THE U.S. PAYMENT CARD INDUSTRY:

SELECT CHALLENGES AND ISSUES FROM A HOSPITALITY INDUSTRY PERSPECTIVE

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I. SCOPE AND BACKGROUND

Payment card acceptance is a critical business function for the hospitality industry. Unfortunately, recent trends regarding merchant acceptance of payment cards have not been good news. The cost of card acceptance has continued to climb as payment systems shift their cardholding base to premium cards that impose higher interchange fees directly deducted from the amounts due merchants. Card system rules governing card acceptance also have become more burdensome as their restrictions on the ability of merchants to reflect differences in the cost of payment types in the prices charged customers deny merchants the ability to respond to increasing card fees on a market-driven basis. And the card systems' enforcement and penalty procedures for alleged security breaches unilaterally impose liabilities and costs on merchants for circumstances for which merchants could bear no actual responsibility.

The purpose of this paper is to discuss these trends and actions merchants can take in response. A key focus will be on the role of the card systems' operating rules in controlling merchant conduct and liability for alleged rule violations acting much like a governmental agency, but without the due process protections that a governmental system might entail. The paper then turns to the role of the card acceptance agreements merchants sign with banks or their processor agents as the means by which the card systems' rules and liabilities are passed through to merchants—potentially as automatic deductions from merchants' cash flow from card transactions. Finally, the paper turns to recent developments (or non-developments) in Washington regarding merchants' relationship with card systems, and suggests possible actions members of the hospitality industry can take to resist the increasing costs and risks of liability from payment card acceptance.

A. Payment Card Acceptance: A Critical Part of the Hospitality Industry

Payment cards are the most predominant customer payment mechanism for hospitality merchants, comprising over 80% of sales at lodging establishments, and 70% at higher-priced table service restaurants.[1]

Merchant payment card acceptance has become increasingly complicated due to an evolving labyrinth of fees, escalating fee levels and types, one-sided acceptance agreements, and restrictive acceptance rules. Further, over the prior decade, merchants have found themselves subject to an amorphous data security regime, designed to shift liability to merchants, and in some cases, regardless of whether the merchant complied with the data security rules.

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[1] Visa Payment Systems Panel Study, *Visa 2006 Payment Trends Summary*, www.bos.frb.org/economic/eprc/conferences/payments2006/papers/hampton.pdf

The payment networks and their bank participants likely view the hospitality industry as a mature payment card acceptance market segment, with hospitality merchants highly reliant on payment cards to operate their business. Thus, those in the hospitality industry seem to be perceived by the payment card industry as among the least sensitive to payment card fees relative to other types of merchants, and as having virtually no choice but to accept payment cards. As such, hospitality merchants find themselves beholden to the payment card industry, and the fees and terms which the industry chooses to extend.

B. Participants and Relationships in the Payment Card Industry

Members of the hospitality industry usually work with multiple entities in order to accept payment cards. At the center of the process, merchants enter into a merchant card processing agreement with a bank (called the “acquiring” bank). The acquirer’s general responsibility is to accept payment card transactions from the merchant, process them with the payment card networks, and settle funds with the merchant.

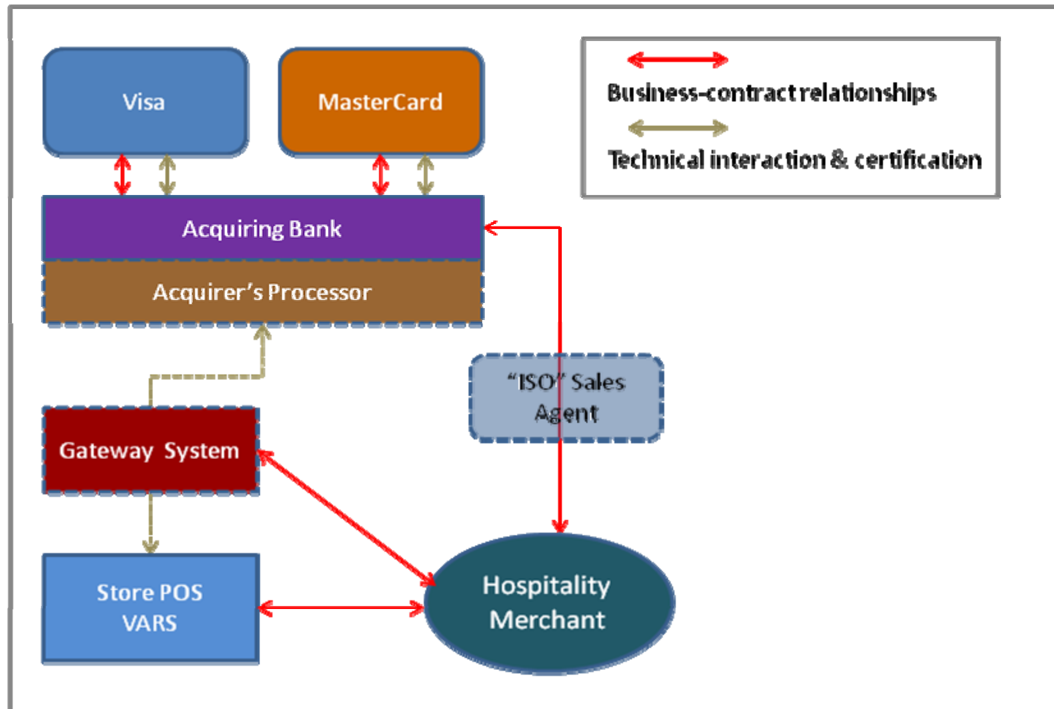
Acquirer banks often engage third party entities, called independent sales organizations (“ISOs”) for merchant card sales. Often times, a merchant agreement is cosigned by an ISO. Acquirers also contract with third party processing companies such as TSYS or Global Payments to manage transaction processing and various back-office functions. However, third party processors are typically not a party to merchant agreements.

Aside from bank acquirers, there are also significant non-bank acquirers such as First Data and Heartland Payment Systems who sell merchant services, contract with merchants and manage merchant’s processing. Nonetheless, the non-banks are required by the card networks to affiliate with a bank to sign merchant agreements and operate their card acceptance services.

Apart from the banks and their third party agents, hospitality merchants contract with third parties for property management and point-of-sale systems installation and maintenance. Hospitality merchants may also contract with entities known as payment gateways which provide transaction routing, reporting, and transaction management functions.

Figure 1 illustrates how various entities interact in contractual and technical manners in providing card acceptance services to a hospitality merchant.

Figure 1 – Entities in the Merchant Card Acquiring Industry



II. U.S. PAYMENT CARD MERCHANT ACCEPTANCE SERVICES: HIGHLY CONCENTRATED SETS OF PROVIDERS IN ACQUIRING, PAYMENT NETWORKS, AND ISSUING

Hospitality merchants operate in a payment card industry that is increasingly concentrated in the hands of a small group of providers. U.S. general purpose payment card spending activity is highly concentrated throughout the merchant acquiring, card issuing, and brand network services markets.

A. Merchant Card Acquiring Market Characteristics

Figure 2 shows the top 10 U.S. acquirers in 2008, ranked by the acquirers' processed Visa and MasterCard sales purchase volume. Merchant card acquiring has increasingly become concentrated among a small number of companies.

Figure 2 – Top 10 U.S. Acquirers

Top 10 Acquirers in 2008 by Visa/MasterCard Purchase Volume
Dollars in Billions, Signature Debit and Credit Purchase Volumes

2008 Rank	Acquirer	2008 Purchase Volume	Cumulative Share of Total Visa/MC Processing Volume
1	Chase Paymentech Solutions	$566.90	22.7%
2	*First Data (*)*	*$293.18*	*34.4%*
3	Bank of America	$283.09	45.8%
4	Elavon (subsidiary of US Bank)	$181.07	53.0%
5	Fifth Third Processing Solutions	$164.90	59.6%
6	Citi Merchant Services	$102.82	63.8%
7	*Global Payments (*)*	*$92.68*	*67.5%*
8	Wells Fargo Merchant Services	$90.84	71.1%
9	*Heartland Payment Solutions (*)*	*$74.68*	*74.1%*
10	First National Merchant Solutions	$51.38	76.2%
	Others	$595.47	100.0%
	Total	**$2,497.00**	

Notes: *(*) indicates an acquirer unaffiliated with a Visa or MasterCard issuer.*
Total Visa/MC credit and signature debit volume for 2008 was $ 2.497 billion per Nilson acquirer report
The top 50 acquirers represent 92.9 % of total Visa/MasterCard purchase volume in 2008.

Sources: Nilson Report Issues #899, (March 2008), #922 (March 2009), #923 (April 2009), #924 (May 2009)

In 2008, the top 10 U.S. acquirers of Visa and MasterCard branded payment transactions processed 76.2% of Visa and MasterCard U.S. sales volume.[2] In contrast, in 1989, the top 10 acquirers processed 49% of Visa and MasterCard sales volume.[3] Notably, most of the top acquirers in 2008 are also significant payment card issuers.

B. Card Issuing Market Characteristics

Similar to the acquiring market, credit and signature debit card issuing in the United States is also highly concentrated: the top 10 issuers of Visa and MasterCard branded credit cards comprise 81% of U.S. purchase volume.[4] Debit card issuance is very similar to credit in its

[2] The Nilson Report Issues #899 (March 2008), #922 (March 2009), #923 (April 2009), #924 (May 2009).
[3] Federal Reserve Bank of Philadelphia, *The Merchant Acquiring Side of the Payment Card Industry: Structure, Operations, and Challenges* (October 2007), www.philadelphiafed.org/payment-cards-center/specialists/kjos
[4] The Nilson Report Issues #918 (January 2009), #924 (May 2009).

concentration: the top 10 issuers of signature and PIN debit cards process 76.2% of purchase volume.[5]

The chart below shows the top 10 U.S. Visa and MasterCard credit card issuers in 2008, ranked by each issuer's sales purchase volume.

Figure 3 – Top 10 U.S. Issuers

Top 10 U.S. Credit Card Issuers in 2008 by Visa/MasterCard Purchase Volume
Dollars in Billions

2008 Rank	Issuer	2008 Purchase Volume ($B)	Cumulative Share of Total Visa/MC Processing Volume
1	JP Morgan Chase	$341.02	24.9%
2	Bank Of America	$250.82	43.2%
3	Citigroup	$213.96	58.8%
4	Capital One	$87.58	65.2%
5	US Bank	$67.72	70.1%
6	Wells Fargo	$43.81	73.3%
7	HSBC	$38.13	76.1%
8	USAA Savings	$26.75	78.0%
9	Barclays	$23.01	79.7%
10	PNC Bank	$12.94	80.6%
	Others	$265.26	100.0%
	Total	**$1,371.00**	

Notes: Total Visa/MasterCard credit card purchase volume for 2008 was $1,371 billion.
The top 10 credit card issuers represent 80.6% of total Visa/MasterCard credit purchase volume in 2008.
The top 50 credit issuers represent 88.3 % of total Visa/MasterCard credit purchase volume in 2008.

Sources: Nilson Report Issues #918 (January 2009), #924 (May 2009)

[5] The Nilson Report Issue #923 (April 2009).

C. Credit Card Brands

The credit card brand payment network market is also highly concentrated. Visa and MasterCard are dominant providers of network services, holding shares of 42.4% and 28.2% of purchase volume respectively.[6] American Express holds 23.9% of credit card purchase volume processed, while Discover Financial Services holds 5.5%.

Figure 4 – Market Shares of Major U.S. Credit Card Brands

Credit Card Brand	Share
Visa	42.4%
MasterCard	28.2%
American Express	23.9%
Discover	5.5%

Source: The Nilson Report # 924 (April 2009).

D. Signature Debit Card Brands

Signature debit card network services are more highly concentrated than credit: Visa and MasterCard branded signature debit cards comprise nearly 100% of signature debit purchase volume, with Visa holding a 72.6% share, and MasterCard a 27.4% share.[7] American Express and Discover's debit programs are both very small, with insignificant market shares.

E. PIN Debit Card Brands

In the PIN debit network services market, Visa's Interlink network is ranked first, with roughly a 40% share of the purchase volume. First Data's Star network, Fidelity's NYCE network, and several others trail Visa's Interlink.[8]

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[6] The Nilson Report Issue #924 (April 2009).
[7] *Id.*
[8] The Nilson Report Issue #914 (November 2008); EFT Data Book, 2009 Edition, ATM & Debit News, Source Media Publications.

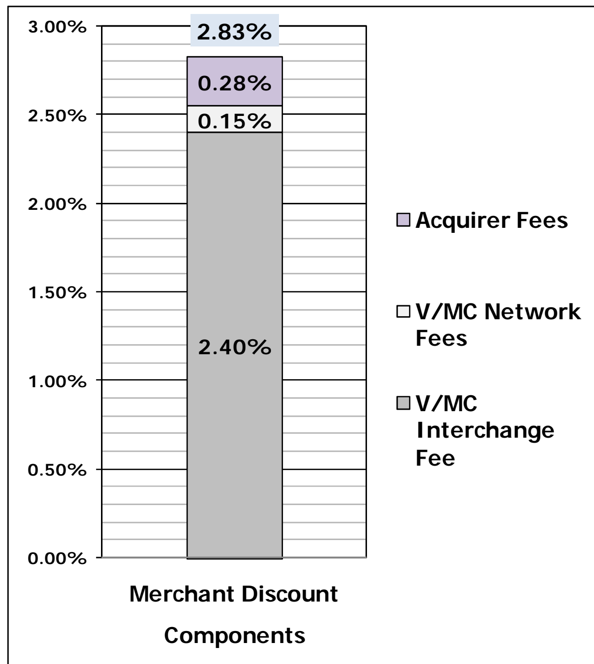
III. MERCHANT ACCEPTANCE COSTS: A LONG TREND OF ESCALATING INTERCHANGE AND PAYMENT NETWORK FEES

U.S. Merchants' general purpose payment card processing expenses have risen dramatically since the early 1990s. While some of the increased expense is attributable to higher levels of consumer use of payment cards, much of the increased expenses are due to fee levels which have markedly increased.

The majority of payment card expenses are the combined fees paid by merchants to the card issuers, acquirers, and payment card networks. Hospitality merchants' credit card acceptance fees in the United States are usually in excess of two percent of the transaction sale amount and depend on a myriad of factors. While most of the fee is charged by the issuer as "interchange," other components are charged by the payment networks, and the acquiring bank.

Merchants also usually bear third party systems and technology expenses associated with card acceptance, amounts that are usually significantly less than the interchange fees paid to card-issuing banks. For illustration, Figure 5 is the combined average direct acceptance cost of a Visa or MasterCard U.S.-issued premium or corporate credit card sale at a U.S. hotelier in 2009.

Figure 5 – Visa and MasterCard Credit Card Acceptance Cost: Premium or Corporate Card at U.S. Hotels



Sources: *The Rising Interchange Tab*, Digital Transactions Magazine at 8 (February 2008); Visa's U.S. interchange fee schedule at usa.visa.com/merchants/operations/interchange_rates.html; MasterCard U.S. interchange rates at www.mastercard.com/us/merchant/acceptance/interchange_rates.html; Palma Advisors research.

The total average direct cost is estimated to be 2.83% of the transaction sale amount. The 2.83% breaks down as follows: (1) An interchange fee payable to the card issuer of 2.40%, (2) network fees of 0.15%, and (3) an acquirer fee of 0.28%.

A. Payment Card Network Interchange Fees

The recent attention paid to the interchange fee component of merchant expenses, both in the courts and in Congress, is not surprising as issuer interchange fees are the largest component of merchants' payment expense, comprising 75% or more of acceptance costs.[9] While banks and payment networks have avoided releasing specific average credit and signature debit interchange fee figures, a 2008 payment card industry trade article estimated the average credit and signature debit interchange fee was 1.85%.[10]

Payment card interchange fees vary by a number of factors, most notably the type of merchant, type of card product being used, merchant's size, and mode of processing the transaction (face to face, e-commerce, etc.).[11]

Interchange fees have risen dramatically since the early 1990s, when they averaged about 1.20% of the sale amount. Figure 6 illustrates the average MasterCard and Visa credit and debit card interchange fee from 1981 through 2007.

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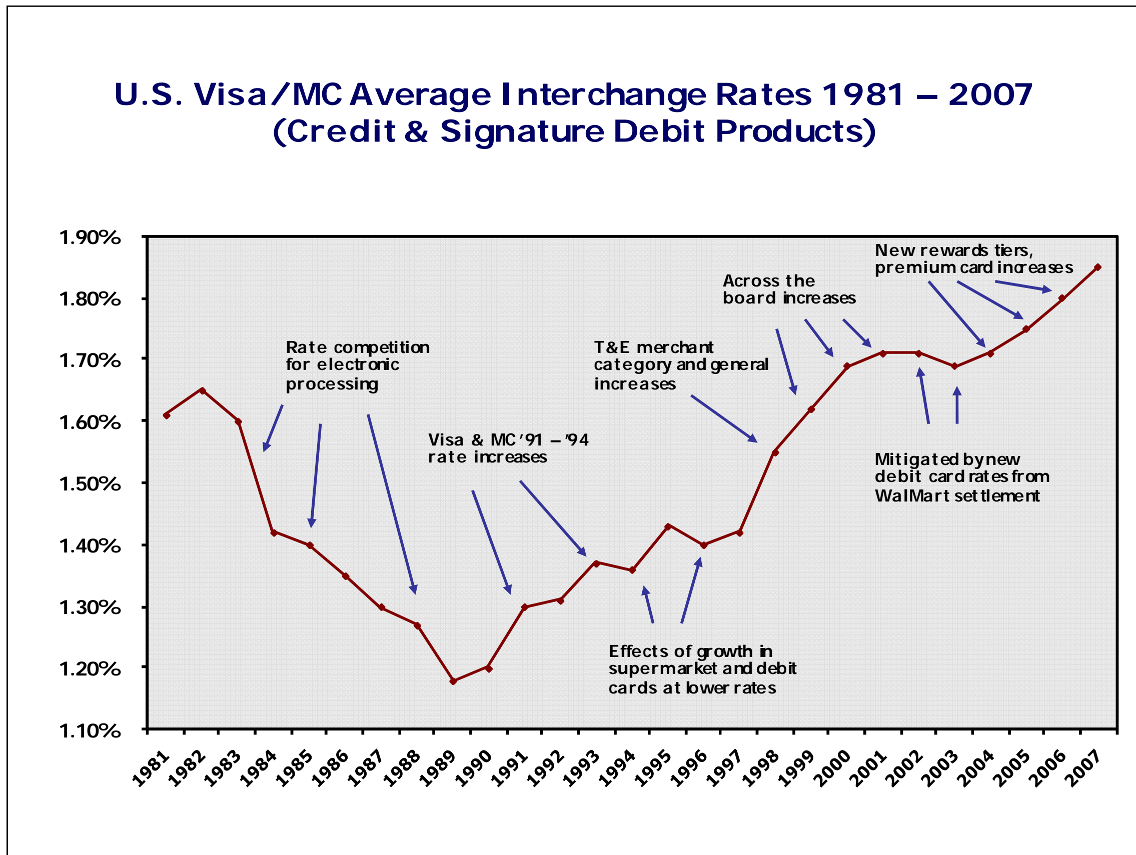
[9] Lauri Giesen, *Those Other Merchant Fees*, Digital Transactions Magazine at 22-25 (December 2009), http://www.digitaltransactions.net/files/DigitalTransactionsDec09.pdf

[10] *Trends & Tactics, Will the U.S. Meddle in Interchange?*, Digital Transactions Magazine at 8-9 (February 2008), www.digitaltransactions.net/archivemag.cfm

[11] U.S. Government Accountability Office, *Credit Cards, Credit Card Interchange Fees Have Increased Costs for Merchants, but Options for Reducing Fees Pose Challenges*, GAO-10-45, at 9-11 (November 2009), www.gao.gov/new.items/d1045.pdf

Figure 6



Sources: Presentation by William Sheedy of Visa at the Kansas City FRB Payments Conference (May 2005); The Nilson Report Issue #833 (May 2005); Cards & Payments Magazine (July 2005); Digital Transactions Magazine (February 2008); Palma Advisors research.

During the period of the 1980s, there was some competition between the Visa and MasterCard networks to lower interchange fees to encourage new merchants to accept payment cards, and existing merchants to adopt electronic processing techniques. The process of competition to attract merchants between Visa and MasterCard by lowering interchange rates reversed in the early 1990s. From the early 1990s to the present, both Visa and MasterCard have regularly raised interchange fees, causing the overall average fee to steadily increase.

The increases in interchange fees from the early 1990s to the present have paralleled a boom in U.S. bank's credit and debit card product profitability. In 2004, the Federal Reserve Bank reported to Congress that U.S. commercial banks' credit card earnings have historically been consistently higher than returns on all other commercial bank activities.[12]

[12] Board of Governors of the Federal Reserve, *The Profitability of Credit Card Operations of Depository Institutions* at 2 (June 2004), www.federalreserve.gov/boarddocs/rptcongress/creditcard/2004/ccprofit.pdf

B. Card Product Graduation – Dynamic "Upgrade" of Card to Higher Interchange Fee Program

While average rates have risen dramatically, hospitality merchants have likely borne a higher level of fee burden due to the higher incidence of rewards and corporate cards being accepted for payment. The payment networks have developed higher fee levels for cards with rewards programs and corporate card products.

Many banks have shifted large parts of their card portfolios into rewards and premium products. The networks introduced technologies several years ago which allowed issuers to dynamically redefine their card portfolios as "rewards cards" or "premium cards" without having to reissue cards to customers. The payment networks termed this new process product "graduation."[13]

Merchants become aware of higher acceptance costs resulting from rewards and premium cards only after being billed by the acquirer. Merchants have no way of knowing beforehand what the cost of accepting a card is. The rewards and premium card interchange programs act as stealth fee increases, known only to the merchant after a transaction is completed and settled.

Figure 7 demonstrates how a hospitality merchant's payment card expense escalates when a card account is redefined as a rewards or premium card.

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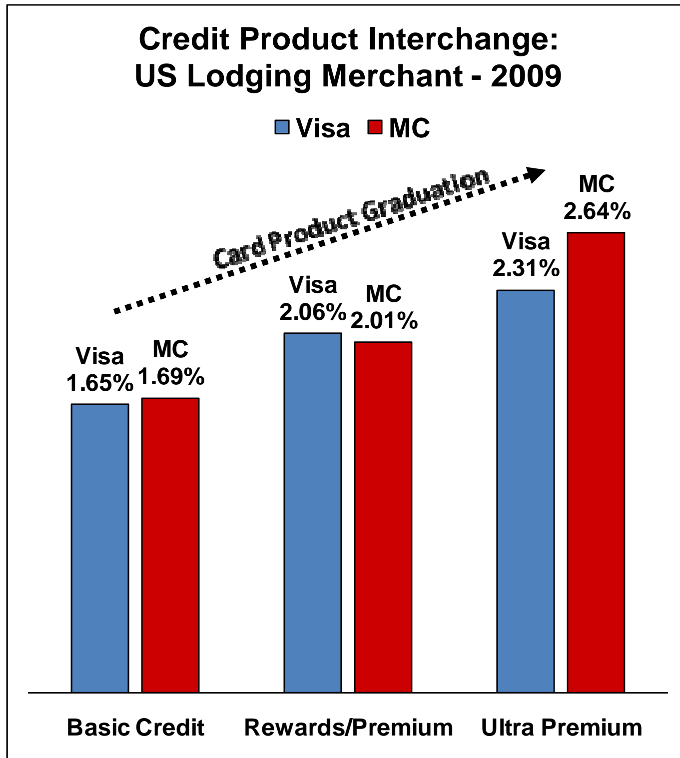
[13] *See* Jim Daly, *A Rewarding New Proposition for Interchange,* Digital Transactions Magazine (April 2007), www.digitaltransactions.net/archivemag.cfm

Figure 7

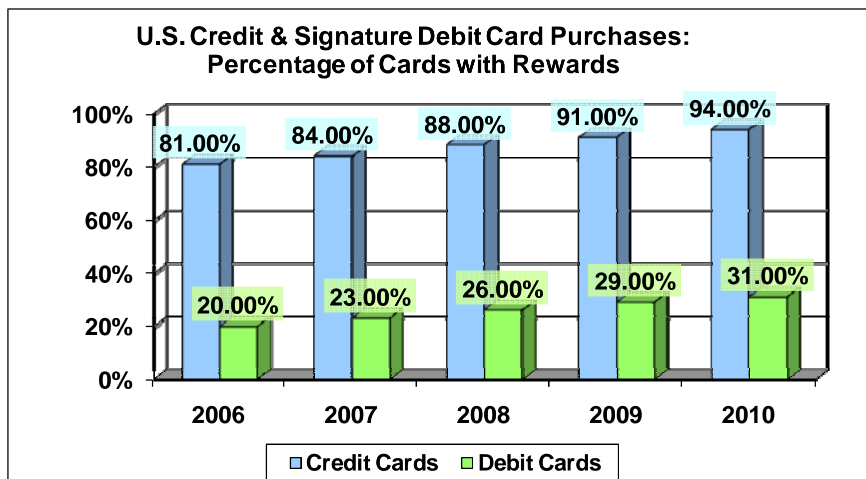


Sources: Visa's U.S. interchange fee schedule at usa.visa.com/merchants/operations/interchange_rates.html; MasterCard U.S. interchange rates at www.mastercard.com/us/merchant/acceptance/interchange_rates.html; Nilson Report Issue #924 (April 2009) (average transaction amounts).

C. Rewards Cards Becoming Ubiquitous

A large majority of credit cards issued now include a rewards program. Recent research indicates upwards of 90% of credit cards and 26% of debit cards are classified as "rewards" cards by the issuers and networks. The proliferation of rewards programs and the higher interchange fees they attract has driven merchant acceptance fees higher even in the absence of explicit rate increases. Merchants increasingly find themselves being charged additional interchange fee "surcharges" outside of their contracted merchant card acceptance rate. See Figure 8.

Figure 8



Source: Digital Transaction Magazine (February 2008).

D. Additional "Quasi" Network Interchange Fees

The payment networks charge merchants other "quasi" interchange-like fees. The payment network fees have been characterized as "a gold mine for the networks" in a recent payment card trade publication.[14] The network fees occur in a number of forms, including assessments, access fees, and cross-border transaction fees. These fees average about 0.20% of a transaction sales amount, yet increase to a staggering additional 1.00% on sales involving foreign-issued cards. The additional networks fees have increased nearly four-fold in 2009 alone, and are estimated to have added hundreds of millions of dollars to merchant payment card processing fee expenses.[15]

E. Acquirer Fees

Of course, acquirers charge fees for their services as well. Ironically, the acquirer fee is the only component of the merchant's payment card expense where there has been significant competition between acquiring firms over the prior 20 years. The result of this competition has been a decline in acquirer fees over the prior 20 years, by roughly 50%.[16] U.S. acquirer fees are heavily dependent on merchant's size and payment card sales volume, and scale from 0.02% up to

[14] Lauri Giesen, *Those Other Merchant Fees*, Digital Transactions Magazine at 22-25 (December 2009), http://www.digitaltransactions.net/files/DigitalTransactionsDec09.pdf

[15] One publication estimated new Visa and MasterCard merchant access fees would produce more than $600 million in new annual revenues for the networks. *See Higher Fees Could be Rainmakers for the Bank Card Networks,* Digital Transactions Magazine (March 2009), www.digitaltransactions.net/newsstory.cfm?newsID=2118

[16] Presentation by William Sheedy of Visa at the Kansas City FRB Payments Conference (May 2005), www.kansascityfed.org/econres/PSR/psrconferences/2005/Industry_panel.pdf; Palma Advisors research.

2.00%. Visa released figures in 2005 indicating the average acquirer fee for U.S. merchants as a whole was 0.28%.[17]

IV. VISA AND MASTERCARD OPERATING RULES—WHAT YOU SEE IS NOT NECESSARILY WHAT YOU GET

In the past, the card systems' operating rules—over 1,000 pages in length for Visa and MasterCard—were secret. That is, merchants would be bound by a changing series of liability provisions about which they could not have actual knowledge. After this embarrassing fact was disclosed in Congressional hearings in 2006,[18] Visa and MasterCard made *edited* versions of those documents available. But the disclosure is incomplete. Visa notes that in publishing the 670-page public edition of its General Rules:

> [W] e have omitted certain proprietary and competitive information from this manual. As such, a reader of this manual may observe non-sequential section numbering, and information that may seem out of context or incomplete regarding the subject. Visa makes no representations or warranties as to the accuracy or completeness of the text contained in this manual.

Further:

> Visa reserves the right to amend, modify, delete or otherwise change the *Visa Operating Regulations* at any time, and such changes, if made after the publication date noted in this version of the *Visa Operating Regulations* … will not appear in this manual. The contents of this manual will be updated in accordance with the normal publication cycle of the *Visa Operating Regulations*. In the event of any discrepancy between the text in this manual and the *Visa Operating Regulations*, the text contained in the *Visa Operating Regulations* takes precedence.[19]

Nonetheless, the merchant is still bound, even if they have no ability to have actual knowledge of the operating rules' contents.

A. Telling Merchants What To Charge Their Customers

Notwithstanding reticence in other areas, the card systems are happy to let the merchant know of some of the restrictions to which it has agreed: to honor all credit or debit cards issued by the card system's members, even if they are "premium rewards" cards carrying higher interchange

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[17] This figure is adjusted 0.9% to remove Visa's assessment fee. *See Merchants Target Interchange Costs*, Cards and Payments Magazine at 40-42 (July 2005).

[18] *Credit Card Interchange Fees: Antitrust Concerns?*: *Hearing Before the S. Comm. on the Judiciary*, 109th Congress at 25-26 (June 19, 2006).

[19] Visa U.S.A. Inc., *Operating Regulations- Volume I, General Rules* (Public Edition, November 15, 2008), http://usa.visa.com/download/merchants/visa-usa-operating-regulations.pdf

fees. Thus, MasterCard prohibits a merchant from providing *any* payment discount other than for cash, and also expressly prohibits merchants from charging customers for any fees they must pay to MasterCard or its members.[20] Visa is a little more "flexible," permitting discounts—so long as they don't provide an advantage to a direct Visa competitor:

> A Merchant may offer a discount as an inducement for a Cardholder to use a means of payment that the Merchant prefers, provided that the discount is:
>
> - Clearly disclosed as a discount from the standard price and
> - Non-discriminatory as between a Cardholder who pays with a Visa Card and a cardholder who pays with a "comparable card."
>
> A "comparable card" for purposes of this rule is any other branded, general purpose payment card that uses the cardholder's signature as the primary means of cardholder authorization (e.g., MasterCard, Discover, American Express). Thus, any discount made available to cardholders who pay with "comparable cards" must also be made available to Cardholders who wish to pay with Visa Cards.[21]

However, Visa contradicts the supposed flexibility of its allowable card discount with an "advertised price" rule which prohibits promoting at the point-of-sale any discounts using the merchant's co-branded cards and which requires that:

> Any purchase price advertised or otherwise disclosed by the Merchant must be the price associated with the use of a Visa Card….[22]

Of course, in most other industries, an agreement imposed by a dominant firm as to the price at which you can sell a competitor's product might be considered an "agreement in restraint of trade." But the major card systems clearly act as if such constraints should not apply to them. Indeed, a recent Visa advertising campaign claims its payment systems are "The Currency of Progress," far superior to mere cash and checks. And even a decade ago, December 14, 1999, Visa's attorneys advocated that courts should view Visa as a "private Federal Reserve."[23]

B. Establishing The Card Systems' Security Penalty Mechanisms

Visa and MasterCard's arrogation of governmental power is best illustrated by their effort to police payment system security (without the accountability of a government-run system). For

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[20] MasterCard, *MasterCard Rules* § 5.9.2 (November 6, 2009), http://www.mastercard.com/us/merchant/pdf/BM-Entire_Manual_public.pdf

[21] *Id.* at § 5.2.D.2.b.

[22] *Id.* at §§ 5.2.D.1, 5.2.D.3.

[23] *See* L. Constantine, G. Schnell, R. Cyr & M. Peters, *Repairing the Failed Debit Card Market: Lessons From an Historically Interventionist Federal Reserve and the Recent Visa Check/MasterMoney Antitrust Litigation*, 2 NYU Journal of Law and Business, 147, 198 n.187 (2005).

better or worse (from merchants' perspective), governments themselves have begun to address the issue of liability for card system data breaches.

For example, January 1, 2010 marked the effective date of a new Nevada law establishing the Payment Card Industry's Data Security Standard ("PCI DSS") as the required method by which merchants and those in the payment system processing chain are to protect sensitive payment card data from unlawful access and misuse. In particular, the new law establishes a safe-harbor defense: a "collector" of card data "shall not be liable for damages for a breach of the security" of its system if it is in compliance with the latest PCI DSS standard and the breach is not the result of gross negligence or intentional misconduct. 2009 Nev. Stat. ch. 355 § 1(3).

However, merchants *already* are subject to significant financial jeopardy arising from a detailed system of penalties and liabilities administered by Visa and MasterCard for alleged PCI-DSS violations. As set out below, the card systems have set themselves up as prosecutor, judge, and jury to penalize merchants and others with expressly denominated "fines," potentially amounting to hundreds of thousands of dollars—amounts that can be deducted automatically from payments owed to merchants from their card acceptance cash flow. In so doing, the card systems have simply presumed themselves to have governmental powers of punishment through mandated compliance with card system operating rules that no merchant ever signs directly. This situation is particularly troubling, given Visa and MasterCard's market power—there is no practical alternative to acceptance of those systems' cards.

At the heart of the card systems' power of punishment are the agreements Visa and MasterCard have with each of their "members," which include not only the banks that issue credit, debit, and stored-value cards, but the acquiring banks that provide card acceptance and processing services to merchants. Under their agreements with the card systems, members must require that merchants and processors agree to be bound by the card systems' operating rules, and these rules, in turn, require adherence by merchants to the PCI DSS requirements and to each card system's auditing, testing, and investigation procedures associated with PCI-DSS compliance. Visa calls its package of standards and compliance measures the "Cardholder Information Security Program" ("CISP"), while MasterCard calls its effort the "Site Data Protection Program" ("SDP Program"). These programs require more than just compliance: for most merchants they require an annual self-certification and quarterly security scans for systems connected to the Internet; larger merchants may need to have an annual onsite audit by a "Qualified Security Assessor."

Both programs are enforced against acquirers, processors, and merchants with a system of fines and penalties. Visa's CISP web site is careful to warn participants of these sanctions, but is vague as to their actual level:

> If a member, merchant or service provider does not comply with the security requirements or fails to rectify a security issue, Visa may fine the responsible member. Visa may waive fines in the event of a data compromise if there is no evidence of non-compliance with PCI DSS and Visa rules. *To prevent fines a member, merchant, or service provider must maintain full compliance at all times, including at the time of breach as demonstrated during a forensic investigation. Additionally, a member must*

demonstrate that prior to the compromise the compromised entity had already met the compliance validation requirements, demonstrating full compliance.[24]

Note that Visa's approach is to fine the "member," i.e., the acquiring bank, if there is a merchant violation; importantly, however, the acquirer's merchant agreements permit recovery of those fines from the merchant. According to Visa U.S.A.'s Operating Regulations,[25] a member is assessed a "fine" of up to $50,000 for the first violation in a rolling 12-month period, up to $100,000 for the second, and "[a]t the discretion of Visa U.S.A." for additional violations. Given that the count apparently includes violations by merchants and processors, it would not be a surprise if the "discretionary" level were easily reached.

MasterCard is more specific. The July 2009 release of its *Security Rules and Procedures-Merchant Edition*[26] specifies "assessments" for merchant non-compliance ranging from up to $10-25,000 for the first violation in a calendar year to up to $80-200,000 for the fourth, dependent on merchant transaction volume (the smallest merchant class, Level 4, appears to be exempt from assessments). Further, acquirers may be liable to card issuers for various loss claims resulting from a compromise, including $25 per reissued card and for other costs.

V. MERCHANT AGREEMENTS: CHANNELING VISA'S AND MASTERCARD'S RULES AND ENFORCEMENT POWERS

It's not unexpected that the agreements merchants signed with acquiring banks (or their processor agents) for accepting payment card transactions are long and complex documents worthy of a mortgage closing. Banks are banks, after all. Beyond specifying the bank's or processor's fees, merchant agreements also contain provisions that often grant acquirers unilateral rights, and create open-ended financial and legal exposures for the merchant. While the appearance and form of merchant agreements vary, most contain numerous troublesome terms for merchants such as the following:

- Allow the acquirer to change the merchants' pricing with limited or no notice.
- Permit the acquirer to establish reserve accounts, seize merchant funds, and retain funds for a period of time the acquirer determines.
- Grant the acquirer a security interest in merchants' funds and other assets, which may violate other lending covenants the merchant has agreed to.
- Establish one-way liquidated damages and indemnification, and in the event of dispute, waive the right to a jury trial.

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[24] *See* http://usa.visa.com/merchants/risk_management/cisp_overview.html#anchor_7 (emphasis added).
[25] Visa U.S.A. Inc., *Operating Regulations* § 1.7.D.27.
[26] MasterCard, *MasterCard Rules* § 10.5.4, http://www.mastercard.com/us/merchant/pdf/SPME-Entire_Manual_public.pdf

- In event of merchant declaring bankruptcy, require merchant waive and suspend various protections of bankruptcy code with regards to alleged liabilities of the merchant card acceptance service.

However, the most important provision of the agreement may be the short provision in which the signing merchant "agrees to comply with the Operating Rules" of the various payment systems whose cards the merchant wishes to accept. By accepting these rules merchants subject themselves to a wide range of rules and penalties—for example, restricting the discounts they can offer for use of different types of payment cards, and most significantly, subjecting themselves to the dominant card systems enforcement mechanisms with respect to data security standards, in which the card system serves as prosecutor, judge, and jury in posing fines and penalties for claimed compromises of card information.

A. Merchant Agreements Provide The Collection Mechanism For The Penalties

The fact that card systems impose fines and "assessments" on their members might be of limited concern for merchants, since merchants normally would have no direct agreements with Visa and MasterCard. As noted above, the agreements that merchants do sign with acquiring banks and/or their processors provide the link between card systems and merchants. The Wells Fargo agreement[27] appears typical: "you agree … to comply with all applicable Association [e.g., Visa and MasterCard] Rules."[28] In turn, the agreement requires compliance with the Visa CISP and the MasterCard SDP programs, stating that, "The Associations or we may impose fines or penalties … if it is determined that you are not compliant with applicable data security requirements."[29] Next, the Agreement requires indemnification of the bank against all "liabilities" growing out of a merchant's use of the bank's acquiring services, "including any third-party indemnifications we are obligated to make as a result of your actions (including any indemnification of any Association or Issuer)."[30] Finally, the agreement gives the bank a right of offset against all funds deposited into a merchant's settlement account from payments from the issuing banks for cardholders' purchases. In particular:

> We may also debit your Settlement Account or settlement funds in the event we are required to pay Association fees, charges, fines, penalties, or other assessments as a consequence of your sales activities. Such debits shall not be subject to any limitations of time specified elsewhere in the Agreement.[31]

In short, should Visa or MasterCard decide a merchant has violated elements of the CISP or the SDP Program, it has large discretion to assess a fine within the parameters outlined above, based

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[27] Denominated as the Wells Fargo Program Guide, www.wellsfargo.com/downloads/pdf/biz/merchant/program_guide.pdf
[28] Section 15.
[29] Section 4.1.
[30] Section 26.1.
[31] Section 10.2.

on the result of an investigation of a claimed breach incident. The fine and other related assessments (e.g., reimbursement for card reissues) are assessed on the acquirer, which then may automatically deduct them from the merchant's settlement fund cash flow. Keep in mind that the evidence of "breach" may merely be from a statistical analysis of "common merchants" used by cardholders whose cards have been the subject of fraudulent activity.[32] A merchant in this group found to be in PCI-DSS non-compliance may be deemed to be the cause of the breach, and subject to any resulting fines and penalties—and automatic offset from funds due to the merchant from payment card purchases.

Significantly, the merchant agreement will hold the merchant liable for these fines and penalties (and any other liabilities to others). This is so even if the fault for an actual (or claimed) breach is that of the software or service vendor that provided the systems or services found to be non-PCI-DSS compliant. For example, the Wells Fargo agreement expressly provides:

> You are solely responsible for the compliance of any and all third parties that are given access by you, to Cardholder data, and for any third party software that you may use.[33]

Even where the merchant bank is providing point-of-sale hardware or software as part of its service, the merchant agreements usually attempt to hold the merchant responsible for any losses arising from alleged breeches of all point-of-sale technology.

B. Is This System Of Card System-Imposed Fines And Penalties Really Legal?

This is a good question, which does not appear to have been answered definitively. It is Hornbook law that contractual "penalties" are unenforceable. That is, contracts may not contain provisions that provide *in terrorem* payment of money to deter a breach, rather than to compensate the other party should a breach occur. The reason is one of public policy: "It is well settled that the imposition of a penalty is exclusively the prerogative of the sovereign and that a contractual provision that operates as a penalty is unenforceable."[34] As the highest court in Maryland recently summarized:

> As Professor Williston has noted, "a liquidated damages provision will be held to violate public policy, and hence will not be enforced, when it is intended to punish, or has the effect of punishing, a party for breaching the contract…." We have long recognized that "one of the most difficult and perplexing inquiries encountered in the construction of written agreements" is determining whether a contractual clause should be regarded as a valid and enforceable liquidated damages provision or as a penalty. Thus, "if there is doubt whether a contract provides for liquidated damages or a penalty, the provision will

[32] *E.g.*, MasterCard, *Common Point of Purchase (CPP) Investigations*, Security Rules and Procedures- Merchant Edition § 10.4.
[33] Section 4.7.
[34] *Wetzler v. Roosevelt Raceway, Inc.,* 622 N.Y.S.2d 232, 235 (1st Dept. 1995).

be construed as a penalty."[35]

The contract law of many states evidences a similar hostility to penalties.[36]

However, the analysis required to determine whether a "fine" imposed by Visa or MasterCard is a "penalty," does not seem to require a "difficult and perplexing" inquiry at all. First, the penalty schedule effectively imposed on merchants does not represent a negotiated arrangement between merchants and Visa and MasterCard. The only contract that merchants have is with the acquiring bank or its processor agent. Merchants simply are compelled to abide by each card system's rules, whatever they might be. And, given the acquirers' right to indemnity from merchants, there is little incentive for an acquirer—the entity in actual contractual privity with the card systems—to resist changes in the level of the penalties, which the acquirers simply can deduct from a merchant's settlement account.

Second, the financial penalty is self-admitted to be just that—a "fine," "penalty," or "assessment" imposed by the card association to penalize and deter violations—with the amount of the fine increasing as the number of alleged violations per year increases. This is just like the fines associated with a traffic ticket, e.g., the greater the number of times a motorist is caught using a "high occupancy" lane while driving solo, the higher the fine. Third, the card systems are not damaged by a violation of the rules at all. The card issuers are separately to be reimbursed for cards reissued and other expenses, and the party being investigated must absorb the cost of the investigation.[37] So the penalties are just that, "penalties;" they do not even purport to be liquidated damages since they clearly are intended to deter violations and have no relationship to the cost to the card system, itself, of a claimed violation.[38]

VI. IS RELIEF ON THE WAY?

As set out above, the two dominant card systems use their members' merchant acceptance agreements as vehicles for unilaterally imposing increasingly burdensome merchant fees, rules, and data security penalty/liability mechanisms. While there has been discussion in the public policy arena concerning these trends, there have been few concrete developments to counteract them. Indeed, unlike the situation in other U.S. trading partners, such as the European Union and Australia, neither of our competition agencies (the Federal Trade Commission and the

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[35] *Barrie School v. Patch,* 933 A.2d 382, 390 (Md. 2007) (citations omitted).

[36] *See, e.g., Williston on Contracts* § 65.3 (May 2009 update).

[37] For example, Visa requires that a "compromised" merchant or Visa member should engage a "Qualified Incident Response Assessor" ("QIRA"). "However, Visa has the right to engage a QIRA to perform a forensic investigation as it deems appropriate, and will assess all investigative costs to the client [Visa member] in addition to any fine that may be applicable." Visa, *What To Do If Compromised* at 12 (December 2008), http://usa.visa.com/download/merchants/cisp_what_to_do_if_compromised.pdf.

[38] The card systems have claimed that other fees paid by merchants, such as the interchange fee and card system processing fees, are, in part, used to reimburse the card systems and issuers for the underlying fraud detection capabilities imbedded in the payment system.

Department of Justice's Antitrust Division) nor the Federal Reserve have taken action to address restrictive rules and high interchange fees imposed on merchants by Visa and MasterCard.

For example, the Federal Reserve would appear to have the ability, under its broad rulemaking powers under the Electronic Funds Transfer Act ("EFTA"),[39] to require clearance of all debit card transactions at par. This would recognize debit cards' role as an electronic check, the at-par form of demand payments from deposit accounts that the card systems seek to replace. (Merchants would pay only their share of the per-transaction cost of processing a debit card payment.) Nevertheless, the Federal Reserve has not addressed this issue—and indeed, it may soon not have the power to do so. Under the financial services reform legislation that passed the House in December, and which is pending in the Senate, authority for EFTA rulemaking is to be transferred to the proposed Consumer Financial Protection Agency. In contrast to the Federal Reserve's broad policy perspective, the new agency's focus may be on rules that directly affect consumers, rather than those that affect consumers indirectly by raising merchants' costs. Consequently, the debit card at-par issue may remain unaddressed.

In Congress, legislation to address the card systems' market power over the merchant community remains—at least for the present—confined to committee discussion. S. 1212, the "Credit Card Fair Fee Act of 2009," introduced by Sen. Durbin, would grant limited antitrust immunity so that merchants, or groups of merchants, could bargain collectively with each major payment card system regarding the terms of access to its system, including both rules and fees. If the parties reached a stalemate, they could turn to "baseball"-style (best-and-final-offer) arbitration before a panel of three "Electronic Payment System Judges." The panel, modeled on the Copyright Royalty Tribunal, would chose which of the final offers "most closely represents the fees and terms that would be negotiated in a hypothetical marketplace for access … between a willing buyer with no market power and a willing seller with no market power." (There are special considerations for issuers or acquirers that are credit unions or banks with less than $1 billion in assets.)

In the House, H.R. 2695, also titled the "Credit Card Fair Fee Act of 2009," introduced by Rep. Conyers, chairman of the House Judiciary Committee, is based on legislation reported out by that committee in 2008. It is similar to Sen. Durbin's bill, except that it does not include a provision for an arbitration panel. Instead, it would require disclosures to the Justice Department of certain cost and price information from either side to help the Department mediate differences between card systems and merchants in their negotiations.

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[39] 15 U.S.C. § 1693, *et seq*. The Federal Reserve confirmed its assertion of a broad grant of regulatory authority under the EFTA in proposing to regulate opt-in requirements for overdrafts associated with debit card transactions. Federal Reserve System, Electronic Fund Transfers-Proposed Rule, 74 Fed. Reg. 5212, 5215 (January 29, 2009) ("The legislative history of the EFTA makes clear that the Board has broad regulatory authority"). *See* L. Constantine, G. Schnell, R. Cyr & M. Peters, *Repairing the Failed Debit Card Market: Lessons From an Historically Interventionist Federal Reserve and the Recent Visa Check/MasterMoney Antitrust Litigation*," 2 NYU Journal of Law and Business, 147, 184-87 (2005).

Rep. Welch's H.R. 2382, the "Credit Card Interchange Fees Act of 2009," is the only bill that has been the subject of a hearing (before the Financial Services Committee) and takes a different approach. H.R. 2382 does not directly address interchange fee levels. Rather, it attempts to affect fee levels indirectly by outlawing specific payment system rules, such as those that prevent merchants from refusing to accept individual card products based on differences in their associated interchange fee levels, and those that restrict the ability of merchants to "steer" consumers to the merchants' preferred form of payment. It further prohibits transactions fees associated with a consumer's use of a "premium" payment card from exceeding the amount associated with use of a non-premium card. The bill would also give the Federal Trade Commission the power to prohibit card system rules or practices that are unfair or deceptive to consumers and merchants or are anticompetitive.

Given the uncertainty surrounding merchant issues in Washington, members of the hospitality industry may need to take action themselves to limit the potential harm from the card systems' unilateral control of merchants' payment card pricing practices and their unilateral imposition of fines and penalties for alleged payment system security breaches.

Larger firms may have sufficient clout with their processors to seek modification of the most onerous indemnification terms that pass card system penalties through to the merchant. All merchants should attempt to limit liability for assessments that are the fault of the merchant's software or systems vendors. At a minimum, merchants should attempt to forestall the automatic deduction from their card payment cash flow of penalties and liabilities for a claimed security breach—a "breach" the evidence for which may simply be a card system's statistical analysis.

Simply put, those in the hospitality industry should resist being at the bottom of the hill as liability cascades downward from all others in the card processing chain.