A History of Credit Card Transaction Costs and the Suppliers Newly Minted Right to Surcharge to Make Credit Cards a More Competitive Payment Channel

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Abstract

In every credit card transaction, major credit card companies impose a fee on merchants, including suppliers in the B2B space, to process the payment by cardholders. Tracing the convoluted history of the origins of that fee stretches back more than half a century. That history may provide context for a supplier evaluating whether to surcharge, or pass the interchange fee to customers.

A History of Credit Cards

Both Visa and MasterCard arose from regional associations of banks that formed joint ventures to operate regional credit card networks. The first step towards credit card landscape familiar to the modern-day card users occurred in 1958 when Bank of America introduced a general-purpose credit card program known as BankAmericard. Twelve years later, in 1970, Bank of America divested its control over the BankAmericard program to National BankAmericard, Inc., a bank-owned joint venture, renamed "Visa" in 1976. Similarly, in 1969, InterbankCard Association was formed, an association that became Master Charge, finally emerging as the familiar MasterCard.

The early history of charging customers for the use of credit cards relates to the lack of technology available at the time. In the 1960s and early 1970s, payment-card transactions were processed largely without the benefit of computer technology. Sales clerks conducted card authorizations either by telephone, or by checking the consumer's card number against large books of card numbers that were known to be invalid. Once transactions were authorized, the merchant sent paper "drafts" from the transaction to its acquiring bank, who then sent the drafts to the appropriate network. The drafts were then sorted according to issuing bank, bundled and sent to the appropriate bank to debit the consumer's account.

From their introduction in the 1950s, through the following initial decades, credit cards represented a miniscule percentage of the total number or dollar volume of transactions. The result was minimal regulation of the industry other than state usury restrictions. Instead, credit cards were governed by various private agreements involving card networks, issuer banks, merchants and cardholders.

Early Challenge to Surcharges

Legislators were keenly alert, however, to the practices of imposing fees for paying by card and moved to allow merchants to encourage consumers to pay by cheaper methods. In 1968, Congress passed the Truth in Lending Act ("TILA"), protecting the right of merchants to have dual-pricing systems. ("Card issuer may not, by contract, or otherwise, prohibit any such seller from offering a discount to a cardholder to induce the cardholder to pay by cash, check or similar means rather than use a credit card.")

However, the TILA required lenders, including credit card issuers, to disclose the cost of credit. Card networks could not calculate what the annual percentage rate ("APR") of credit would be in advance for every good or service. In addition, card networks simply did not want to make such disclosures, as TILA regulations required the conversion of surcharges into an APR based on a 30-day extension of credit. An example of the result of this requirement is that a 5% surcharge would increase the APR by an extraordinary 60%, deterring potential customers and violating state usury laws.[1] The card networks' solution was to incorporate no-surcharge rules into the private agreements constituting the credit card networks' operating rules.

In 1974, the first litigation was instituted by Consumers Union against American Express ("Amex"), claiming that Amex's contractual ban on differential pricing was an illegal restraint on trade constituting an antitrust violation. Amex settled the lawsuit by agreeing to allow merchants to provide consumers with differential price information. Congress also attempted to shield consumers from the fees imposed by credit card companies.

In 1976, the first ban on "surcharging", passing the cost for processing credit cards to a cardholder, was implemented with the introduction of a temporary federal ban providing that: "No seller in any sales transaction may impose a surcharge on a cardholder who elects to use a credit card in lieu of payment by cash, check or similar means." Pub. L. No. 94-222, 90 Stat. 197. The federal ban was renewed once in 1981, however, in 1984 legislators opted to allow the ban to expire.

At this point, following the lapse on the federal ban on surcharging, merchants appeared to have won the battle in combating rising costs of processing credit card transactions. It soon proved to be a pyrrhic victory: the credit card companies fought the lapse on the federal ban on two fronts. First the card companies retained the contractual no-surcharge rules imposed on any merchant who agreed to accept their cards. Second, credit card companies lobbied state legislators to introduce surcharge bans at state level. Ten states acceded to the pressure of the credit card companies, and, on the premise of consumer protection, state bans were introduced in some of the most populous states including New York, California, Texas and Florida. The combination of

[1] The issue of violating state usury laws became obsolete following the decision of the Supreme Court in *Marquette National Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299 (1978), allowing nationally chartered banks to circumvent state usury laws by issuing cards from a different state. The decision enabled banks to issue cards on a national basis for the first time.

contractual prohibitions on surcharging and the ten state bans lead to an absence of protection for the merchant against the exorbitant fees of the credit card networks for almost thirty years.

Today's Reality

In 2005, a pet-relocation company located in Atlanta, Georgia, became the unlikely catalyst to the downfall of surcharge prohibitions. In May 2005, Animal Land, Inc. sued Visa for a declaration that its no-surcharge rule violated antitrust laws by preventing Animal Land and other merchants from assessing a discrete, denominated charge upon customers using credit cards as opposed to cash, checks or debit cards. In the ensuing months, numerous US merchants and trade associations brought claims against the dominant credit-card networks, alleging that they engaged in illegal price-fixing in violation of the federal antitrust laws, the Sherman Act, and impermissibly banned merchants, including suppliers, from encouraging customers to use less expensive payment methods.

After eight years of litigation, Visa and MasterCard entered into a national class action settlement, agreeing to drop their contractual prohibitions against merchants, including suppliers, imposing surcharges on credit-card transactions. In January 2013, for the first time in almost thirty years, merchants became entitled to surcharge. Pursuant to Rule 5.6.1.3 of the Visa Core Rules, in "the US Region or a US Territory, a Merchant may assess a fixed or variable US Credit Card Surcharge on a Visa Credit Transaction, subject to applicable laws or regulation." The MasterCard Rules of December 11, 2014, contain a similar provision for surcharging in its Rule 5.9.2 permitting any merchant to "require a MasterCard Credit Cardholder to pay a Surcharge."

The class action litigation settlement applied primarily to the forty states that had no prohibition on surcharging. Nonetheless, the ten states that adopted anti-surcharge statutes also came under pressure from pro-surcharge activists. In October 2013, a federal judge in New York declared the Empire State's legislative ban on assessing a surcharge to be unconstitutionally vague and an impermissible violation of the right to commercial free speech. A federal court in California followed suit in March 2015, striking down the substantially similar Californian prohibition. Both decisions are under appeal.

Credit card companies essentially have been free to amass major profits from the imposition of swipe fees, arguably at the expense of merchants, for more than half a century. In the last ten years, the cumulative effect of consistent and sustained litigation brought by merchants throughout the country has resulted in the tide turning against the card networks, and it would appear, looks likely to consign any prohibition against surcharging to the annals of history.

In light of the card rule changes to allow surcharging, and the increased use of cards by customers in the B2B space, suppliers are rolling out surcharge programs to offset this most expensive channel, and now a customer's preferred payment channel.

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