ Congress responded in 1976 by specifically prohibiting credit surcharges for three years²⁰⁷ and exempting discounts

198. Kitch, *supra* note 186, at 220; see also Gerald P. O’Driscoll, Jr., *The American Express Case: Public Good or Monopoly?*, 19 J.L. & ECON., 163, 164 (1976); *Discounts for Cash?*, TIME, Apr. 29, 1974, at 93, 93; *Suit for Consumers Says Credit Cards Hurt Cash Buyers*, N.Y. TIMES, Feb. 21, 1974, at A29.

199. THE IMPACT OF CREDIT CARDS ON SMALL BUSINESS, SUBCOMM. NO. 5, SELECT COMM. ON SMALL BUS., H.R. REP. NO. 91-1500, at 56 (1970) (“If the requirements operate only in a manner that precludes discrimination against all credit customers, there may be [an] easily understandable and legally defensible basis for such clauses . . . [I]f, in fact, these clauses preclude the merchant from granting discounts on cash sales, then this would appear to constitute price-fixing in violation of the antitrust laws.”).

200. Kitch, *supra* note 186, at 220 n.5.

201. 15 U.S.C. § 1602(f) (2000).

202. Kitch, *supra* note 186, at 224.

203. See Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 45 (1980).

204. Fair Credit Billing Act of 1974, Pub. L. No. 93-495, sec. 306, § 167(b), 88 Stat. 1515 (1975) (codified as amended at 15 U.S.C. § 1666f(b) (2000)); see also 12 C.F.R. § 226.4(c)(8) (2006).

205. *Id.*

206. FCBA *Two-Tier Pricing and Procedures for Federal Reserve Board Regulation Writing: Hearing Before the Subcomm. on Consumer Affairs*, 94th Cong. 2-3 (1975) (statement of Jeffrey M. Bucher, Board of Governors of the Federal Reserve System); see also COMM. ON BANKING, HOUSING, & URBAN AFFAIRS, CASH DISCOUNT ACT, S. REP. NO. 97-23, at 2 (1981); Kitch, *supra* note 186, at 225.

207. Act of Feb. 27, 1976, Pub. L. No. 94-222, § 3(c), 90 Stat. 197 (1976).

from state usury and disclosure rules.²⁰⁸ The legislative history contains no explanation for the decision to ban surcharges but to permit limited discounts.

Congress renewed the surcharge ban in 1978 for an additional three years but let the ban lapse in 1981.²⁰⁹ Several months later, and “only after considerable debate and the addition . . . of a requirement that a study be prepared by the Federal Reserve Board,”²¹⁰ Congress passed the compromise Cash Discount Act, which eliminated the 5 percent limit on cash discounts²¹¹ but reinstated the surcharge ban for a further three years.²¹² The federal surcharge ban lapsed in 1984.²¹³

Today, federal law no longer bans credit surcharges but continues to prohibit state and private restrictions on cash discounts.²¹⁴ Additionally, twelve states prohibit some or all credit surcharges.²¹⁵ Most state no-surcharge rules are apparently the result of the credit card industry lobbying in the 1980s, when it was uncertain whether the federal surcharge ban would be renewed after it lapsed.²¹⁶ While federal law no longer prohibits surcharges, it

208. *Id.* at § 3(d); S. REP. NO. 97-23, at 2. The surcharge prohibition had a sunset provision, which was renewed twice. See Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, § 1501, 92 Stat. 3713 (1978) (enacting a two-year extension); Cash Discount Act, Pub. L. No. 97-25, § 201, 95 Stat. 144 (1981) (enacting a three-year extension). The prohibition lapsed in 1984. *Id.*

209. The ban lapsed on Feb. 27, 1981. It was renewed as of July 27, 1981. See 92 Stat. 713.

210. BD. OF GOVERNORS OF THE FED. RESERVE SYS., CREDIT CARDS IN THE U.S. ECONOMY: THEIR IMPACT ON COSTS, PRICES, AND RETAIL SALES 4 (1983).

211. Cash Discount Act, § 101.

212. *Id.* § 201.

213. *Id.*

214. 15 U.S.C. § 1666f(a) (2000); see also 12 C.F.R. § 226.12 (f)(1) (2006).

215. Ten states forbid surcharging outright. CAL. CIV. CODE § 1748.1(a) (Deering 2005); 5 COLO. REV. STAT. § 2-212(1) (2007); 42 CONN. GEN. STAT. ANN. § 133ff(a) (West 2007); FLA. STAT. ANN. § 501.0117 (West 2006) (second degree misdemeanor to surcharge); KAN. STAT. ANN. § 16a-2-403 (1995); ME. REV. STAT. ANN. tit. 9A, § 8-303.2 (1997); MASS. ANN. LAWS ch. 140D, § 28A(a)(2) (LexisNexis 2007); N.Y. GEN. BUS. LAW § 518 (McKinney 1996); OKLA. STAT. ANN. tit. 14A, § 2-417 (West 1996); TEX. FIN. CODE ANN. § 339.001(a) (Vernon 2006). In addition, Minnesota permits a surcharge, but limits it to 5 percent, 20D MINN. STAT. ANN. § 325G.051(a) (West 2004), and New Hampshire bans surcharges by travel agencies, 31 N.H. REV. STAT. ANN. 358-N:2 (1996).

216. The legislative history of state no-surcharge rules indicates that most were the result of credit card industry lobbying in the 1980s. Nine states adopted their no-surcharge rules in the early 1980s, either when it appeared that the federal no-surcharge ban would not be renewed (in 1981) or after the federal ban had lapsed (in 1984). Thus, Massachusetts enacted its no-surcharge rule in 1981, Act effective Dec. 24, 1981, ch. 733, § 28A(a)(2), 1981 Mass. Acts 1143, 1167, as did Maine, Maine Consumer Credit Truth-in-Lending Act, ch. 243, § 8-303(2), 1981 Me. Laws 328, 353, and Oklahoma updated its no-surcharge rule in 1982 to remove a 5 percent discount limitation and preclude surcharges. Act of June 1, 1982, ch. 14A, § 2-211, Okla. Sess. Laws 118, 121. New York adopted its no-surcharge rule in 1984. Act of June 5, 1984, ch. 160, 1984 N.Y. LAWS 1707, 1707. California, which in 1974 adopted a law requiring that merchants have an option of giving cash discounts, 1974 Cal. Stat. 3402, adopted its no-surcharge rule in 1985. Act of Sept.

does not prevent the credit card networks from enacting private no-surcharge rules, nor does it address other merchant restraints.

One of the three original explanations given by credit card industry executives for no-surcharge and no-discount rules—compliance with TILA—no longer serves to explain the existence of no-surcharge rules. TILA no longer counts a credit card surcharge or a cash discount toward the APR, so the legal problem created by TILA is no longer extant. As the next Subpart shows, the consumer protection concerns over credit surcharges and cash discounts make little sense. Thus, the sole remaining reason for no-surcharge rules is because the card networks benefit from disguising the cost of cards to consumers and imposing an externality on merchants and noncardholders.

C. The Cash Discount Act as Consumer Protection?

The Senate Committee Report on the Cash Discount Act portrayed the Act as a pro-consumer action,²¹⁷ but this claim is suspect. Major consumer groups, such as the Consumer Federation of America and Consumers Union, opposed the Cash Discount Act's continuation of the surcharge ban.²¹⁸ Moreover, the report's argument makes little sense from a pro-consumer

23, 1985, ch. 913, 1985 Cal. Stat. 2907, 2908 (to be codified at CAL. CIV. CODE § 1748.1). Connecticut adopted its no-surcharge rule in 1986, Credit Card Surcharges and Acceptance of Bank Credit Cards Act, No. 86-222, 1986 Conn. Acts 434, 434 (Reg. Sess.), as did Kansas, Act of Apr. 22, 1986, ch. 90, sec. 2, 1986 Kan. Sess. Laws 455, 456 (codified as amending KAN. U.C.C. ANN. § 16a-2-401 (1985)). Florida's no-surcharge rule dates from 1987, Act effective Oct. 1, 1987, ch. 87-42, § 1, 1987 Fla. Laws 178, 178, as does Minnesota's 5 percent surcharge limit. Act of May 20, 1987, ch. 172, § 1(1), 1987 Minn. Laws 360, 360.

Three states enacted their laws somewhat later. New Hampshire's no-surcharge rule dates to 1992. Act of May 13, 1992, ch. 233, § 358-N:2, 1992 N.H. Laws 309, 309. Texas enacted its no-surcharge rule in 1997, Act effective Sept. 1, 1997, ch. 1008, tit. 4, sub. ch. 339, § 339.001(a), 1997 Tex. Gen. Laws 3091, 3439, and Colorado enacted its rule in 1999, Act of Apr. 30, 1999, ch. 146, § 5-3-10, 1999 Colo. Sess. Laws 426, 431, then repealed it and reenacted it in a substantially similar form in 2000. Consumer and Commercial Transactions Act, ch. 265, § 5-2-212, 2000 Colo. Sess. Laws 1178, 1206. There is no readily apparent explanation for the timing of these later enactments.

217. COMM. ON BANKING, HOUSING, & URBAN AFFAIRS, CASH DISCOUNT ACT, S. REP. NO. 97-23, at 3-4 (1981).

218. *Id.* at 16. The surcharge ban was also opposed by several government agencies, including the Federal Reserve Board (FRB), the Federal Trade Commission, the Office of Comptroller of the Currency, the Federal Home Loan Bank Board, and the Credit Union Administration. *See id.*; *see also The Cash Discount Act: Hearing Before the Subcomm. on Consumer Affairs*, 98th Cong. 5-6 (1984) (statement of Nancy H. Teeters, Governor, Federal Reserve System). The FRB has been consistent in its questioning of the surcharge restriction. *See Cash Discount Act: Hearing on S. Res. 414 Before the Subcomm. on Consumer Affairs*, 97th Cong. 10 (1981) (statement of Nancy H. Teeters, Board of Governors, Federal Reserve System).

standpoint. Although the committee recognized that “discounts for cash and surcharges on credit cards may be mathematically the same,” it argued that “their practical effect and the impact they may have on consumers is very different.”²¹⁹ Despite recognizing the mathematic equivalence, the Senate Banking Committee displayed the framing bias in its concern for the credit consumer penalized with a surcharge. The committee had no problem with a cash consumer receiving a “bargain.”

The report explained its distinction between surcharges and discounts through the claim that two-tiered pricing is deceptive because the sticker price is not always the price paid.²²⁰ Allowing cash discounts, the report argued, would add price flexibility into the system while guaranteeing that the sticker price would be the highest price possible:

[P]ermitting unlimited cash discounts and prohibiting surcharges allows the competitive free market to operate. Merchants can utilize two-tier pricing systems and thereby price cash purchases lower than credit purchases, if they choose to do so.

But, they cannot implement two-tier pricing systems which deceive or mislead the consumer. By permitting only cash discounts, the Committee intends to assure that consumers will be seeing at least the highest possible price they will have to pay when they see a tagged or posted price. In other words, consumers cannot be lured into an establishment on the basis of the “low, rock-bottom price” only to find at the cash register that the price will be higher if a credit card is used.²²¹

The committee was concerned that credit consumers might fall victim to bait-and-switch pricing via surcharges.

Two-tiered pricing, either through discounts or surcharges, makes it more difficult for consumers to compare prices, unless merchandise is routinely tagged with both prices and when sales quotes are given for both cash and credit. Yet, there is no reason to think that a comparison of maximum prices (allowing discounts, not surcharges) is any better than a comparison of minimum prices (allowing surcharges, not discounts).

Comparing price minimums, not maximums, is the more effective way for consumers to gauge the price of a payment system.²²² Most people are better at addition than at subtraction,²²³ in part because of addition’s

219. S. REP. NO. 97-23, at 3–4.

220. *Id.* at 4.

221. *Id.*

222. See Bar-Gill, *supra* note 94, at 1381.

223. See Gary B. Nallan et al., *Adult Humans Perform Better on Addition Than Deletion Problems*, 44 PSYCHOL. REC. 489, 497 (1994).

commutative property, so it is better to have a baseline onto which surcharges can be added than a baseline from which they can be subtracted.

When consumers compare price minimums, they perceive the cost of the underlying good itself plus the baseline cost using any method of payment. Surcharges then alert the consumer to the extra cost of different payment systems. Credit surcharges illustrate the marginal cost of using credit. Cash discounts do not give such a clear signal to consumers. The chairman of the Federal Trade Commission (FTC), writing in opposition to the surcharge ban, recognized that surcharges, not discounts, drive home the true marginal cost of credit transactions to the consumer:

In theory, a discount and a surcharge are equivalent concepts, but one is hidden in the cash price and the other is not. From a practical standpoint the surcharge seems easier to implement and more likely to ensure that the price credit card users pay reflects the cost of accepting credit cards.²²⁴

Consumers deal with price differentials on a regular basis, such as when deciding in which jurisdiction to shop, based on state and local sales taxes, which are not reflected on merchandise tags. A consumer living near the border of a state with a sales tax and a state without a sales tax is aware that purchasing the same items in the sales tax state will be more expensive, even if the sticker price is the same. A credit surcharge could be applied in the same manner as sales tax, as a percentage added onto a bill at the register, with signs posted detailing the surcharge applicable to different card types. It would not take much for consumers to learn that the same item would be more expensive when purchased with a credit card and to then conduct a personal cost-benefit analysis for which payment system to select.

Any real consumer protection concerns could easily be addressed by the FRB and FTC through mandating pricing disclosure guidelines so consumers would know the relevant surcharge before payment.²²⁵ Moreover, the market itself would serve to discipline sharp dealing by merchants. Although a merchant might use two-tiered pricing to lure in customers, consumers would walk away if abused, so merchants who use bait-and-switch pricing might well lose customers. And, given that a merchant who charges a credit surcharge is offering this advertised price, although only for cash payments, there is nothing per se deceptive. Only convenience and cash flow impede a

224. S. REP. NO. 97-23, at 11–12 (1981) (letter from Federal Trade Commission (FTC) Chairman Michael Pertschuk to Senator William Proxmire).

225. *Id.* at 11; *cf.* Council Directive 98/6, art. 3, 1998 O.J. (L 80) 28 (EC) (directing member states to adopt regulations requiring merchants to indicate both selling price and unit price for all covered products).

consumer from paying in cash instead of credit, and these are poor policy grounds for protecting surcharges restrictions.

D. The Contemporary Relevance of Network Effects

The history of merchant restraints shows that they were not adopted because of network effect concerns, but because of no longer germane regulatory concerns and because of the boost they gave credit cards by disguising consumer costs. Concerns about negative network effects are absent in early explanations of merchant restraints by credit card networks, and the consumer protection arguments are really an argument made for protecting cardholders from having to pay their own way.

Simply because network effects and consumer protection concerns fail to explain merchant restraints historically, though, it does not follow that they are currently inapplicable. The following section, however, shows that even in the current competitive environment, these concerns are invalid and fail to justify merchant restraint rules.

1. The No-Surcharge Rule

No-surcharge rules have only been studied in theoretical or modeling contexts; there is no direct empirical study of the rules.²²⁶ Economic modeling of payment system economics, including network effects, has generally assumed the existence of only one network competing against nonnetworked products.²²⁷ In such a situation, a network externality always causes a deadweight loss. But this deadweight loss disappears if the network's competitor is another network, as one network's loss is another's gain.²²⁸ Network effects are not an important competition policy concern in the context of an established payment network competing against other payment networks.²²⁹ In such a context, negative network effects on one network are

226. For an indirect empirical examination of no-surcharge rules, see Levitin, *supra* note 95, at 36–44.

227. Sujit Chakravorti & Roberto Roson, *Platform Competition in Two-Sided Markets: The Case of Payment Networks*, 5 REV. NETWORK ECON. 118, 139 (2006) (citing the limited modeling of competing two-sided networks).

228. Of course, a numerically equivalent gain or loss for either network will not have the same effect on the networks' values. If a network with one million participants loses one participant, the negative externality on the remaining participants is de minimis, but if a network with ten participants gains one, the positive externality on the original participants is significant.

229. E.g., Alan S. Frankel & Allan L. Shampine, *The Economic Effects of Interchange Fees*, 73 ANTITRUST L.J. 627, 655 (2006).

simply offset by positive network effects on another. Merchant restraints create a barrier to entry for newer, more cost-efficient networks.

Negative network effects are only a reasonable concern in the first place if the existence of the network itself produces net social welfare. This is the assumption that underlies much of the economic modeling of payment networks.²³⁰ This assumption makes sense if there are no good substitutes for the networked product or if the entrance of a new product to a market creates beneficial competition in the market. The assumption makes little sense in the context of mature products, like credit cards, that compete with other network products.

The assumption of inherent value or social benefit in the existence of a network developed in the classical network economic situation of the railroad. In the late nineteenth century, there was a clear net social welfare benefit from the railroad. If the railroad didn't haul goods, the goods didn't get moved. No comparable alternative existed to the network; barges and horses were not a good substitute. The same logic applied to telephone networks; telegraphs and the postal system were poor alternatives to the network, and the service offered by the network produced a net increase in social welfare. Notably, classic network products all have a tendency toward monopoly and did not originally compete directly with other network products.

When credit cards came onto the market in a meaningful way in the 1960s and 1970s, the situation was not unlike that of the railroad and the telephone. Alternative payment technologies—cash and checks—were not great substitutes. Consumers did not want to carry large amounts of cash, and merchants did not want to bear the credit risk of checks. Accordingly, social welfare benefited from the existence of credit card technology. Merchant restraint rules originally shielded the nascent credit card networks from the competitive price pressures that would have inhibited their development.²³¹ Merchant restraints effectively subsidized the development of credit card networks, although these were self-granted, sub-rosa subsidies, rather than legislative subsidies.

In the early days of credit cards, merchants were price inelastic relative to consumers. Merchants were willing to tolerate relatively high interchange fees in the early days of credit card networks both because the number and the volume of card transactions were relatively small and because they experienced a marginal benefit from card acceptance as cards enabled greater spending by masses of credit-constrained consumers. In the early days of

230. See Evans & Schmalensee, *supra* note 111, at 91–92.

231. See *id.* at 85.

credit cards, if consumers had been required to pay more at point of sale for using cards, it is unlikely that credit cards would have become a mass-market product. No-surcharge rules allowed the card networks to retain control over the perceived allocation of costs within the network and impose a cross-subsidy on noncardholders so as to grow the network.

Now, however, credit card networks are past the chicken-and-egg problem that plagues new two-sided networks. Credit cards are now widely accepted by merchants and used by consumers. Credit cards are an established product that does not need subsidization to thrive. Mature credit card networks still exhibit network effects.²³² But network effects present different concerns depending on context, and a nascent payment system in a market with a limited number of competing products, none of which are strong substitutes, is a very different context than a mature payment system competing with other payment networks.

Network effects are network—that is, brand—specific. There is no generic credit card network effect. Credit card networks compete with each other for cardholders and merchants. To the extent that a cardholder or merchant switches from Visa to Discover, there is a negative network externality on the Visa network's remaining participants, but this is offset by a positive network externality for the Discover network's participants. As between particular credit card brands, competition policy should not care which one succeeds. Antitrust law is, after all, about protecting “*competition*, not *competitors*.”²³³

Likewise, credit card brands compete with other payment systems that are reasonably strong substitutes for each other for transacting purposes, particularly card-based debit and ACH systems, which are very strong substitutes for credit cards as transacting mechanisms.²³⁴ They offer similar convenience and better security against fraud. While the maximum liability for unauthorized transactions is higher for debit cards in the United States, a debit card fraud does not affect a consumer's credit report, unlike a credit card fraud.

All payment systems are two-sided networks and exhibit network effects. Credit card merchant restraints, which once eased the entry of credit cards into the payments marketplace, are now a barrier to entry for new payment systems. There is social welfare value in having a networked product when

232. See Klein et al., *supra* note 22, at 584.

233. *Brown Shoe Co. v. United States*, 370 U.S. 294, 320 (1962).

234. See Jonathan Zinman, *Debit or Credit?* 4 (Aug. 2007) (unpublished manuscript), available at http://www.dartmouth.edu/~jzinman/Papers/zinman_DebitorCredit_aug07.pdf (stating that debit is a strong substitute for credit).

there is no reasonable alternative. But when consumers have a choice among competing networked products, there is no inherent value to the existence of any particular network. As the European Commissioner for Competition Policy stated in a speech announcing a ruling that MasterCard's interchange fee was illegal:

It is *not* sufficient that a MIF [multilateral interchange fee] simply increases the sales volumes of a [credit card network] scheme to the sole benefit of the member banks. Rather, a MIF should contribute to objective efficiencies such as to promote more efficient payment means to the detriment of less efficient ones. Also, the proceeds from a MIF should not just increase bank's revenues—they should be clearly dedicated to the achievement of efficiencies.²³⁵

Indeed, to take the network effects argument to its extreme, the value of the network to consumers will be maximized in a monopoly situation in which all consumers are part of the network. This result proves too much.

The network effects concern is simply inapplicable in the context of mature payment networks competing against other mature payment networks. Any negative network externality is offset by a positive one when cardholders or merchants switch payment systems. For any given volume of transactions, it is a zero sum game; short of bartering, consumers always need payment systems. Therefore, net social welfare remains constant. It is not an all-or-nothing proposition of having payment systems or not, but a question of which payment system. That question should be answered by the free market.

Indeed, in the context of competing networks, the no-surcharge rules impose a competition externality by shifting usage from more efficient to less efficient networks. No-surcharge rules, supposedly designed to protect against negative network effects, actually impose them on the more efficient networks. Even by the logic of the network effects claim, as ahistorical as it is, merchant restraint rules have transformed from a shield to a sword as credit card networks have matured and new payment system networks have emerged. The network effect justification for merchant restraints is inappropriate in the context of a mature network that competes with other mature networks.²³⁶

235. Neelie Kroes, Eur. Comm'r for Competition Policy, Commission Prohibits MasterCard's Intra-EEA Multilateral Interchange Fees (Dec. 19, 2007) (emphasis in original), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/08/9&format=HTML&aged=0&language=EN&guiLanguage=en>.

236. Similarly, the sole study of honor-all-card rules, Rochet & Tirole, *supra* note 122, does not attempt to determine the effect of multiple networks all having honor-all-card rules on competition; it only considers the possibility of one network that competes with competitors who do

We also know that credit card networks can operate profitably in the absence of no-surcharge rules, so the network effects concern is simply a concern about networks' level of profitability, not viability. Recent experience shows that credit card networks have profited and grown in the absence of no-surcharge rules in Australia and Europe. Australia banned the no-surcharge rule in 2003.²³⁷ MasterCard and Visa are not only still in business in Australia, but have seen card usage rise,²³⁸ even as the average MasterCard and Visa interchange rates in Australia have fallen by nearly half, from 0.95 percent of purchase price to 0.50 percent,²³⁹ while the average merchant discount fees for MasterCard and Visa have fallen from 1.40 percent of purchase price to 0.79 percent.²⁴⁰ Six European countries have individually banned no-surcharge rules,²⁴¹ and MasterCard has recently voluntarily rescinded its no-surcharge rule for all of Europe,²⁴² yet continues to operate profitably throughout the continent. In short, there is ample experiential proof that established credit card networks do not need no-surcharge rules to thrive.

not similarly bundle products. Nor does the study attempt to account for the use of honor-all-card rules to bundle identical products of different price.

237. RESERVE BANK OF AUSTRALIA, COMMON BENCHMARK FOR THE SETTING OF CREDIT CARD INTERCHANGE FEES 10 (2005), available at http://www.rba.gov.au/PaymentsSystem/Reforms/CCSchemes/common_benchmark_cci_fees.pdf.

238. Reserve Bank of Australia, Credit Card and Charge Card Statistics, <http://www.rba.gov.au/Statistics/Bulletin/CO1hist.xls> (last visited Jan. 21, 2008).

239. RESERVE BANK OF AUSTRALIA, DEBIT AND CREDIT CARD SCHEMES IN AUSTRALIA: A STUDY OF INTERCHANGE FEES AND ACCESS 43 (2000) (providing a 0.95 percent average interchange fee in 1999); Press Release, Reserve Bank of Australia, Credit Card Benchmark Calculation (Sept. 29, 2006), available at http://www.rba.gov.au/MediaReleases/2006/PDF/mr_06_08_benchmark_calc_credit_card.pdf (setting the cost-based interchange rate to 0.5 percent from its previous level of 0.55 percent).

240. Reserve Bank of Australia, Merchant Fees for Credit and Charge Cards, <http://www.rba.gov.au/Statistics/Bulletin/CO3hist.xls>. Total merchant fees on MasterCard and Visa have declined from 1.45 percent of purchase price in March 2003 to 0.85 percent of purchase value in December 2007. *Id.*

241. Finland, the Netherlands, Portugal, and Sweden all ban surcharge restrictions for credit and debit cards. *Surcharging in Europe*, NILSON REP., Sept. 2004, at 1, 6. The UK bans surcharge restrictions only for credit cards. The Credit Cards (Price Discrimination) Order 1990, Statutory Instrument 1990 No. 2159, art. 3, para. 1, http://www.opsi.gov.uk/si/si1990/Uksi_19902159_en_1.htm. In 2006, Switzerland reached a settlement with MasterCard and Visa issuers that included a four-year rescission of the no-surcharge rule (referred to as a nondiscrimination rule in Switzerland). Press Release, Wettbewerbskommission, *Credit Card Interchange Fees: Information for the Media* 3.

242. MasterCard rescinded, without comment, its no-surcharge rule for all of Europe effective as of January 1, 2005, but has retained the rule for other regions. *Surcharging in Europe*, *supra* note 241, at 6–7; MASTERCARD INT'L, *supra* note 41, at 2–32.

2. The Honor-All-Cards Rule and Other Merchant Restraints

The defense of honor-all-cards rules, and by implication, the all-outlets and no-minimum- and no-maximum-amount rules, rests on casting these rules as a form of consumer and network protection. No-differentiation rules, although designed to limit merchants' ability to price credit cards, rather than accept them selectively, are also covered by the consumer and network protection arguments. As Benjamin Klein and his colleagues have written:

An honor-all-cards rule is the essence of a payment card system because it assures each cardholder that his card will be accepted at all merchants that display the mark of the card's payment card system. If merchants could decide which issuer's cards of a particular payment system they would accept, the benefits of guaranteed acceptance would be undermined and the value of the payment card system would be diminished. Individual merchants cannot independently decide whether or not to accept a particular issuer's version of the payment card without substantially damaging the reputation of the entire payment card system. Consequently, all payment card systems have an honor-all-cards policy and do not leave it up to the discretion of individual merchants to accept or refuse payment cards of individual issuers once the merchant has agreed to accept the payment system's cards.²⁴³

Thus, the honor-all-cards rule is cast as serving a dual function of consumer protection and network protection. Absent the honor-all-cards rule, the all-outlets rule, no-minimum- and no-maximum-amount rules, and the no-differentiation rule, consumers would never know whether their card would be accepted for a particular transaction and on what terms. This uncertainty would make the brand's cards less desirable to consumers, some of whom would cease to carry the card, which would have a negative externality on the entire network.

The consumer and network protection argument, however, assumes that merchants would discriminate in their acceptance of cards within a brand. Is this a realistic concern? As we have seen, these rules were originally adopted by multi-issuer networks to deal with the problems created by banking regulation in the 1960s, when banks rarely had presences beyond a single state and needed to ensure that merchants would honor cards issued by banks with which they were unfamiliar.

243. Klein et al., *supra* note 22, at 592; see also *Hearing on Credit Card Interchange Fees Before the House Committee on the Judiciary Antitrust Task Force*, 110th Cong. 11 (2007) (statement of Timothy J. Muris, Professor, George Mason School of Law); Klein et al., *supra* note 22, at 574.

Today, this not a valid concern. Ten large banks with national presences account for 89 percent of MasterCard and Visa outstandings.²⁴⁴ Merchants have no reason to care whether a MasterCard is issued by Citibank or Citizens Bank or whether a Visa is issued by Bank of America or Chase. The essential variation in credit cards within a brand for a merchant is not the identity of the issuer, but the cost of accepting the card, which is set by the acquirer. The only reason for a merchant to refuse to honor a particular card within a brand is because it is more expensive to accept than another of the brand's cards. The function served today by honor-all-cards rules is not ensuring the viability of a multi-issuer network, but rather ensuring networks' ability to issue high-cost cards. The proof of this change in function is that American Express and Discover adopted honor-all-cards rules when they were still single-issuer networks but with different card cost tiers.

So, would merchants honor all cards if the honor-all-cards rule were rescinded? The answer is clearly yes, but this result comes about because in the absence of an honor-all-cards rule, the types of cards in existence would be different. If the honor-all-cards rule was eliminated, merchants would likely refuse to accept cards that had high interchange fees (and hence high merchant discount fees). This refusal would create substantial market pressure on card issuers to stop issuing high interchange fee cards. Indeed, absent an honor-all-cards rule, there would likely be no more than de minimis interchange fee variation among cards within a brand; were it otherwise, merchants would simply refuse the higher interchange cards of the brand unless they saw a corresponding benefit to accepting higher interchange cards.

Eliminating the honor-all-cards rule would lead to a situation in which there would be little variation among cards within a brand. Merchants would, therefore, have no reason to discriminate among cards within brands in terms of acceptance or surcharging. Merchants like credit cards; they just do not like being forced to accept higher cost cards from which they receive no benefit. Eliminating the honor-all-cards rule would not lead to consumer uncertainty regarding card acceptance and thus a potential negative network externality, because there would be uniform acceptance within brands due to the product uniformity that would result from eliminating the rule.

Therefore, consumer and network protection arguments in favor of the honor-all-cards rule are fallacious because they look selectively, rather than holistically, at the effect of the absence of the honor-all-cards rule and fail to account for the net economic effect of eliminating the rule. The consumer and network protection argument in favor of the honor-all-cards rule fails to

244. See *Top 10 U.S. Merchant Portfolios*, *supra* note 123.

consider the effect on interchange rates and thus on merchant incentives to discriminate among cards within a brand if the rule were rescinded.

Of course, consumers might be marginally harmed by the loss of product variation that would occur in the absence of an honor-all-cards rule. But, as noted above, to the extent that there is variation in cards, it is largely a variation in rewards programs, and credit cards should be seen primarily as a payment and borrowing product, not as a device for garnering frequent flier miles. Moreover, this harm would be offset by the benefit of lower prices, both for remaining low-cost credit card consumers and for cash consumers.

The justifications for both categories of merchant restraint rules—those that restrict merchants' ability to price cards and those that restrict merchants' ability to accept cards selectively—do not hold up under scrutiny. The network effects rationale for merchant restraints is an anachronistic, *ex post facto* justification for rules that were adopted to address legal and business problems specific to the 1960s, but have since taken on other functions.

There is no credible theoretical justification for merchant restraints: They are naked restraints on trade that distort competition among payment systems and encourage greater levels of credit card usage at higher prices. The remainder of this Article analyzes merchant restraints under antitrust law.

IV. ANTITRUST ANALYSIS OF MERCHANT RESTRAINTS

Merchant restraints violate section 1 of the Sherman Antitrust Act.²⁴⁵ Section 1 provides, "Every contract, combination in the form of trust or

245. Notably, while interchange fees have been held not to violate antitrust laws, *National Bancard Corp. (NaBanco) v. Visa U.S.A., Inc.*, 779 F.2d 592, 601–05 (11th Cir. 1986); *Kendall v. Visa U.S.A.*, 518 F.3d 1042 (9th Cir. 2008). No court has yet ruled on merchant restraints. The relevance is questionable since *NaBanco* predated the widespread use of cards. See *supra* note 18, for a discussion of *Kendall*. No-surcharge rules are also arguably a violation of the Cash Discount Act, Pub. L. No. 97-25, § 201, 95 Stat. 144 (1981), but it is hard to read too much into the Cash Discount Act given the twists and turns in the Act's history. See *supra* Part III.B.4.

Merchant restraints might also violate section 2 of the Sherman Antitrust Act, 15 U.S.C. § 2 (2000). Section 2 of the Sherman Act provides that "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce . . . shall be deemed guilty of a felony . . ." As defined by the Supreme Court:

The offense of monopoly under § 2 of the Sherman Act has two elements: (1) the possession of monopoly power in the relevant market and (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.

United States v. Grinnell Corp., 384 U.S. 563, 570–71 (1966).

Monopoly power is "the power to control prices or exclude competition." *Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 481 (1992) (quoting *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 391 (1956)). Attempted monopolization requires a specific

otherwise, or conspiracy, in restraint of trade or commerce . . . is . . . illegal.”²⁴⁶ Section 1 of the Sherman Act is not read literally to bar every contract, conspiracy, or combination in restraint on trade. Instead, it is interpreted to bar only unreasonable restraints on trade.²⁴⁷

Sherman Act section 1 violations are reviewed under either the rule of reason standard or the per se standard. The rule of reason standard requires courts to weigh the anticompetitive effects of the alleged activity against its procompetitive effects in determining a violation. The per se standard, by contrast, is a strict liability rule.

Merchant restraints rules can be characterized as different types of traditional section 1 violations with varying standards of review: tying, horizontal price-fixing (between competitors) and vertical price-fixing (between producer and reseller). They may also represent a hybrid section 1 violation of a vertical restraint with horizontal effects.

A. Defining the Relevant Market

A prerequisite of any antitrust claim is a definition of the relevant market, that is the trade or commerce, in which trade is being restrained. Courts are split in defining the relevant market in payment system antitrust cases. Market definition is an issue that arises under both section 1 and section 2 (monopolization) of the Sherman Act, but the analysis is the same in either context, as well as in the merger review context.

intent to monopolize and a “dangerous probability” of success. *United States v. Am. Airlines, Inc.*, 743 F.2d 1114, 1118 (5th Cir. 1984).

Arguably, merchant restraints are the device by which credit card networks jointly monopolize or attempt to monopolize the payments industry. The gravamen of such charges is that merchant restraints expand credit cards’ share of the total payment system’s market share at the expense of other payment systems. This charge, of course, depends on payment systems forming the relevant market, as opposed to solely credit cards being the relevant market. *See infra* Part IV.A. If the relevant market is payment systems, not just credit cards (and arguably even if it is just credit cards), it appears that credit card networks do have the power to control prices, even if they only make up under 30 percent of the payment systems market, the usual threshold for monopolization analysis. Merchant restraints set the relative level of all payment systems at point of sale by equalizing them, and then through rewards programs, credit card networks actually offer consumers the cheapest transacting system. This system has the same effect as being able to set absolute prices. In doing so, credit card networks manage to exclude or at least limit their competition. Card networks’ ability to control prices in this manner is hardly the result of a superior product, business acumen, or historic accident, but instead the result of calculated business decisions.

^{246.} 15 U.S.C. § 1 (2000).

^{247.} *Texaco Inc. v. Dagher*, 547 U.S. 1, 5 (2006) (citing *State Oil Co. v. Khan*, 522 U.S. 3, 10 (1997)).

The earliest antitrust case addressing the relevant market in a credit card context, *National Bancard Corp. v. Visa U.S.A. Inc.*,²⁴⁸ defined the relevant market as the general payment systems market.²⁴⁹ More recent cases have defined the relevant market as general purpose credit card network services,²⁵⁰ and held that credit cards and debit cards are distinct product markets.²⁵¹

For antitrust purposes, the relevant market is defined as narrowly as possible. It “is composed of products that have reasonable interchangeability for the purposes for which they are produced—price, use and qualities considered.”²⁵² “Because the ability of consumers to turn to other suppliers restrains a firm from raising prices above the competitive level, the definition of the ‘relevant market’ rests on a determination of available substitutes.”²⁵³ Thus, if the consumers of a network’s credit card services would switch to another credit card when faced with a price increase for the network’s cards, then those cards would not be distinct product markets. Likewise, if consumers would switch to other payment instruments when faced with a price increase for all credit cards (or even just one network’s cards), then credit cards would not be a distinct product market from the other payment instrument product market(s) because consumers would treat them as substitutes. If, on the other hand, consumers of a network’s credit card services continue to use the network’s credit cards despite a price increase and do not switch to another card brand, the network’s cards are a distinct product market. And if the consumers do not switch from credit cards at all despite price increases throughout the credit card market, then credit cards are a distinct product from other payment instruments.

Before applying this heuristic, it is important to consider how the definition of the relevant market is complicated by the two-sided nature of payment systems.²⁵⁴ Should the relevant market be defined in relation to cardholders, merchants, or both?

Several scholars have cogently suggested that in light of the two-sided nature of payment systems, it is necessary when defining a market to account for the net effect on a network’s profitability if it increases prices for either

248. 596 F. Supp. 1231 (S.D. Fla. 1984).

249. *Id.* at 1257.

250. *United States v. Visa U.S.A. Inc.*, 163 F. Supp. 2d 322, 335 (S.D.N.Y. 2001).

251. *In re Visa Check/MasterMoney Antitrust Litig.*, No. 96-CV-5238, 2003 WL 1712568, at *2 (E.D.N.Y. Apr. 1, 2003).

252. *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 404 (1956).

253. *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210, 218 (D.C. Cir. 1986).

254. See Renata B. Hesse & Joshua H. Soven, *Defining Relevant Product Markets in Electronic Payment Network Antitrust Cases*, 73 ANTITRUST L.J. 709 (2006).

type of consumer.²⁵⁵ In particular, they argue that traditional antitrust market definition tools, such as the hypothetical monopolist test used in the Department of Justice's Merger Guidelines, are still applicable to two-sided markets.²⁵⁶ The Merger Guidelines, a tool for executive agencies to analyze whether mergers would be detrimental to competition, define the relevant market as the largest one in which a hypothetical monopolist could impose a small but significant nontransitory increase in price (SSNIP) (typically calculated as a 5 percent price increase).²⁵⁷ These scholars would add to this definition that the SSNIP imposed on either type of consumer must not be offset by a reduction in revenue from the other type of consumer that renders the price increase unprofitable.²⁵⁸ Thus, the market definition question is: What is the largest possible market in which a hypothetical monopolist operating a two-sided network could profitably impose a SSNIP on (at least) one type of consumer?

While the Merger Guidelines deal with a hypothetical monopolist, no such hypothetical firm is necessary for analyzing the relevant market for merchant restraints. Under the Merger Guidelines' measure of market definition as updated for two-sided markets, it would appear that general consumer payment systems, rather than general purpose credit card services, are the relevant market. Every credit card network has raised its prices to merchants significantly and nontransitorily without losing market share to other payment systems.²⁵⁹ Between 2000 and 2006, the weighted average merchant discount fee rose 23 percent overall,²⁶⁰ while the credit card market share of consumer payment systems increased from 23.4 percent to 26.17 percent of purchase volume.²⁶¹ Merchant restraints already have the effect of allowing credit cards to "charge significantly more than a competitive price, i.e., without losing too many sales to the other products to make its price unprofitable."²⁶² On this basis, consumer payment systems, rather than general purpose credit cards, appear to be the relevant market for analyzing merchant restraint rules.

255. Eric Emch & T. Scott Thompson, *Market Definition and Market Power in Payment Card Networks*, 5 REV. NETWORK ECON. 45, 59 (2006); Hesse & Soven, *supra* note 254, at 738.

256. See Hesse & Soven, *supra* note 254.

257. U.S. DEPT OF JUSTICE & FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES 6 (1992).

258. See Hesse & Soven, *supra* note 254.

259. See *supra* charts 1 & 5.

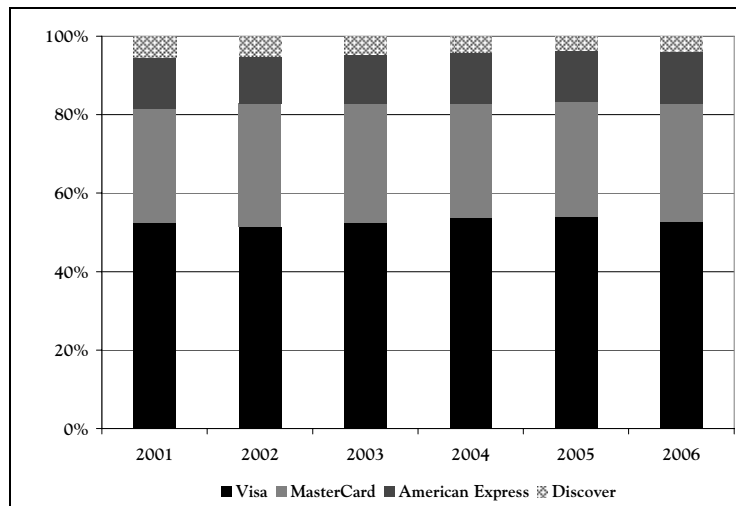
260. *Merchant Processing Fees*, *supra* note 4; see also Lee Manfred, *The Kansas City Fed Conference: Another Skirmish in the Interchange Controversy*, FIRST ANNAPOLIS NAVIGATOR, May 2005, at 2 (estimating that "credit card issuers' absolute interchange revenue has increased 27% from 2002 to 2004").

261. *Consumer Payment Systems*, *supra* note 9.

262. *United States v. Visa U.S.A. Inc.*, 163 F. Supp. 2d 322, 335 (S.D.N.Y. 2001).

The market analysis does not stop here, however, as an unsolved puzzle remains from the aforementioned methodology of adapting the Merger Guidelines to two-sided markets. As Chart 9 shows, market shares among the card networks for payment card transactions has remained static from 2001 to 2006, despite significant interchange increases by all of the networks. How are we to explain that all credit card brands have significantly raised their interchange fees while gaining market share relative to other payment systems and without any significant impact on market share amongst themselves?

CHART 9: PAYMENT CARD MARKET SHARE BY TRANSACTION VOLUME
(2001–2006)²⁶³



On some level, this phenomenon can be ascribed simply to credit cards being a superior product to other payment systems. But unless the consumer demand curve for credit cards is vertical (a most unlikely scenario), the price theory of demand tells us that we should see some tapering off in demand as prices rise. Of course, because of merchant restraints, consumers never see an increase in the price of transacting with a credit card; indeed, they never see any transaction price whatsoever for using a credit card.

Another explanation is that credit cards are a separate market, which is why they would not lose market share when prices rise. But all of the networks have raised the interchange rates, albeit not uniformly. There is not adequate publicly available data to compare the amount of each network's

263. CardData, *supra* note 12.

price increase, and determine whether there is any significance to the variation in price increases, but there is certainly significant variance in the merchant discount fee charged to merchants both by brand and by product within brand. There is no publicly available data on charge volume or outstandings by product, so we cannot draw conclusions about intrabrand competition on this basis. But we still have the puzzle of why brand market shares remained static even when prices increased nonuniformly.

A possible resolution to this puzzle is to define each credit card network as a separate, relevant market. The idea of defining each network as a market unto itself seems, on first impression, both bizarre and tautological, but even seemingly interchangeable products may be separate markets for antitrust purposes.

Adopting a functional market definition and market power analysis, the Second Circuit has acknowledged that even seemingly interchangeable products, like a brand name pharmaceutical and its generic equivalents may be separate markets for antitrust purposes.²⁶⁴ Thus, a brand name drug may in fact be a market unto itself and not compete against generic equivalents. The evidence for this argument included the substantial price differential between the brand name and generic equivalents²⁶⁵ and the inelastic demand for the brand name product.²⁶⁶ The brand name drug's price did not decline with the entry of a cheaper generic into the market; it actually rose, and with little effect on consumer demand.²⁶⁷

Credit card networks also appear at first blush, to be interchangeable products. To consumers there is no difference between a MasterCard and Visa. They have near identical acceptance among merchants and can be used for all the same transactions in the same way. Likewise, for merchants there is no significant difference, other than price, between an American Express card and a Discover card.²⁶⁸ Moreover, the networks seem to compete against each other in their consumer advertising.²⁶⁹

Yet it is impossible to explain how all credit card networks have raised their interchange rates without a corresponding decline in corresponding transaction volume, except by viewing each credit card network as its own

264. *Geneva Pharms. Tech. Corp. v. Barr Labs., Inc.*, 386 F.3d 485, 496–500 (2d Cir. 2004). Notably, pharmaceuticals have two-sided market characteristics, with doctors and patients both as consumers.

265. *Id.* at 496–97.

266. *Id.* at 497–98.

267. *Id.* at 496–97.

268. There may be minor differences in the chargeback process and other rules, but these are incidental to the central function of payment.

269. EVANS & SCHMALANSEE, *supra* note 22, at 190–201 (discussing network advertising campaigns).

product. Despite nonuniform price increases among credit card networks, none of the networks have lost market share to other, cheaper payment systems. Moreover, the market share shifts among the networks, which have varied year-to-year, do not correlate with their pricing.

The only apparent explanation for this phenomenon is that credit card networks do not compete with each other for either merchant acceptance or cardholders. Merchants can, and generally do, accept multiple credit card brands, and the merchant does not choose what card brand is used for a transaction; that is the cardholder's choice. The merchant can only control the menu of options, not select among them. The cardholder too is not limited to carrying one network's card, and when a cardholder chooses among card products, the choice is really whether to use a particular product of a particular issuer, not whether to use a particular network's card. The features that differentiate cards for consumers, such as rewards programs or, to a much lesser extent, pricing, are issuer- not network-specific.²⁷⁰ Inter-network competition appears to be primarily a competition for issuers, not a competition for cardholders or merchants. For the purposes of merchants and consumers, each card network is a separate market.

Indeed, we know that merchants do not see Visa as a substitute product for MasterCard and vice versa because merchants have not stopped accepting either networks' products as the result of price increases. Rather than being a tautology, a definition of each individual card network as being a market unto itself is the only way to explain the anomalies of credit card competition patterns. And because each network is a market unto itself, each network exercises a monopoly over its own services.

Absent merchant restraints, each credit card network would compete with other credit card networks and with all other payment systems. That is, with proper efficiencies, the relevant market for analyzing market power would be a market for all consumer payment systems. Merchant restraints warp market definition by cabining off each network from competition with other networks. Merchant restraints form artificial boundaries within these markets to protect credit cards from having to compete against more cost-efficient payment products and against each other. Because of merchant restraints each credit card network is a market unto itself for its services,

270. Until recently there was no distinction between the issuer and the network for American Express or Discover. See *supra* text accompanying note 57. Now that both networks have third-party issuers, it is apparent that the features that differentiate cards for consumers are in fact issuer, and not network, specific. For example, American Express generally offers a superior level of services to cardholders, but many of these services are limited to cards issued by American Express bank, and not by third-party issuers.

which is why each network has been able to raise its prices significantly without losing market share to other payment systems or to other credit cards. Merchant restraints make each credit card network the relevant market.

Once market definition is settled, the inquiry turns to market power.²⁷¹ Market power is the “power to control prices or exclude competition.”²⁷² Determining market power, though, depends on market definition. Since each card network is a market unto itself, market power is self-evident. But even if we were to define the market as either a consumer payment systems market or the general purpose credit card market, it would not alter the conclusion that credit card networks jointly and severally exercise market power by controlling prices through merchant restraints.²⁷³ Merchant restraints set the prices charged to credit card consumers as equal to the prices charged to the consumers of all other payments systems. Merchant restraints also set the prices of all credit cards as equal to each other, both between brands and within brands. By so doing, merchant restraints give credit card networks the power to exclude competition. By shifting the basis of competition in payment systems away from cost and to bundled benefits, merchant restraint rules erect a powerful barrier to entry for competitors with more cost-efficient products.

B. Tying

Honor-all-card rules are tying provisions that appear to violate section 1 of the Sherman Act.²⁷⁴ Honor-all-card rules require that merchants who take one type of credit card product or service—nonrewards cards—also purchase another product or service—rewards card transactions. Thus, acceptance of two products—regular credit cards and premium rewards cards are tied together by honor-all-card rules. The same goes for the tying of consumer cards and corporate cards.

271. It is unclear whether market power is a requirement of a Sherman Act section 1 claim. See *United States v. Visa U.S.A. Inc.*, 344 F.3d 229, 238 n.4 (2d Cir. 2003).

272. *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 391 (1956) (footnote omitted).

273. In 2003, the Second Circuit upheld a finding of joint and several market power for Visa and MasterCard in the payment card network services market based on figures of then 47 percent and 26 percent of payment card network market share respectively. *Visa*, 344 F.3d at 240.

274. See 15 U.S.C. § 1 (2000).

Tying by a party with market power is per se illegal.²⁷⁵ If the credit card networks are found to have market power, then the only defense available to them against a tying claim is that rewards cards and corporate cards are not separate products from regular credit cards. There must be two products for tying. It is hard to argue that rewards cards and corporate cards are not separate products from regular consumer cards. The credit card industry has long viewed corporate cards as a distinct market, and has priced and marketed rewards cards separately. Moreover, as we have seen, merchants do not cease to accept rewards and corporate cards in response to a SSNIP; indeed, even without merchant restraints they would not likely do so, but merely surcharge for them. The solitary product defense is unconvincing.

C. Horizontal Price-Fixing

Merchant restraint rules likely constitute horizontal price-fixing arrangements. Horizontal price-fixing—price-fixing between competitors—is a per se section 1 violation.²⁷⁶ First, nondifferentiation and honor-all-cards rules are the fixing *between the competing banks within a network* of the price of credit card services to merchants. Merchants are required to accept all of the network brand's cards and at the same price.

Second, if the market is defined as general purpose credit cards, then no-surcharge rules can be seen as horizontal price-fixing *between the different credit card networks* because they equalize the point-of-sale price of all credit card networks' cards. Traditionally, horizontal price-fixing requires some form of an agreement. Conscious parallelism in pricing is itself not illegal,²⁷⁷ but anything beyond mere parallel pricing by oligopolists might be sufficient.²⁷⁸ Rules that mandate parallelism might rise to the requisite

275. See *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2, 15–18 (1984). As with vertical price-fixing, recent Supreme Court decisions indicate that tying might no longer be per se illegal, but only a rebuttable presumption. See, e.g., *Ill. Tool Works Inc. v. Indep. Ink, Inc.*, 547 U.S. 28, 44–45 (2006) (eliminating the presumption of market power for patent holders and avoiding the use of the term “per se” in discussing anticompetitive effects).

276. See, e.g., *Arizona v. Maricopa County Med. Soc’y*, 457 U.S. 332, 348 (1982); *Catalano, Inc. v. Target Sales, Inc.*, 446 U.S. 643, 647 (1980).

277. See, e.g., *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 227 (1993) (“Tacit collusion . . . sometimes called conscious parallelism . . . [is] not in itself unlawful.”); see also Donald F. Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal*, 75 HARV. L. REV. 655 (1962).

278. See *In re High Fructose Corn Syrup Antitrust Litig.*, 295 F.3d 651, 654–55 (7th Cir. 2002) (holding parallel pricing changes by competitors is prima facie evidence sufficient to survive a motion for summary judgment in the case of an oligopoly market in which five sellers controlled 90 percent of the market). *But see Williamson Oil Co. v. Philip Morris USA*, 346 F.3d 1287 (11th Cir. 2003) (“Evidence that does not support the existence of a price fixing conspiracy any more

level, and the unusual degree of overlap between the bank participants in the networks surely satisfies the requisite level of agreement or would be a sufficient plus factor beyond parallel pricing, regardless of whether the banks are the owners or merely participants in the networks. As an unnamed former MasterCard general counsel wrote to the Department of Justice in 1992, “[E]ach of the Associations is a fishbowl, and officers and board members are aware of what the other is doing, much more so than in the normal corporate environment.”²⁷⁹ There is a difference between parallel pricing among pure competitors, such as airlines, and competing associations with overlapping membership, such as credit card networks.

Perhaps more crucially, the very form of the no-surcharge rules provides the agreement. No-surcharge rules are written so that they specifically link different networks’ prices to each other. All the credit card networks, not just one, have no-surcharge rules, and they also have other merchant restraints designed to bolster the effect of no-surcharge rules, particularly requiring that merchants accept all cards of the networks’ brand for all transactions.

These rules go beyond mere parallel pricing and have the same effect as if there were an active agreement between networks.²⁸⁰ Whether such functional collusion would suffice for violation of section 1 absent direct agreement is uncertain, but given how recent antitrust jurisprudence looks to the economic realities, rather than to formalities,²⁸¹ it should. If no-surcharge rules are horizontal price-fixing arrangements, they are illegal regardless of any economic justification.

D. Vertical Price-Fixing

No-surcharge and no-differentiation rules can also be cast as vertical price-fixing arrangements between the issuer, the network, and the acquirer

strongly than it supports conscious parallelism is insufficient to survive a defendant’s summary judgment motion.”). Judge Posner, however, has long advocated viewing conscious parallel pricing by an oligopoly as a violation of the Sherman Act. Richard A. Posner, *Oligopoly and the Antitrust Laws: A Suggested Approach*, 21 STAN. L. REV. 1562 (1969). See Matthew M. Bunda, Note, *Monsanto, Matsushita, and “Conscious Parallelism”: Towards a Judicial Resolution of the “Oligopoly Problem,”* 84 WASH. U. L. REV. 179 (2006), for a recent attempt to reconcile the Posner and Turner positions.

279. *Merchants Seek Structural Changes to Interchange in Amended Suit*, GREEN SHEET, May 22, 2006, at 34, available at http://www.greensheet.com/gsonline_pdfs/060502.pdf.

280. See sources cited *supra* note 43, for text of rules.

281. See, e.g., *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2720 (2007) (reversing the 96-year-old precedent that minimum resale price restrictions were per se antitrust violations, and instead holding them to be subject to rule of reason review); *Ill. Tool Works Inc. v. Indep. Ink, Inc.*, 547 U.S. 28, 31 (2006) (reversing an older doctrine that the possessor of a patent was deemed to have market power).

to fix the price of the interchange rate, as no-surcharge and no-differentiation rules ensure that the interchange rate gets passed on in whole to merchants as consumers of card services.²⁸²

Vertical price-fixing typically involves a wholesaler and a retailer fixing the price of their own product at resale. Vertical resale price fixing of both maximums and minimums is reviewed under the rule of reason standard; it is not a per se violation.²⁸³ As we have seen, however, the supposed pro-competitive economic rationales for merchant restraints based on the need to avoid the network externality wither under scrutiny, so there is no pro-competitive concern to offset the anticompetitive effects of the rules.

No-surcharge rules have aspects of both maximum and minimum vertical price-fixing. If merchants are seen as retailers of credit card services to cardholders, then no-surcharge rules are imposing a maximum price level for credit cards—that of competing payment systems. No-surcharge rules are also imposing a minimum price *on other payment systems*. Typically, vertical price-fixing involves a manufacturer setting an absolute resale price for its own product. Here, though, merchant restraints link the resale price of a network's card product to that of a competitors' product.

Nondifferentiation rules do the same in terms of fixing the price of higher interchange rate cards and lower interchange rate cards—the maximum retail price for the high interchange rate cards is constrained to being the retail price of the low interchange rate cards, and the minimum retail price of the low interchange cards is the retail price of the high interchange cards.

E. Hybrid Section 1 Violations?

No-surcharge and nondifferentiation rules can also be seen as unique hybrid antitrust violations in that they are vertical arrangements that have the horizontal price restraint effects. No-surcharge and nondifferentiation rules fix the relative, not the absolute price that *merchants* can charge for credit cards and thus for all other payment systems. No-surcharge rules do not fit neatly into the established categories of section 1 violations. Instead, they resemble competitor-based pricing provisions (CBPP) or

282. Alternatively, no-surcharge rules can be seen, from a consumer perspective, as a vertical arrangement between the networks' members and the merchants to fix the price of credit cards (and all payments) at the point of sale.

283. *Leegin*, 127 S. Ct. at 2720 (stating that the rule of reason standard governs the legality of vertical minimum resale price restrictions); *State Oil Co. v. Khan*, 522 U.S. 3, 10–19 (1997) (finding that rule of reason governs the legality of vertical maximum resale price restrictions).

parity clauses, such as Most Favored Nation (MFN) clauses or Meeting Competition Clauses (MCCS) in contracts.

MFN clauses are essentially guarantees that a buyer will receive the best price offered. MCCS provide that one buyer (or seller) will match any offer made by a competing buyer (or seller). CBPPs insure against bidding wars, which makes them useful for parties purchasing unique goods or services. CBPPs can also be used to allocate risk of price changes, and insure against competitive disadvantage, and incentivize cost minimization.²⁸⁴

The problem with CBPPs is that while on their face they appear to have no effect other than to guarantee the best possible price for one party in the contract, they may actually lead to higher prices for competitors and deter price competition. CBPPs can “create the same effect as a horizontal conspiracy to fix price [in which] the contract with the ‘victim’ can substitute for the horizontal contract or agreement.”²⁸⁵ Absent a CBPP, a seller might provide some purchasers with greater discounts than others. If the party imposing a CBPP makes up a significant portion of the seller’s revenues, however, the CBPP may inhibit the seller from discounting for other purchasers.²⁸⁶ Thus, the FTC has brought enforcement actions against MFNs used by parties to market power because “[a]n MFN clause imposed by a dominant group of competing sellers can establish a price floor and restrict competition that otherwise would allow prices to go below that floor.”²⁸⁷

While Richard Posner has cogently argued that all interdependent pricing should itself constitute an agreement for the purposes of the Sherman Act,²⁸⁸ his position remains a minority view. The majority position is that the key factor in distinguishing between CBPPs that have procompetitive effects and those with anticompetitive effects is the market power of the party imposing the CBPP. No court has yet held that CBPPs are necessarily antitrust violations.²⁸⁹ But if no-surcharge rules are seen as a form of CBPP,

284. Joseph J. Simons, *Fixing Price With Your Victim: Efficiency and Collusion With Competitor-Based Formula Pricing Clauses*, 17 HOFSTRA L. REV. 599, 608–10 (1989).

285. *Id.* at 601.

286. See Jonathan B. Baker, *Vertical Restraints With Horizontal Consequences: Competitive Effects of “Most-Favored Customer” Clauses*, 64 ANTITRUST L.J. 517, 519 (1996).

287. Press Release, Fed. Trade Comm’n, FTC Challenges “Most Favored Nation” Clause in Tennessee Pharmacy Network Contract (Jan. 19, 1996), available at <http://www.ftc.gov/opa/1996/01/rxcare.htm>.

288. RICHARD A. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* 71–75 (1976).

289. See, e.g., *Blue Cross & Blue Shield United of Wis. v. Marshfield Clinic*, 65 F.3d 1406, 1415 (7th Cir. 1995) (holding that the use of the MFN clause by a lawful monopolist was not price-fixing “in this case”); *Ocean State Physicians Health Plan v. Blue Cross & Blue Shield of R.I.*, 883 F.2d 1101 (1st Cir. 1989); *Kartell v. Blue Shield of Mass., Inc.*, 749 F.2d 922 (1st Cir. 1984); *E.I. du Pont de Nemours & Co. v. F.T.C.*, 729 F.2d 128 (2d Cir. 1984). Yet courts have

then credit card networks' market power likely means that no-surcharge rules violate section 1 of the Sherman Act, even if they do not fit into its conventional categories.

If we define the relevant market as consumer payment systems, then we see that no-surcharge rules tie the price of credit card brands to the price of their competitors' products—both to other credit cards and to other payment systems. No-surcharge rules are not price-fixing in the sense of saying, "The price of our product must be \$X." Instead, they are saying, "The price of our product at must be the same as all our competitors' prices." No-surcharge rules fix relative prices, not absolute prices. Thus, the card networks are not only fixing their own prices; *they are fixing their competitors' prices as well, without their competitors' consent.*

No-surcharge rules fix the price of credit cards relative to other payment systems. They also fix the price of credit card brands relative to each other. And no-differentiation rules fix the relative prices of different credit card products within each brand. Honor-all-cards rules, all-outlets rules, and no-minimum- and no-maximum-amount rules ensure that merchants are unable to avoid no-surcharge and no-differentiation rules. Merchant restraints present a complex and interwoven group of antitrust violations combining horizontal and vertical price-fixing and tying. The precise analysis of these violations depends upon market definition, but under any of the possible definitions—consumer payment systems, general purpose credit cards, or individual networks—merchant restraints violate antitrust law.

CONCLUSION

Merchants charge consumers the same price for all credit card transactions, although rewards cards and corporate cards cost far more than others. Merchants finance the rewards card and corporate card programs, but they do not derive any marginal benefit from them. Rather than generating additional sales, rewards and corporate programs merely induce consumers to shift transactions away from less expensive payment systems.

Credit card network merchant restraint rules prohibit merchants from accepting certain credit cards selectively and from pricing according to cost of payment. Merchant restraints thus prevent merchants from signaling to consumers the costs of different payment methods. Accordingly, consumers

also declined to hold CBPPs to be per se legal, and have denied motions to dismiss complaints based on competitor-based pricing clauses. See, e.g., *Blue Cross & Blue Shield of Ohio v. Bingaman*, No. 1:94 CV 2297, 1996 U.S. Dist. LEXIS 17091, at *9-*10 (N.D. Ohio, June 24, 1996); *United States v. Delta Dental of R.I.*, 943 F. Supp. 172, 192 (D.R.I. 1996).

never internalize the costs of their choice of payment system. Merchant restraints thus encourage more credit card transactions at higher price than would occur in a perfectly efficient market. The restraints also permit card issuers to externalize the costs of rewards card and corporate card programs to merchants and, ultimately, to consumers who do not use such cards. Thus, merchant restraints distort competition within the credit card industry and among payment systems in general.

The primary defense of merchant restraint rules—the need to protect against a negative network externality—is both historically inaccurate and inapplicable in the current competitive environment. Merchant restraints are naked restraints on trade that were created in response to federal branch banking, Truth-in-Lending, and state usury regulations, rather than in response to network economic concerns. Lacking a positive procompetitive justification, merchant restraints should be banned as antitrust violations.

As an array of new electronic payment systems begins to attempt to break into the market,²⁹⁰ the time is ripe for a reconsideration of merchant restraint rules and the regulation of payment systems in the United States. Banning merchant restraint rules would not be regulating credit card networks, as much as forbidding networks with market power from regulating the market themselves. The removal of merchant restraints would subject interchange fees to market discipline and would allow the free market, rather than powerful market players, to set the cost of the most ubiquitous transaction cost—payments.²⁹¹

290. See Levitin, *supra* note 13, at 478–85.

291. In March, 2008, bipartisan legislation was introduced that would require merchants and large card networks to negotiate with each other, with discovery, over interchange and merchant restraint rules and, if an agreement cannot be reached, to have a special administrative law judge panel decide which party's position is closer to what would prevail in a perfectly efficient competitive market. The proposal of the party that is closest to the judges' determination of perfectly efficient market terms will then govern for the next three years. See The Credit Card Fair Fee Act of 2008, H.R. 5546, 110th Cong. 2d Sess., Mar. 6, 2008, available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h5546ih.txt.pdf.