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MASTERCARD'S SINGLE ENTITY STRATEGY

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INTRODUCTION

Professor Victor Fleischer's analysis of the MasterCard IPO suggests that the adoption of this particular deal structure was driven not by transactions costs, but branding considerations and antitrust exposure.[1] Fleischer identifies two features of the MasterCard IPO as particularly responsive to both branding and potential antitrust liability: (1) the "reverse" dual-class voting structure and (2) the charitable foundation. Fleischer correctly points out the proposed structure would reduce potential antitrust exposure by decreasing the merchant banks' control over pricing decisions and highlights an important and underappreciated relationship between antitrust rules and corporate structure. This comment supplements Fleischer's analysis of the antitrust implications of MasterCard's new governance structure. Part I summarizes the antitrust environment facing the cooperative networks serving MasterCard and Visa.[2] Part II considers the antitrust implications of MasterCard's new organizational structure and Part III concludes with some thoughts regarding what the MasterCard IPO tells us about the role of lawyer.

I. MasterCard, Antitrust, and Interchange Fees

MasterCard is no stranger to antitrust litigation and related regulatory proceedings in the United States and elsewhere. Antitrust challenges have also been raised in response to MasterCard's exclusive membership policies and requirements that merchants accept all cards issued by a particular network. For example, In *United States v. Visa U.S.A.*, the Second Circuit upheld a district court judgment ruling that MasterCard's "Competitive Programs Policy" ("CPP") violated Section 1 of the Sherman

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[1] Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L. J. 239 (1984). Scott Peppett explores the potential for the MasterCard IPO to create bargaining power by distancing itself from Visa. See Scott Peppett, Updating Our Understanding of Lawyers: Lessons from MasterCard, __ Harvard Negotiation Law Review __ (2006) (this issue).

[2] Visa recently announced a similar, but less dramatic, reorganization adding a majority of independent directors among the 15 voting members of its board, which is granted final approval rights over all pricing decisions. See Robert E. Litan and Alex J. Pollack, The Future of Charge Card Networks, AEI-Brookings Joint Center for Regulatory Studies Working Paper 06-03 (February 2006), at 6.

Act under a rule of reason analysis.[3] Discover Financial Services, Inc. and American Express have also challenged the CPP and MasterCard's "Honor All Cards" rule, which requires merchants who accept MasterCard cards to accept for payment every validly presented MasterCard card, under Section 1 and Section 2 of the Sherman Act.

Not all of the legal challenges to MasterCard's network involve interchange fees. Interchange fees flowing from the acquirer to the credit card issuer are the most recent feature of MasterCard's business to attract antitrust scrutiny. *National Bancard Corp. v. Visa, U.S.A.* ("*Nabanco"*) established the legality of interchange fees under the rule of reason.[4] A key element of the Eleventh Circuit's ruling was that the interchange fee coordinated two sides of a market:

> "[a]s a practical matter the card-issuing and merchant-signing members have a mutually dependent relationship . . . .In short, the cardholder cannot use his card unless the merchant accepts it and the merchant cannot accept the card unless the cardholder uses one."[5]

Economists have recently focused a great deal on the theory of interchange fees and the economics of two-sided markets more generally.[6] The defining characteristics of two-sided markets are that two different groups of customers are connected by an intermediary, and that the value to each group depends on the size of the other group.[7] Pricing in two-sided markets involves a complicated balance of the relative importance of network effects and elasticity of demand on each side of the market. It is this process that determines both the direction and magnitude of the subsidy paid from one group to the other. Notwithstanding the increase in our economic knowledge regarding the dynamics of two-sided markets, which tends to suggest that interchange fees are the outcome of the competitive process in which acquirers subsidize issuers, interchange fee has been the subject of a great deal of regulatory interest.

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[3] United States v. Visa U.S.A., 344 F. Supp. 229 (2d Cir. 2003). Importantly, the Second Circuit's ruling rejected the notion that MasterCard (or Visa) are a single entity contracting with a supplier, but instead, characterized the restrictions at issue as "a horizontal restraint adopted by 20,000 competitors." Id. at 242.

[4] National Bancard Corp. v. Visa U.S.A., 779 F.2d 592 (11th Cir. 1986), *cert. denied*, 479 U.S. 923 (1986).

[5] Id. at 602. The court recognized that jointly determining interchange fees was necessary for the network's survival because it facilitated universal acceptance, and therefore survived rule of reason analysis. See, e.g., Broadcast Music Inc. v. CBS, 441 U.S. 1 (1979).

[6] See, e.g., Two Sided Markets and Interchange Fees, 1 Payment Card Econ. Rev. (2003); David S. Evans and Richard Schmalensee, The Economics of Interchange Fees and Their Regulation: An Overview; David S. Evans and Richard Schmalensee, Paying with Plastic: The Digital Revolution in Buying and Borrowing (2d ed. 2005); Jean-Charles Rochet and Jean Tirole, Cooperation Among Competitors: Some Economics of Payment Card Associations, 33 Rand J. Econ. 549 (2002); Dennis W. Carlton & Alan Frankel, The Antitrust Economics of Credit Card Networks, 63 Antitrust L.J. 643 (1995); Todd J. Zywicki, The Economics of Credit Cards, 3 Chap. L. Rev. 79 (2000).

[7] See, e.g., Timothy J. Muris, Payment Card Regulation and The (Mis)Application of the Economics of Two-Sided Markets, 2005 Colum. Bus. L. Rev. 515, 517-18 (2005).

The most prominent of the antitrust proceedings currently pending against MasterCard are the forty-seven lawsuits challenging interchange fees that have been consolidated in the District Court for the Eastern District of New York. The merchant banks' new antitrust claims boil down to the argument that *Nabanco* was either wrongly decided and per se analysis is therefore appropriate, or alternatively, that an updated application of the rule of reason will reveal that interchange fees are anticompetitive in fact. However, interchange fees have been viewed skeptically by regulators in the United States and around the world. For example, the European Union is currently engaged in a "sector inquiry" into the financial services industry, including an investigation of interchange fees. The Office of Fair Trading of the United Kingdom ("OFT") issued a decision concluding that MasterCard's interchange fees violate United Kingdom and European Union competition law. The Reserve Bank of Australia implemented regulation in October 2003 which would oversee and regulate interchange fees.[8] Most recently, the Subcommittee on Commerce, Trade and Consumer Protection solicited testimony on the topic of interchange fees.[9]

The primary, but not sole, theory of competitive harm offered by merchant banks and rivals such as American Express and Discover Card against MasterCard has been that MasterCard's member banks' involvement in interchange pricing decisions amounts to collusion in violation of Sherman Act § 1. When one considers that any damages from a successful claim by the merchant banks would be trebled, it becomes clear that immunity from these suits would provide substantial value to MasterCard. Fleischer describes this value as follows:

> "[I]f MasterCard is legally viewed as a single independent entity, however, it becomes more difficult (at least going forward) to find anti-competitive collective action or collusion among the banks . . .. The IPO structure, in sum, allows MasterCard to buy itself immunity from future lawsuits over interchange fees."[10]

The key feature of the MasterCard IPO in terms of reducing its future antitrust liability is the reverse dual class structure which reduces merchant banks' control over MasterCard's governance and pricing decisions. Part II discusses in greater detail the implications of MasterCard's strategy.[11]

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[8] See Muris, supra note __, at 536-548 (discussing the impact of government regulation of interchange fees, concluding that "by regulating interchange fees, Australia has forced issuers to increase fees and reduce card benefits, all to the detriment of cardholders").

[9] See, e.g., Testimony of Timothy J. Muris Before The Subcommittee on Commerce, Trade and Consumer Protection: The Law and Economics of Interchange Fees (2006).

[10] Victor Fleischer, The MasterCard IPO: Protecting the Priceless Brand, __ Harvard Negotiation Law Review __ , pin (2006).

[11] See also Litan and Pollock, *supra* note __ (discussing the impact of MasterCard's reorganization on its antitrust exposure and noting that the reorganization would not impact "market dominance" rationale's for interchange fee regulation).

II. MasterCard's Single Entity Strategy

In *Copperweld Corp. v. Independence Tube Corp.*,[12] the Supreme Court shielded "the coordinated activity of a parent and its wholly-owned subsidiary" from liability under § 1 of the Sherman Act by holding that such enterprises would be viewed as a single entity. Though the Supreme Court explicitly limited its holding "to the narrow issue" of a corporation colluding with its wholly-owned subsidiary, lower courts have applied the *Copperweld* immunity principle to other governance structures. For example, there appears to be near universal agreement that two sister corporations, wholly owned subsidiaries of the same parent, are not capable of a Section 1 agreement.[13] Despite widespread agreement that such immunity is appropriate in these circumstances, *Copperweld* did not address the question of "under what circumstances, if any, a parent may be liable for conspiring with an affiliated corporation it does not completely own."[14]

MasterCard's primary interest in *Copperweld* immunity is its extension to partially owned corporations. Recall that the interchange fee lawsuits allege that merchant banks conspire, in violation of Section 1, to fix set interchange fees to the detriment of consumers. However, *Copperweld* protection does not necessarily extend to all agreements between entities partially owned by the same entity. Lower courts addressing this issue have emphasized *Copperweld's* analysis of the "unity of interest" between the entities.[15] The logic driving this focus is that a parent's ability to assert control at any moment is sufficient to prevent a subsidiary from taking actions that deviate from the parent's interests.[16] Extending the logic, some lower courts have ruled that *Copperweld* immunity is triggered by an agreement between a parent and a 51 percent-owned subsidiary.[17] Similarly, in *City of Mt. Pleasant v. Associated Electric*

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[12] Copperweld Corp. v. Independence Tube Corp., 467 U.S. 752 (1984).

[13] The leading antitrust treatise describes post-*Copperweld* decisions as "virtually unanimous" in their rejection of conspiracy claims against sister corporations. Philip Areeda & Herbert Hovenkamp, Antitrust Law, Volume VII at 1464f (2d ed. 2005). See, e.g., Directory Sales Mgmt. Corp. v. Ohio Bell Tel. Co., 833 F.2d 606, 611 (6th Cir. 1987); Eichorn v. AT& T Corp., 248 F.3d 131 (3d Cir.), cert. denied, 122 S. Ct. 506 (2001). See also Century Oil Tool, Inc. v. Production Specialties, Inc., 737 F.2d 1316 (5th Cir. 1984) (finding two corporations wholly owned by three persons who manage the affairs of the two corporations incapable of Section 1 agreement).

[14] 467 U.S. at 767.

[15] Id. at 770-71 ("because coordination between a corporation and its division does not represent a sudden joining of two independent sources of economic power previously pursuing separate interests, it is not an activity that warrants § 1 scrutiny").

[16] Id.

[17] Novatel Communications v. Cellular Telephone Supply, 1986-2 Trade Cas. (CCH) ¶ 62,172-73 (N.D. Ga. 1986); Direct Media Corp. v. Camden Tel. & Tel., 998 F. Supp. 1211, 1217 (S.D. Ga. 1997); Rohlfing v. Manor Care, Inc., 172 F.R.D. 330, 344 (N.D. Ill. 1997). Interestingly, the Department of Justice addressed this issue in a set of 1988 guidelines in favor of the 50 percent rule:

> A parent corporation and any subsidiary corporation of which the parent owns more than 50 percent of the voting stock are a single economic unit under common control and are thus legally incapable of conspiring with one another within the meaning of Section 1. If a parent company

Cooperative, a rural electrical cooperative consisting of three tiers of cooperatives with interlocking ownership was incapable of conspiring in violation of Section 1 because the members shared a common goal of providing low cost electricity to consumers.[18] While the majority of decisions confer *Copperweld* protection in circumstances of majority ownership, a number of recent decisions have refused to do so.[19]

Fleischer's analysis suggests that MasterCard's IPO structure is the outcome of a decision that economizes not only on transactions costs, but also litigation and regulatory costs created by the specter of antitrust liability. The idea that corporate structure might be influenced by antitrust concerns is not entirely new. For example, a number of sports leagues have been designed as a single entity in order to achieve Section 1 immunity. For example, Major League Soccer ("MLS"), the Continental Basketball Association, the Women's National Basketball Association, and the American Basketball League have organized themselves as single entities at least in part to achieve *Copperweld* protection.[20]

The MLS is a recent example of an attempt to design a sports league around *Copperweld*'s protections.[21] Without going into great detail, MLS owned the various teams in the league, but each team is managed by an "operator/investor" who invests in the MLS but runs an individual team and whose compensation is linked to team performance. In addition, the "operator/investors" controlled a majority of voting shares on the board. While the MLS successfully invoked *Copperweld* at the district court level,[22] the First Circuit ultimately applied rule of reason analysis in lieu of a fact intensive *Copperweld* determination.[23] Sports leagues, like all economic entities, can be expected to economize on their own unique combination of agency, marketing, and regulatory costs. While this process has resulted in a number of single entity leagues, it is

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> controlled a significant, but less than majority, share of the voting stock of a subsidiary, the Department would make a factual inquiry to determine whether the parent corporation actually had effective working control of the subsidiary.

U.S. Department of Justice, Antitrust Enforcement Guidelines for International Operations, Case 9 (1988), reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,109. These guidelines have been withdrawn and subsequent guidelines have failed to address the issue.

[18] 838 F. 2d 268 (8th Cir. 1988).

[19] See, e.g., Aspen Title & Escrow, Inc. v. Jeld-Wen, Inc., 677 F. Supp. 1477 (D. Or. 1987); Geneva Pharm. Tech. Corp. v. Barr Labbs, Inc., 201 F. Supp. 2d 236 (S.D.N.Y. 2002).

[20] See generally Martin Edel et al., Panel III: Restructuring Professional Sports Leagues, 12 Fordham Intell. Prop. Media & Ent. L. J. 413 (Winter 2002).

[21] Id. at 435 (quoting Jeffrey Kessler: "so why did the MLS owners choose to form a single entity? They did it so that they could claim an exemption from Section 1 of the Sherman Act and not have to compete with each other for their players. There is no other reason.").

[22] Fraser v. Major League Soccer, 97 F. Supp. 2d 130 (D. Mass. 130).

[23] Fraser v. Major League Soccer, 284 F.3d 47 (1st Cir. 2002) (Boudin, J.).

interesting to note that the bulk of sports leagues that have adopted the single entity structure have failed.[24] I do not mean to suggestion causation. There are obviously explanations for the failures of these leagues that are not related to organizational structure. The failures experienced by single entity sports leagues illustrate that minimizing antitrust liability and regulatory costs does not guarantee a successful product.

MasterCard, like the sports leagues, faces its own unique set of costs. MasterCard faces the unique task of providing a platform in payment cards markets that coordinates both sides of the market: acquirers and issuers. As the discussion above suggests, MasterCard faces the risk of substantial regulatory costs in carrying out this function.[25] The MasterCard IPO alters corporate structure in an effort to minimize these costs by reducing merchant banks' economic control of MasterCard from 100% to 41%. The key point for the purposes of antitrust analysis is that the merchant banks control less than 50% of the voting rights in the post-IPO entity – the public will hold 83% of the shares and the MasterCard Foundation the other 17%. While *Copperweld* protection is not automatically extended to entities controlling only a minority of voting rights, there is no question that the post-IPO structure reduces the likelihood of Section 1 liability. In the current antitrust environment, where interchange fee litigation threatens substantial damage awards against MasterCard, which would be trebled, reducing these costs is critical.

Litan and Pollock point out that the benefits of MasterCard's single entity strategy might extend beyond a reduction in liability in future lawsuits. Specifically, Litan and Pollock recognize the possibility that the new governance structure might produce other benefits at the remedy stage of pending litigation or in the regulatory process:

> "If both card networks become more proprietary – that is, they are owned by public stockholders and the members no longer control the setting of interchange fees – then the argument for treating the two networks as overlapping entities is more readily dismissed, and along with it, so is the case for regulating any fees the two networks may set."[26]

This explanation of antitrust benefits deriving from MasterCard's reorganization is consistent with Fleischer's description:

> "By the time pending litigation is resolved, MasterCard will be an independent entity, and it may have been so for quite some time. By that time, the lawsuits over interchange fees may feel a little bit like suing Microsoft in a post-Google

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[24] See Edel et al., supra note __, at 434 (quoting Jeffrey Kessler: "as we have seen so far, the single entity has been a failure from a business sense").

[25] At least one plaintiff has stated that it is seeking damages that exceed MasterCard's ability to pay, though MasterCard has publicly denied the veracity of this assertion. MasterCard S-1 Form.

[26] Litan and Pollock, supra note __, at 30.

world . . .. Regulators and judges may, in particular, may lose some zeal once it becomes clear that things have changed, even if logically this is no excuse for illegal behavior in the past."[27]

MasterCard's single entity strategy has other important antitrust implications. It has already been noted that *Copperweld* immunity does not render MasterCard immune from the antitrust laws in their entirety. The potential for liability resulting from the exercise of monopoly power, rather than collusive conduct, remains. An immediate consequence is that successful invocation of *Copperweld* immunity requires that the court to combine the activities of the component entities for the purpose of market power analysis and may therefore increase the potential for liability under Section 2.[28] Monopoly maintenance or exclusion based claims are not merely academic concerns for MasterCard, who is currently facing antitrust suits regarding membership exclusivity and brand exclusion. The fact that MasterCard is willing to risk potentially increased antitrust exposure under Section 2 in exchange for an increased probability of retaining control of interchange fees suggests that interchange is, in fact, essential to the stability of the credit card network.

While MasterCard's single entity strategy is not likely to purchase MasterCard immunity for prior conduct, it may well accomplish two very significant objectives: (1) minimizing the possibility that a court or regulator will perceive joint setting of interchange fees as a competitive problem in need of a solution, and (2) minimizing *future* antitrust liability associated with the setting of interchange fees.

III. Concluding Thoughts

Professor Fleischer's case study highlights the link between regulatory costs --- antitrust liability in this case --- and deal structure. Consistent with Fleischer's emphasis on non-traditional branding mechanisms,[29] it seems appropriate to note that MasterCard's ability to invoke *Copperweld* in the future will depend, in part, on the message that it communicates to the public regarding the nature of its relationship with merchant banks. To be sure, MasterCard's single entity strategy does not completely immunize interchange fees from liability because *Copperweld* does not appear to protect every instance of less than 100% ownership, and because Section 2 liability remains. Therefore, a crucial component of MasterCard's strategy of minimizing Section 1 exposure includes convincing the marketplace, and would be regulators, that MasterCard retains control over the merchant banks' use of the MasterCard brand.

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[27] Fleischer, supra note __.

[28] See generally *Copperweld*: The Basics and Beyond, Antitrust Source 10-11 (March 2003).

[29] See, e.g., Victor Fleischer, Brand New Deal, 107 Mich. L. Rev. __ (2006).