THE SECOND CIRCUIT COURT'S DECISION REJECTING THE CREDIT CARD CLASS ACTION SETTLEMENT: WHAT IT MEANS TO A SUPPLIER'S RIGHT TO SURCHARGE IN THE B2B SPACE?

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On June 30, 2016, the U.S. Court of Appeals for the 2nd Circuit (Circuit Court) vacated the multibillion dollar credit card class action settlement (Card Settlement) brought in 2006 by retailers against Visa and MasterCard alleging conspiracy in violation of the Sherman Act. In 2013, the U.S. District Court of New York had approved the settlement, which was the largest antitrust class action settlement in history. The Circuit Court found the Card Settlement an "unreasonable and inadequate" solution for merchants (nearly all retailers) accepting cards, coupled with conflicting interests of class counsel. The question is whether the Card Settlement will be renegotiated or the case may go to trial.

A key provision of the Card Settlement for suppliers accepting cards in the B2B space was the right to surcharge customers the interchange fee, which led to Visa and MasterCard amending their operating rules setting standards for merchants, including suppliers, to surcharge. In light of the Circuit Court's ruling, will the card networks further amend their operating rules and void the supplier's right to surcharge?

Given the increase in the number of customers using credit cards to pay B2B invoices (both existing and new), and that cards are the most expensive payment channel, the topic is central to many supplier's finance teams attempting to manage profit margins. The short answer is that the card network surcharge rules remain in force, and it is not expected that they will be voided. The supplier's right to surcharge will remain unaffected.

How We Got Here: A Brief Background of the Credit Card Litigation

The Retailer Lawsuits and Class Settlement

In 2004, 19 national retailers and trade associations (including Kroger, PayLess, Safeway) filed lawsuits against Visa and MasterCard, alleging that the card companies conspired to fix artificially high interchange fees in violation of the Sherman Antitrust Act. The plaintiffs were virtually all retailers accepting cards in the B2C space. The suits were consolidated and certified as a class action in 2006 in the U.S. District Court for the Eastern District of New York.

Millions of retailers and businesses were members of the class. In a class action lawsuit, parties with similar claims are able to sue a defendant, providing smaller claimants to be represented. Class members are bound to the settlement, unless there is an opt-out provision.

After four years of negotiation, the District Court approved the settlement. The key terms of the settlement:

> For merchants accepting cards from January, 2004 through November, 2012, they would share $7.25 billion. Class members could opt out of the settlement, but those accepting the settlement were barred from suing;
>
> For merchants accepting cards after 2012, they would have the right to surcharge, but would not share in the cash settlement. They are bound by the terms of the settlement.

The Class Settlement was appealed by a number of retailers, contending Visa and MasterCard would have the ability to impose even higher interchange fees. The settlement would also bar retailers from suing over interchange rules and rate settings.

The Opt Out Litigants

Several of the largest retailers opted out of the Card Settlement and sued Visa and MasterCard. These retailers found the settlement did not change the high interchange fees. Rather than lower the fees, Visa and MasterCard proposed in the settlement that they be passed to customers as a surcharge. However, Walmart noted that the "proposed modification to the no-surcharging rule for Visa and MasterCard provides no benefit to customers or merchants such as Walmart" (email to Bloomberg of January 28, 2013). In the same week, Target and Macy's both announced they would not surcharge. The national retailers' election not to surcharge was economic: they believed consumers would take their business to retailers that did not surcharge.

Retailers would also be prohibited from suing over interchange rules and rate settings. Retailers also complained that the class action lawyers had a conflict of interest in representing both classes of settling merchants. Eight thousand retailers opted out.

A Brief History of Surcharging

Historically, credit card companies' network rules prohibited suppliers and retailers from imposing the interchange fee on customers through a surcharge. This contractual ban on surcharging resulted from a decades-long debate on the topic. It was only with the Class Settlement in 2013, followed by an amendment of the card network rules, that suppliers were given the right to surcharge.

The Visa and MasterCard Rule Changes Allowing Surcharging

Consistent with the Card Settlement, in 2013 Visa and MasterCard amended its rules to allow suppliers and retailers the right to surcharge. The key provisions of the rule changes:

- The surcharge must be disclosed to the card networks and card holders;
- Surcharge the interchange fee, which may not exceed 4%;
- The surcharge amount is the average of the preceding six months interchange fee;
- An election of brand level and product level;
- Debit card may not be surcharged.

The Second Circuit's Rejection of the Settlement: a Conflict of Interest, Binding Future Claimants and a Surcharge Right with Little Value to Settling B2C Class

Notwithstanding over 400 depositions, 32 days of expert testimony, and 80 million pages of documents which were tied to years of card litigation and negotiating the Class Settlement, the three panel Circuit Court unanimously found it fundamentally flawed.

The Settlement Agreement broke the class of plaintiffs into two groups: one which accepted Visa or MasterCard from 2004 to 2012, and another which accepted the cards from 2012 onward. The first class of merchants was to be paid $7.25 billion, but could opt out of the Class Settlement. The second class was offered a temporary interchange rate decrease and the right to surcharge, but was barred from suing the card networks regarding their rate structure. The class action attorneys represented both classes.

The Circuit Court found that a rich cash payout for one class, and a cash free, temporary interchange reduction coupled with a surcharge right for the other class created a conflict of interest for the attorneys who were representing both classes. The court noted the lawyers were in a position to negotiate terms that could benefit one class and harm the other. Further, the court noted:

> "One class of plaintiffs receives money as compensation for the defendants arguable past violations, and in return gives up the future right of others. The Supreme Court has addressed such circumstances and ruled that an adjudication coming to this result is impermissible."

On the topic of surcharging, the Circuit Court noted the value to retailers was illusory as most would not surcharge. The court's comments highlight the fundamental distinction between B2C and B2B surcharging. With B2C surcharging, retailers risk losing business as consumers will buy from a competitor that is not surcharging.

By contrast, in the B2B space, the trade relationship between the supplier and customer is multifaceted. A supplier surcharging likely does not risk losing the business from a customer. The customer is given many incentives by the card company that override the surcharge. Even if a customer pushes back on the surcharge, the customer may elect another payment form, such as ACH, to avoid the surcharge.

The Circuit Court decertified the case as a class action. The case returns to the New York federal court.

The Supplier's Right to Surcharge in Light of Circuit Court's Ruling

While the Circuit Court ruling sinks the Card Settlement negotiated after a decade of litigation, the issue for suppliers is whether Visa and MasterCard will void the amendments to the operating rules allowing them to surcharge, given the right to surcharge was a provision of the Settlement Agreement.

The short answer for suppliers that are surcharging, continues. The network rules have not been amended to bar surcharging.

For those suppliers planning to roll out a surcharge, the evidence indicates that Visa and MasterCard do not intend to void the rules allowing surcharging. The card network's interest in advancing surcharging was shown in allowing suppliers and merchants to surcharge months before the District Court gave final approval of the Class Settlement. With the card networks amending their operating rules to allow surcharging, suppliers and retailers have relied on these changes to offset card expense.

With the card network's focus to expand use of credit cards in the B2B space, to then revoke a supplier's surcharge right would undermine this effort. Likewise, the card networks will likely face further litigation with retailers in the B2C space regarding the interchange fee structure. Visa and MasterCard were battling 12 million retailers at the trial court level. Further, in another antitrust suit regarding branded debit cards brought by retailers, Visa and MasterCard may face damages of nearly $40 billion, which is pending review by the U.S. Supreme Court.

Added to this, the European Commission is bringing suit against MasterCard for comparable antitrust violations that the card networks have artificially inflated interchange fees, and are seeking damages of $24 billion. Given this, the card network's self-interest is to preserve its standing in the B2B space and continue with surcharging.

As a start, the card networks continue to push market share in the B2B space, by contrast, in the B2C space they have saturated the market. Companies in the B2B space constantly hear from card issuing banks to persuade them to use cards to pay their suppliers, and accept cards from their customers. If these suppliers don't have the option to surcharge, more will push back even accepting cards because of the expense. An end note is that alternative payment

channels continue to emerge that are more price competitive than cards, if those cards cannot be surcharged.

The issue ultimately is who pays the costs to run the credit card network, which interchange fees total approximately $60 billion annually. In the B2C space, retailers appreciate that surcharging consumers is not an effective strategy for risk of losing business, but yet accept cards as it increases sales. The fight with retailers is trying through litigation to lower the card network fee structure.

By contrast in the B2B space, suppliers have more leverage in the trade relationship, including moving the interchange to the customer. By allowing surcharging, the card networks seem less concerned as to who pays the interchange fee, whether the cardholder or business accepting the card, but that the operating costs of the card network are being covered.

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