

The Second Circuit's Decision in *United States v. Visa/MasterCard*

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Editor's Note: Look in your wallet or pocketbook. How many charge or credit cards do you find there? About 75 percent of those cards are issued by competing consortia of banks—the well-known Visa and MasterCard brands, representing 50 percent and 26 percent, respectively, of general purpose cards.

American Express and Discover, in contrast, are proprietary firms that also offer well-known cards. They have, in recent years, sought to convince some of the banks in the Visa and MasterCard consortia to carry their cards. So-called exclusionary rules of both consortia prevent this—even though the consortia allow any bank to be a dual issuer of both Visa and MasterCard cards.

In 1998, the U.S. Department of Justice began a case challenging both Visa's and MasterCard's rules as anticompetitive. In a decision by a unanimous three-judge panel in the fall of 2003, the Second Circuit, applying the rule of reason, agreed that the Visa and MasterCard "exclusionary rules" had caused actual, unreasonably anticompetitive effects.

Three committees of the Antitrust Section—Financial Markets and Institutions, Section 1, and Civil Practice—found the decision of great interest and jointly sponsored a "brown bag" telephone conference. That conference featured a spirited discussion of the issues among four of the attorneys who participated in the trial of the case and the appeal to the Second Circuit.

The panelists challenged each other on a variety of questions that went to the core of the Second Circuit's application of the rule of reason:

- Could MasterCard, a firm that holds a 26 percent market share, really hold market power?
- Could a rule that allowed a bank to be a dual issuer of Visa and MasterCard cards, but prohibited a bank from issuing either American Express or Discover cards, be viewed as appropriate and ancillary to the joint ventures?
- If an arrangement is subject to the rule of reason, should (and did) the court's analysis change because the rules were promulgated by joint ventures of horizontal competitors?

- *Can the Second Circuit's ruling in the government's suit square with the Tenth Circuit's 1994 ruling in the private Mountain West action?*
- *Did the courts properly consider the practices of the card issuers in foreign markets in determining that use of the exclusionary rule in the United States was unlawful?*

The participants stand at loggerheads on these issues. And, as we go to press, Visa and MasterCard are expected to apply to the Supreme Court for certiorari, with their petitions for certiorari due on May 10, 2004.

—MATTHEW MOLOSHOK

MELVIN SCHWARZ: This is a “brown bag” program sponsored by three different committees of the ABA Antitrust Section: the Financial Markets and Institutions Committee, the Section 1 Committee, and the Civil Practice Committee.

I was trial counsel for the United States in this case in the district court. Our three panelists are: Adam Hirsh of the U.S. Department of Justice, Antitrust Division, who argued the appeal of this case in the Second Circuit; Larry Popofsky, who participated in the trial and has been counsel for Visa USA for many years; and, last but not least, Ken Gallo, who was trial counsel for MasterCard.

I'd like to give you a very brief thumbnail sketch of the case. This case was brought in October 1998 by the Department of Justice. Its complaint was based solely on Section 1 of the Sherman Act.¹ The complaint named three defendants: Visa USA, Visa International (the parent umbrella entity for Visa's international operations), and MasterCard International (which includes within it the U.S. operation).

The DOJ challenged two practices. The first was the defendants' practice of permitting their boards of directors to have substantial portfolios of “general purpose cards” in the other's system. As a result, Visa's board included members whose banks issued substantial (and in some case more) MasterCard cards than Visa cards—although that was rare for Visa. The flip side was that MasterCard board members could have a substantial portion or even a majority of Visa cards while they sat on the MasterCard board and made policy. It was the government's view that this last practice, which we referred to in shorthand as “dual governance,” had significant anti-competitive effects.

Before I go into the second practice, I should define the term “general purpose cards.” That term refers to credit and charge cards, also referred to as “payment cards,” that are accepted by a broad range of unaffiliated merchants. That distinguishes it from a card that might be accepted only at a particular department store or a group of stores, rather than being generally accepted.

The second practice was followed in the United States only. Both Visa and MasterCard had what we call exclusionary rules. These rules barred any of their member banks from issuing either American Express or Discover cards but did not bar them from issuing the other bank-owned network's cards.

The government viewed the exclusionary rules as substantially restricting competition in two markets. The first market was the market for general purpose cards, which is to say, a consumer market. The second market was for general purpose card network services, that is, the market in

¹ 15 U.S.C. § 1.

which card issuers seek to obtain clearing services and other network processes that permit acceptance of the cards nationally and internationally.

There was a thirty-four-day trial in the Summer of 2000 in the Southern District of New York before Judge Barbara Jones. The witnesses included merchants, present and former Visa and MasterCard executives, competitor witnesses from American Express and Discover, and four different economists—one from the Government, two from Visa and, one for MasterCard. In October 2001, Judge Jones issued a lengthy decision.² In it, Judge Jones ruled against the government on the “dual governance” count but in favor of the government on the exclusionary rules. (I should note in passing that the Judge also held Visa International liable for Visa USA’s exclusionary rule although Visa International had not imposed this rule and did not use it internationally). The government did not file an appeal, but all three defendants appealed. The Second Circuit affirmed on September 17, 2003.³

That gives you the general gist. To begin the discussion, each of the panelists will comment briefly on what lessons they take away from the Second Circuit decision.

ADAM HIRSH: I should start by giving a disclaimer that I’m here today in my personal capacity. The views expressed are my own. They do not purport to reflect those of the Antitrust Division or the U.S. Department of Justice.

The first thing to note about the Second Circuit decision is that it is short, direct, and concise. The slip opinion is only twenty-three pages, half of which sets out the background. So there’s only about eleven pages of discussion of the legal issues. The Second Circuit relies heavily on Judge Jones’s district court opinion, which the court of appeals praised as “commendably comprehensive and careful.”⁴

The second thing I’ll note is that facts matter. This was a full-blown rule of reason case. The district court made numerous findings, in a 157-page slip opinion. Essentially, the Second Circuit upheld those findings. The first finding concerned market power. The Second Circuit agreed with the district court that Visa and MasterCard, jointly and each separately, held market power. An important point here (which I’m sure Ken Gallo from MasterCard will talk about) is that the finding of market power was not based on their market shares. MasterCard’s share was 26 percent. It’s what you *do* with that share that indicates whether you hold market power.⁵

The second finding concerned anticompetitive effects. The Second Circuit agreed that, at the network level, “competition has been seriously damaged by the defendants’ exclusionary rules.”⁶ These rules resulted in “the total exclusion” of American Express and Discover from bank networks. The Second Circuit agreed that banks would issue American Express and Discover cards but for the bylaws at issue. Thus, the record indicated “price competition and innovation in services would be enhanced if four competitors, rather than only two, were able to compete . . . for issuing banks.”⁷

² *United States v. Visa U.S.A. Inc.*, 163 F. Supp. 2d 322 (S.D.N.Y. 2001) (opinion and proposed final judgment), *modified*, 183 F. Supp. 2d 613 (S.D.N.Y. 2001) (making changes to the proposed final judgment and entering judgment).

³ *United States v. Visa USA Inc.*, 344 F.3d 229 (2d Cir. 2003).

⁴ *Id.* at 234.

⁵ *Id.* at 238–40.

⁶ *Id.* at 240.

⁷ *Id.* at 241.

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—HIRSH

The third finding (and the Second Circuit was very strong on this) was that the exclusionary rules should be characterized as horizontal, rather than vertical, restraints. Defendants spent a lot of time arguing that this should be treated as a vertical case, but the Second Court flatly rejected that argument.⁸ And what makes it horizontal is that it is “an agreement among competitors on the way in which they will compete with one another.”⁹

The fourth finding was that the exclusionary rule had harmed competition. The defendants argued that all that was at stake was harm to competitors, not competition, but the Second Circuit made clear that those are not mutually exclusive, stating: “Without doubt the exclusionary rules in question harm competitors. The fact that they harm competitors does not, however, mean that they do not also harm competition.”¹⁰ Antitrust lawyers are always quoting *Brunswick*¹¹ about harm to competitors, not competition. This case addresses that.

The last thing I would take away concerns procompetitive justifications. The Second Circuit held that it is not sufficient to claim a procompetitive justification; you have to back it up with facts. Visa and MasterCard had claimed that their rules were ancillary to their joint venture. The district court rejected that on the facts. The Second Circuit agreed that, without factual support, there were no procompetitive justifications to outweigh the competitive harm.¹²

M. LAURENCE POPOFSKY: Can I start with a disclaimer, too? My disclaimer is I don’t mean to be disrespectful to the government. But it’s clear from what I will say that I think the courts applied an appalling analysis. Why the government should have (a) won it, and (b) defended it is quite beyond me.

Let me start out with an observation about history, since at heart I’m really a misplaced historian. Once upon a time, which is to say in the early 1970s, several banks formed the Visa organization as a joint venture to get around the fact that there was no interstate banking permitted then. MasterCard did the same. The world as it evolved initially, therefore, was there was a Visa joint venture, a MasterCard joint venture, and proprietary firms, American Express and, much later on, Discover and a few others.

Along the way, Visa made the judgment, then being somewhat smaller than MasterCard, that competition for it and for the world as a whole would be better if it had a rule which prohibited MasterCard banks from issuing Visa cards. And it passed such a rule. That was challenged by a Visa bank and eventually upheld under the rule of reason—upheld in the sense that to evaluate it you would have to have a full trial.¹³

Visa in the meantime went to the DOJ and asked, “Will you support us so that competition can be preserved between the systems, between the networks, if you will?” The DOJ, in what Bill Baxter called the worst decision that it ever made, declined to do so.¹⁴ Visa abandoned its rule.

⁸ *Id.* at 241–43.

⁹ *Id.* at 242–43 (quoting *NCAA v. Bd. of Regents*, 468 U.S. 85, 99 (1984)).

¹⁰ *Id.* at 243.

¹¹ *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477 (1977).

¹² 344 F.3d at 243.

¹³ *Worthern Bank & Trust Co. v. Nat’l BankAmericard, Inc.*, 485 F.2d 119 (8th Cir. 1973).

¹⁴ See DONALD BAKER & R. BRANDEL, *THE LAW OF ELECTRONIC FUND TRANSFER SYSTEMS* ¶ 23.02[3] (1988). Baxter later filed an affidavit in the *Mountain West* litigation (see *infra* note 15) on behalf of Visa in which he characterized the Division’s position with respect to duality as a “serious mistake.”

To the surprise of the DOJ, virtually every bank in the United States went dual, i.e., chose to issue both MasterCard and Visa. So, the world that evolved featured this remarkable phenomenon—two joint ventures competing with one another, yet having joint members and competing at the same time with proprietary firms.

We now flash forward to 1988. Discover tried to issue a Visa card. Visa refused, passing a rule that said, Discover, you're a competitor; you can't issue a Visa card. Visa's rule was upheld by the Tenth Circuit (after Visa had lost at the trial) and cert was denied.¹⁵ In 1996, AmEx said that it would like to start soliciting Visa and MasterCard banks to issue AmEx cards. And Visa responded with a rule, and MasterCard with a policy, saying that's a no-go as well because AmEx was trying to reconstruct the bad, once-upon-a-time world of duality, only AmEx wanted it to be *tri*-ality, where banks would issue AmEx, as well as Visa, as well as MasterCard.

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First, the government sought to regulate governance between the associations. That effort was roundly rejected by the trial court, again, "on the facts." Second, the government asked the courts to order the associations to permit AmEx and Discover to be issued by the banks. In other words, even though the government wanted Visa banks out of MasterCard's board and vice versa, it would force them both to carry AmEx and Discover. The two claims were at war with one another. The government ends up with what I think is the worst possible result. They are, in effect, compelling the market to go to triality and quadrality, although that is not what they wanted initially. Nor was it consistent with what they said about their concerns over opportunism if, in fact, AmEx and Discover were permitted to issue Visa or MasterCard cards.

So, what do we have then in the Second Circuit's opinion? Adam's absolutely right. It's an eleven-page discussion in which virtually nothing is defensible. It is true that the Circuit honored the trial court's findings as a basis for affirmance. But in doing that, it makes two fundamental assumptions about how a trial court should view the facts, i.e., the prism for evaluating facts before it.

First, in evaluating harm to competition, the trial court and the court of appeals both pay lip service to the rule of reason—the correct rule—the rule the government itself espoused. The courts then proceed to apply essentially a *per se* analysis to the facts because the joint venture is definitionally horizontal in one sense. In that way, these rulings sidestep all the vertical cases that focus on harm to competition. And in that way, these rulings avoid the facts of the case, which showed there was no harm to competition or any foreclosure in the usual sense of either American Express or Discover.

The second prism that these courts looked through was the justification prism. The trial court, instead of accepting the obvious—that joint venture rules that prohibit "moonlighting" are standard, procompetitive, and justified—started looking for something else. And the court of appeals said, well, that was just a factual inquiry.

Take your paradigm case: No lawyer is permitted simultaneously to practice law at Paul, Weiss and at Sullivan & Cromwell. Both are partnerships, a kind of joint venture. You would not expect that a lawyer could do that. Nor should you expect to need a great deal of effort trying to demon-

—POPOFSKY

¹⁵ SCFC ILC Inc. v. Visa USA Inc., 36 F.3d 958 (10th Cir. 1994), *reversing in part*, 819 F. Supp. 956 (D. Utah 1993), *cert. denied sub nom.*, Mountain West Fin. Corp. v. Visa USA Inc., 515 U.S. 1153 (1995) (*Mountain West*).

strate why a firm's establishment of such a restriction was procompetitive. It seems self-evident. But these courts ignored it, refused to address it, ignored the precedents and, in a few lines, simply say that such a restriction is unreasonable.

SCHWARZ: Let me interject one fact that I didn't mention but which was relevant to your comment, Larry. Just before trial, Visa USA instituted a requirement that all Visa's board members had to have at least 75 percent of their card portfolio in the Visa system. Judge Jones noted that rule change as a factor in her decision. And with that, Ken, would you care to add your thoughts?

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KENNETH GALLO: I'll make two brief points, picking up on some things Larry touched on. First, the Second Circuit essentially said that whether the restraint in question is vertical or horizontal impacts the substantive rule of reason analysis.

Defendants had argued that American Express was not competitively disadvantaged by this rule because there was no showing that American Express was foreclosed from getting its product to consumers. American Express was a very effective competitor, having a market share only slightly smaller than MasterCard's. Since American Express could get its product to consumers and expand output if there was demand for its product, there was no anticompetitive effect. But the Second Circuit gave that argument very short shrift. It held this is not a vertical case; this is a horizontal agreement among the members of the joint venture. The circuit court implied, if it didn't say it expressly, that this meant that a lesser showing was required under the rule of reason. I think that's just wrong.

The question of whether a restraint is horizontal or vertical goes to the issue of whether the *per se* rule or rule of reason applies. But once one agrees that the rule of reason applies—which everybody did in this case, including the lower court, the Second Circuit, and the government—then the geometry doesn't matter anymore. At that point, under cases like *North American Soccer League*¹⁶ and *Clorox*,¹⁷ the question ought to be whether the competitor is being effectively foreclosed from getting its products to consumers. The Second Circuit dodged that issue by acting as if the horizontal versus vertical character resolved, or was very important to, the rule of reason question. That is a real problem and is likely to create problems in the future.

Second, the district court and the Second Circuit found that MasterCard had market power with a 26 percent share. But a lot of case law, including *Jefferson Parish*,¹⁸ says there's a very strong presumption that if you have less than a 30 percent share, you don't have market power. There's no mention of those cases in the Second Circuit's decision. Nor is there any explanation as to how MasterCard, with a 26 percent share, could reduce output or raise prices when it has a competitor like Visa in the marketplace who had nearly a 50 percent share, and would pick up any of MasterCard's reduced output. Last, there's no explanation as to why MasterCard should be deemed to have market power at 26 percent and we need the full weight of the federal antitrust laws to protect American Express when American Express had about a 20 percent share. Somehow, with a 20 percent share, American Express has been substantially foreclosed from competing. But at a 26 percent share, MasterCard is able to exercise substantial market power.

—GALLO

¹⁶ *N. Am. Soccer League v. Nat'l Football League*, 670 F.2d 1249 (2d Cir. 1982).

¹⁷ *Clorox Co. v. Sterling Winthrop, Inc.*, 117 F.3d 50 (2d Cir. 1997).

¹⁸ *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2 (1984).

The case really doesn't address any of those anomalies. I think addressing them would have been essential to a cogent examination of market power.

The last point is that if someone's counseling a joint venture in light of this opinion, you have to pause very long on the ancillary restraint doctrine and how viable it is. If MasterCard, with a 26 percent share, can be deemed to have violated the federal antitrust laws because it has a loyalty rule of a type used very routinely in joint ventures, one needs to be very careful counseling around that issue.

SCHWARZ: It's slightly inaccurate to suggest that, in the trial court, the government conceded that a full-blown rule of reason analysis was necessary. Once we proved, as we thought we had, substantial anticompetitive effects, one only needed to make a quick look to see if there was any pro-competitive justification. It quickly became a moot point because a full-blown rule of reason analysis was conducted in any event.

HIRSH: The Second Circuit addresses that, by saying, in effect, that since we have a very large record in front of us, we don't need to decide whether the government could have gotten away with proving less.¹⁹

POPOFSKY: I'm really perplexed at the thought that this kind of controversy could have been addressed and resolved on a quick look basis. Although I know the government made a pass at it in the trial court, I thought it was almost a throw away, particularly after *California Dental*.²⁰

On its face, we had a practice which, as Ken pointed out, raised significant issues about whether there was an actual harm to competition. In addition, there was the interplay between this issue and whether the arrangement in question was horizontal or vertical. On its face, we had a restraint, the justification for which was virtually self-evident and which, as Justice Rehnquist once said, is at the core of the old ancillary restraint doctrine.²¹ So it is inconceivable a district court could seriously say, on a quick look, that is presumptively illegal.

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SCHWARZ: Larry, let me put it to you that Visa and MasterCard did not have, in our view, an exclusivity provision. They had a duality provision. That is, it was okay for some of their supposed competitors to have access to banks—indeed, there were even exceptions in the case of Citibank, which had its Carte Blanche on a separate network—yet there was express discrimination against American Express and Discover.

That fact undercuts your Paul, Weiss/Sullivan & Cromwell example, because in this case, it was okay to work at some firms, but not at others.

—SCHWARZ

GALLO: MasterCard and Visa, for the historical reasons that Larry laid out, had evolved in this so-called duality context. There's no question in my mind that the backdrop of Visa and MasterCard having banks that issued each other's cards made a big difference to the courts. That made it a much more complicated case instead of a simple case of a loyalty rule.

¹⁹ 344 F.3d at 238 n.4.

²⁰ *California Dental Ass'n v. FTC*, 526 U.S. 756 (1999).

²¹ *Nat'l Football League v. N. Am. Soccer League*, 459 U.S. 1074, 1078 (1982) (Rehnquist, J., dissenting from denial of *cert.*).

Having said that, a loyalty rule is generally viewed as an ancillary restraint. Do you come to it from a legal perspective, with a sort of favorable presumption or not? And can MasterCard and Visa explain the distinction that was made with respect to American Express? The Second Circuit and the trial court didn't struggle very hard to figure out if there was a distinction. In essence, they said, "You have a different rule for Visa than you do for American Express, therefore, it must be a pretext." It seems to me it's considerably more complicated than that, given the history in the industry.

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HIRSH: Loyalty rules are not necessarily ancillary. What makes a restraint ancillary is whether it's reasonably necessary to further the procompetitive aspects of the joint venture. You have to look at why it's enacted and how it's applied. Loyalty could just be another word for "not dealing with competitors." It may be beneficial to the joint venture, but that doesn't make it procompetitive.

What were the actual facts about these loyalty rules? The district court found, and the Second Circuit agreed, that these so-called loyalty rules were so riddled with exceptions that they weren't procompetitive. There was MasterCard's and Visa's exemptions for each other, their largest competitor. Also, Citibank, as Mel pointed out, which owns its own network—the Diners Club/Carte Blanche network—is dedicated to MasterCard but could still issue Visa cards. You've also got the foreign experience, where exclusionary rules don't apply—there, you have some banks that issue both Visa and MasterCard, and American Express cards. There was no evidence that that caused any lack of loyalty or that the associations were concerned about it.

—HIRSH

So, the district court rejected this particular procompetitive justification on the facts and the Second Circuit said, "That's right."

POPOFSKY: But there's no sense at all in this opinion, or even in the district court opinion, that they considered whether the Visa rule is analogous to a loyalty provision for a partnership. How you can get to a right result without analyzing that? The defendants were compelled, in a practical sense, to have a dual system, if you look back at the history of it. The defendants ended up hung by the history but without analysis.

As we got to the modern era as it were, Visa, at least, thought it would try to break duality. Hence, the rule that Mel mentioned, that started to try, internally, to control governance based on portfolio percentages. Visa was, in effect, saying, we'll draw the line in the sand on duality and not go to triality and quadrality because that would be harmful, not only to us, but to competition as a whole. From Visa's point of view, duality necessarily compromised competitive incentives. Visa, at least in its promotions, had had to hold its punches. It didn't say MasterCard had bad products and we're much better. All they ever did was say, "We're everywhere you want to be." So, there was no economic question that duality has a negative impact on competition. But that doesn't justify forcing triality.

Finally, Visa offered an expert to address the remarkable anomaly that American Express, if the government position is sustained, could sign up a Visa bank on a unilateral basis whenever it wanted and whosoever wanted. AmEx is not an open joint venture. It could pick and choose the members it wanted. That was what raised the opportunism issue. Visa and MasterCard are both open joint ventures. And our expert detailed why that mattered, and mattered dramatically. What ought to occur, and was occurring, was not an extension into triality to accommodate American Express, but a retreat from duality. We end up with a world which is, on its face, irreconcilable with the loyalty oath world one would like to see in place.

HIRSH: On Larry's duality point, we were always, I think, consistent that dual *issuance* was pro-competitive. We were trying to carve away the anticompetitive aspects of dual *governance* while maintaining the procompetitive aspects of dual or multi-issuance.

SCHWARZ: Ken, let me ask you a more focused question. The Second Circuit found a separate market for general purpose cards and also for network card services. But the trial court did not have any specific elasticity data. Is defining a market without looking at elasticity of demand data a significant departure from past precedents?

GALLO: I didn't view it as a substantial departure from precedent. There are many cases where the court determines the contours of a market and does a market definition analysis without using cross-elasticity data as such.

This was a strange situation because consumers really don't perceive they are paying a price for using their cards. (Sometimes they actually get a benefit for using their general purpose card if, for example, they get mileage on an airline.) That made it very difficult to figure out how you would apply the standard 5 percent test to ascertain if consumers would change from a general purpose card to a different form of payment if the consumer faced a price increase. The consumer was paying zero. A 5 percent increase of zero is still zero.

Nevertheless, having found that the consumers viewed it as a zero price, the district court then purported to apply the 5 percent test and said, even if the price went up 5 percent, people wouldn't switch. So, therefore, general purpose cards do not compete with other forms of payment, such as cash or checks. To me, it was a little bit mind-boggling to say the price is zero but yet we're going to go ahead and rely on a price test.

It seemed to us that the right test would have been to figure out whether MasterCard and Visa innovate in order to take share away from cash and check. Do they bring out new products? Do they have those competitive products on their radar screen when they bring out new innovations? If they innovate, they face competition. That is the analysis that we think should have been done but wasn't done.

SCHWARZ: Did defendants dispute the existence of a separate general card network services market?

POPOFSKY: Absolutely. Because it was always a wordplay without economic meaning. The network market may be just another name for systems competition. There clearly is competition between Visa, MasterCard, AmEx, and Discover. But a Visa or MasterCard rule that prohibited members of the joint venture from issuing Discover or AmEx points at the issuing market, not at the services or brand market. And when the government said that what you were doing was stopping the brands from competing for banks, what they were really saying was you were stopping the brands from getting their product to the consumer because you had a rule that was directed at issuance. No matter how you looked at it, it was all about the issuing market. This notion that somehow network markets were being impacted was entirely derivative of what happened in the issuing market.

You'll see the opinion discusses Coke and Pepsi and the whole question of exclusive distributorships.²² In any exclusive distributorship, you could say "network competition" was harmed,

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—GALLO

²² 344 F.3d at 242–43.

independent of what happens in the resale of the products by distributors to consumers. But we don't think of exclusive arrangements that way. No one thinks that integrated firms are denying their competitors network services because they're integrated. One could have a network market that mattered. Suppose Visa had a rule that required member banks to obtain security services from Visa when security services are available from lots of others, including AmEx. But this wasn't about that. This was about the AmEx brand presented to consumers. So, the invocation, if you will, of network services had a certain mysticism about it that was severed from what the trial was all about.

HIRSH: This is about input markets. Network services are an input to issuing. If there was a problem with three-inch screws as an input for making airplanes, that may not have a significant competitive impact on the price of airplanes. But sometimes problems in the input market will cause competitive impacts. This is one of those cases. The networks do not just sell services to issuing banks. They work with the banks to develop new products. You get innovation at the network level. You get a lot of support at the network level besides just the backbone services. That's not to cut short the backbone services because the courts found that increased competition among four networks (rather than just Visa and MasterCard) for bank services would improve network services themselves.

So the court found lots of areas where competition at a network level has real-world competitive effects for consumers. As a result, even though consumers get their cards from banks at the issuing level, as Larry is fond of pointing out, that all goes back to what competition is like at the network level.

SCHWARZ: Ken, I'm going to turn back to what I think is an important legal issue in the case. The Second Circuit distinguished precedents like *CDC*²³ and the Ninth Circuit's *Gilbarco* case,²⁴ which treated exclusive dealing arrangements as presumptively legal. The Second Circuit asserted that this was a different situation because they were horizontal arrangements.

Assume first that a MasterCard director testified we had to have this rule because either all the banks should get access to American Express and Discover cards or none of the banks should. How do you tie that evidence in with your analysis or maybe you view it as irrelevant?

GALLO: I see it in two different steps. I see, first, the question of the Second Circuit's approach to whether this rule had an anticompetitive effect on the marketplace. On that question, they distinguished cases that they characterized as vertical, like *CDC* and *Gilbarco*, and drew a distinction between vertical and horizontal restraints.

The question you posed to me goes more to MasterCard's business justification for having this so-called loyalty rule. I think the Second Circuit made a mistake, because it said that whether the arrangement is horizontal affects the rule of reason analysis one applies. I just don't think that's right. You should look at whether it's horizontal or vertical for deciding whether to apply the per se rule. Once you apply the rule of reason analysis, the fact that it's horizontal or vertical should not determine the outcome.

²³ *CDC Techs., Inc. v. IDEXX Labs., Inc.*, 186 F.3d 74, 80 (2d Cir. 1999).

²⁴ *Omega Envtl., Inc. v. Gilbarco, Inc.*, 127 F.3d 1157 (9th Cir. 1997).

Obviously, when you have a joint venture structure like MasterCard, rules or policies that MasterCard adopts can usually be characterized as having a horizontal element to them. But the question that the rule of reason requires you to answer is this: has MasterCard passed a rule or policy that forecloses American Express from being able to get products to the ultimate consumer? If American Express can get products to consumers, it seems to me that American Express has the ability and motivation to compete with MasterCard on innovations and quality, as we expect in interbrand competition. In those circumstances, we ought not really be worried about the question of whether the policy is horizontal or vertical. If American Express can get its product there, then we're going to have interbrand competition for quality and variety and innovation.

The Second Circuit seems to assume that more variety and more innovation is always better. That's not necessarily true. There may be no consumer benefit to having yet another version of a credit card or charge card on the market.

Competition will generate the best and cheapest products. And it's for the market to determine. It is not up to the collective agreement of horizontal competitors to decide which products will come out and which won't.

HIRSH: Ken keeps saying that American Express can get whatever card it wants to consumers. That's just not so. It can certainly mail a card to anyone, but it can't get the cards it wants to consumers because the cards it wants to get to consumers are the ones issued through banks. What the district court found, and the Second Circuit agreed, is that a network issuing a card with a bank is a different kind of card. A Citibank-issued American Express card is different from a Bank of America-issued American Express card—just as banks issuing on the Visa or MasterCard networks create different cards. Those are different kinds of products. As a result, if they are kept out of the bank-owned network, American Express and Discover cannot get all the cards they want to consumers.

The second point is this: Ken said that the court is assuming that more is better. Well, that's pretty much the basis of antitrust law, isn't it? Competition will generate the best and cheapest products. And it's for the market to determine. It is not up to the collective agreement of horizontal competitors to decide which products will come out and which won't. If American Express or Discover decided not to issue certain products, that is a unilateral business decision. But it's not up to a collective agreement of banks to decide what American Express and Discover can or cannot issue.

On the other point, relating to the difference between vertical and horizontal restraints, courts have always drawn a sharp distinction between vertical and horizontal agreements. People should be happy about that. There's a real wariness about when competitors get together and start making rules among themselves that affect competition. If you didn't differentiate vertical from horizontal, vertical agreements would actually end up suffering because they wouldn't get the lenient treatment that they do.

Ken at the outset asserted that the Second Circuit turned this into a per se case once it determined the restraint was horizontal. I don't think that's true at all. The court said this is not a presumptively legal arrangement.²⁵ It's a classic horizontal agreement. It didn't then say, therefore, defendants lose. The court instead found actual anticompetitive effects and that is why defendants lost. It wasn't just because the arrangements were horizontal.

—HIRSH

GALLO: The notion that American Express should get access to MasterCard banks (because it wants to “compete better” as a partner with some MasterCard bank that has some unique or very valuable marketing skill) should only withstand scrutiny if the government and American Express

²⁵ 344 F.3d at 242–43.

would allow it to work the other way. That is, does MasterCard get access to American Express assets?

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—*POPOFSKY*

POPOFSKY: Does MasterCard get access to a portion of the integrated American Express Corporation simply because it decides that American Express, for example, has a very good marketing skill? Most people would laugh at that notion. But because MasterCard is structured as a joint venture, the government says those banks should be available to American Express to pick and choose as it likes. I don't think the anticompetitive effect should be determined by the structure of the competitors. That's where I think the Second Circuit went wrong. Its opinion strikes at the heart of joint venture law. The ruling in effect says, joint ventures, you are second-class citizens. Because you're horizontal, everything you do is suspect. And my goodness, I thought that had been rejected twenty-plus years ago. But here it is again.

The second thing I would say, as proof of the pudding, if you will, is the Tenth Circuit decision in *Dean Witter*.²⁶ There, Discover wanted to issue a Visa card. It said it would be one of the ten biggest and best Visa cards in the whole wide world if it were permitted to do so, offer new features, benefits for the consumer, improve competition, etc. The Tenth Circuit saw it as a horizontal arrangement. Of course: it was a joint venture. But the Tenth Circuit looked at the issuing market, and determined that, with hundreds and hundreds of issuers, how in the world could the denial of Discover's right to issue a Visa card make any significant competitive difference? What in the world is the difference in the horizontal agreement there from the horizontal agreement here? So, I concur with Ken's observations: Geometry ought not to matter. Ultimately, I think the Tenth and Second Circuit decisions are absolutely irreconcilable.

HIRSH: Four judges have now disagreed with your view of that case.

POPOFSKY: I think the shocking thing is that the Second Circuit doesn't even address it.

SCHWARZ: The government never saw any irreconcilability at all between the two. The holding in the Tenth Circuit case was basically that competition among the networks was more important than additional intrabrand competition in the form of one additional issuer among thousands. We believed that this case stands exactly in the same position—that interbrand competition among the networks is extremely important and needs to be protected.

GALLO: American Express does, in fact, compete in the network services market. It does so as an integrated corporation, and it uses its network services, in conjunction with its issuance and distribution facilities, to provide an integrated product to the ultimate consumer. And MasterCard competes as a joint venture, both as a network and as an issuer, to provide a complete product to the consumer.

If American Express can begin to pick apart the joint venture, it could reduce interbrand competition. It creates the incentive for American Express to pick some feature that it likes that a MasterCard bank has, rather than develop a competitive product. Worse yet, MasterCard doesn't have the corresponding ability to do that to American Express. Cohesion of the joint venture was a procompetitive justification for the policy.

²⁶ *SCFC ILC, Inc.*, *supra* note 15.

HIRSH: I'll note that the Second Circuit says, "The District Court found no evidence to suggest that allowing member banks to issue cards of rival networks would endanger cohesion in a manner adverse to the competitive process."²⁷

SCHWARZ: Fair enough. Would it have mattered if Visa and MasterCard intended their rules to create cohesion but they turned out to be wrong?

HIRSH: The district court looked and didn't find evidence that the exclusionary rules were adopted to enhance or bring about cohesion. The court also found that the rules in practice do not enhance cohesion, and also that American Express or Discover cards being issued by banks wouldn't endanger cohesion. So, the district court found three different levels of facts to reject that purported justification.

If you're asking, what if the court had found facts the other way? To be ancillary, they'd have to have a reasonable design to enhance a procompetitive aspect of the joint venture. Then, if there had been procompetitive justifications, they'd have to be weighed against the anticompetitive effects that were found. It's a fact-intensive inquiry.

POPOFSKY: Visa passed its rule specifically to protect cohesion. MasterCard had a different experience but it focused very much on American Express's statements that they were going out to try to cherry pick. So the cohesion purpose was self-evident.

Both the district court judge and perhaps the appellate court were impacted by the foreign evidence that Visa did not have comparable rules abroad. The courts reasoned that, if you didn't have them in Portugal, you must not really care about them in the United States. But why accept foreign evidence without a predicate showing of comparable circumstances? The government's expert actually disclaimed an ability to compare the circumstances. There was no showing that any of the experiences abroad were comparable to the American market where Visa and AmEx stood in an entirely different position vis-à-vis each other. I don't need to go in beyond that, but I think it's an unfortunate fact that the foreign evidence weighed so heavily.

SCHWARZ: I would just note for the audience that if you are looking for case law that would support the notion that comparison to markets outside the United States is a valid way to make a point with respect to your antitrust arguments, this is the case. ●

²⁷ 344 F.3d at 243.