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THE CONSTITUTIONAL PARADOX OF THE DURBIN AMENDMENT: HOW MONOPOLIES ARE OFFERED CONSTITUTIONAL PROTECTIONS DENIED TO COMPETITIVE FIRMS

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Abstract

The Durbin Amendment is the first of the major provisions of the Dodd-Frank Act to have been implemented—but only after it withstood a constitutional challenge on the basis of the Takings Clause in the U.S. Court of Appeals for the Eighth Circuit. Now that the Amendment has taken effect, this Article addresses the false economic logic that led to its passage and the dubious arguments used to sustain its constitutionality. On the first issue, the supporters of the Durbin Amendment denounced the highly effective debit card system as a form of cartelization of the industry, which yields excessive returns to banks while overcharging retailers high rates for low-cost services. That objection rests on three central fallacies. The first is that the industry is monopolistic, when in fact, there is extensive competition for customers at every level. The second is that this critique ignores the economics of two-sided markets, under which transfer payments from retailers to customers expands the universe of debit card customers, spreading around the cost of operating the system. The third is that the costs of providing debit card services are limited to the marginal costs of providing services, but this critique ignores the fixed costs necessary to put the system in place.

The failure to realize that these fixed costs need protection against government expropriation is the central error of the Eighth Circuit, which

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For the record, I represented TCF, the plaintiff in the litigation discussed in this Article, through the first hearing before Judge Lawrence L. Piersol on April 4, 2011. I should like to thank David Evans and Gregory Pulles, former General Counsel at TCF, for their valuable comments.

falsely assumed that firms in competitive industries need less protection than regulated monopolies. The paradox is that this argument gets it exactly backwards. The justification for regulating natural monopolies is to imitate competitive rates to the extent possible. But that justification is singularly unavailable with the debit card industry, which the Eighth Circuit held lacked monopoly power. At this point, there is no justification for *any* rate regulation, given that the debit card companies are already at the competitive rate and cannot recoup all their losses—direct charges to their customers requires the loss of the efficiency gains that interchange fees are able to exploit to good effect in a two-sided economic market. Thus, the Durbin Amendment, because of paradoxical thinking, has resulted in unconstitutional regulatory takings of the debit card companies.

INTRODUCTION: THE DURBIN PARADOX

Congress, with great fanfare, signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law on July 21, 2010.[1] The legislation contains many complex provisions that regulate major features of the banking and credit system in the United States. Without question, the two most important and controversial portions of this statute are its Financial Stability Oversight Council, which is charged with the task of

1. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified in scattered sections of the U.S. Code).

dealing with the "systematic risks" that large banks and other financial institutions are said to impose on the economy, and the Consumer Financial Protection Bureau, which gives the federal government vast powers to regulate a wide range of credit card lending practices in the United States.[2]

This Article, however, shall bypass these epochal developments. Instead, it shall focus on one lesser feature of the Act, the Durbin Amendment, which is found in section 1075 of the Act and regulates in a systematic fashion the *debit* card interchange fees that banks can charge merchants through various intermediaries,[3] most notably Visa and MasterCard. Those provisions were recently subject to a constitutional challenge by TCF National Bank, which lost in both the U.S. District Court for the District of South Dakota[4] and the U.S. Court of Appeals for the Eighth Circuit.[5] The central basis of the challenge was that the restrictive rate structure under the Durbin Amendment was a confiscatory taking in violation of the Takings and Due Process Clauses of the Fifth Amendment to the United States Constitution.[6]

The purpose of this Article is to attack these decisions for their odd inversion of constitutional law, which I call the paradox of the Durbin Amendment. It is commonly assumed that the government has a greater ability to regulate firms that hold monopoly power than those which operate in a competitive industry.[7] It is on this ground alone that the elaborate body of constitutional doctrine allows for some government regulation of natural monopolies. The basic position is that the law should seek to work its way between two obstacles. First, it must make sure that a firm that is the sole supplier in a given territory does receive monopoly rents. But it also must make sure that the firm's invested capital is not confiscated, which is done by assuring the firm a competitive rate of return on its investment. What is distinctive about the Durbin Amendment

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2. For a detailed discussion of the statute, see C. Boyden Gray & John Shu, *The Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010: Is It Constitutional?*, ENGAGE: J. FEDERALIST SOC'Y PRAC. GROUPS, Dec. 2010, at 66, http://www.fed-soc.org/doclib/20101223_Gray ShuEngage11.3.pdf.

3. Dodd-Frank Act § 1075, 124 Stat. at 2068.

4. TCF Nat'l Bank v. Bernanke (*TCF I*), No. CIV 10-4149, 2011 U.S. Dist. LEXIS 45059, at *14 (D.S.D. Apr. 25, 2011), *aff'd*, 643 F.3d 1158 (8th Cir. June 29, 2011). For the record, I worked closely with TCF in the initial stages of the case through the preliminary hearing of April 4, 2011, before Judge Lawrence L. Piersol of the South Dakota District Court.

5. TCF Nat'l Bank v. Bernanke (*TCF II*), 643 F.3d 1158, 1165 (8th Cir. June 29, 2011).

6. *See TCF II*, 643 F.3d at 1163. The relevant provision of the Fifth Amendment reads, "nor [shall any person] be deprived of life, liberty or property, without due process of law; nor shall private property be taken for public use, without just compensation." U.S. CONST. amend. V.

7. *See* Duquesne Light Co. v. Barasch, 488 U.S. 299, 307–16 (1989) (discussing these rationales); *see also* Michael W. McConnell, *Public Utilities' Private Rights: Paying for Failed Nuclear Power Projects*, 12 REGULATION, no. 2, 1988 at 35, *available at* http://www.cato.org/pubs/regulation/regv12n2/reg12n2-mcconnell.html.

decisions is that they turn this balance upside down. The courts that recognize the need to protect firms with monopoly power deny that protection to firms whose invested capital is in a competitive industry.

In order to deal with these issues, it is necessary to set the issue in context. The topic here is by no means insignificant because of the rapidly expanding size of the debit interchange market. As Judge Lawrence L. Piersol wrote:

> Networks reported that debit and prepaid interchange fees totaled $16.2 billion in 2009. The average interchange fee for all debit transactions was 44 cents per transaction, or 1.14 percent of the transaction amount. The average interchange fee for a signature debit transaction was 56 cents, or 1.53 percent of the transaction amount. The average interchange fee for a PIN debit transaction was significantly lower than that of a signature debit transaction, at 23 cents per transaction, or 0.56 percent of the transaction amount. Prepaid card interchange fees were similar to those of signature debit, averaging 50 cents per transaction, or 1.53 percent of the transaction amount.[8]

These revenues are not, of course, pure profit. A large fraction of them are needed to design, build, repair, and upgrade the basic debit card system—a system that has grown so rapidly in recent years that it now handles both more transactions and more dollars than the credit card system, with checks and cash occupying an ever smaller fraction of the overall payments market.[9] The Durbin Amendment has proven such a jolt to the system that it has been the subject of extensive legislative reexamination, including a failed effort by Senators John Tester of Montana and Bob Corker of Tennessee to postpone the implementation of the Amendment for a year in order to better gauge its economic effects.[10] At the same time, the Federal Reserve Board has worked full tilt to issue the Amendment's necessary implementing regulations, putting out a preliminary set of highly restrictive regulations on December 16, 2010,[11]

8. *TCF I*, 2011 U.S. Dist. LEXIS 45059, at *10 (quoting Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722, 81,725 (proposed Dec. 28, 2010) (to be codified at 12 C.F.R. pt. 235)).

9. *See* FED. RESERVE SYS., THE 2010 FEDERAL RESERVE PAYMENTS STUDY: NONCASH PAYMENT TRENDS IN THE UNITED STATES: 2006–2009 (2011) [hereinafter 2010 FEDERAL RESERVE PAYMENTS STUDY], *available at* http://www.frbservices.org/files/communications/pdf/press/2010_payments_study.pdf.

10. Anisha, *Tester-Corker Durbin Amendment Delay Falls Short*, NERDWALLET (June 8, 2011), http://www.nerdwallet.com/blog/2011/tester-corker-durbin-amendment-delay-falls-short/.

11. *TCF I*, 2011 U.S. Dist. LEXIS 45059, at *8 ("On December 16, 2010, pursuant to subsection (a)(3), the Board issued proposed regulations, presented two alternatives as to interchange rates, and asked for comments as to which alternative it should adopt. In short, one

and final regulations on June 29, 2011,[12] about two months after they were due; the rates went into force on October 1, 2011, instead of July 21, 2011, as had been originally planned.[13] The initial set of regulations called for a debit interchange rate that would under no circumstances exceed twelve cents per transaction, a sharp decline from the forty-seven cents per transaction under the unregulated rate regime.[14] The final regulations, issued after the TCF challenge was turned aside by the Eighth Circuit, roughly doubled the twelve-cent figure, providing that "an issuer may not receive or charge an interchange transaction fee in excess of the sum of a 21-cent base component and 5 basis points of the transaction's value (the *ad valorem* component)."[15]

On April 25, 2011, Judge Lawrence L. Piersol of the District Court of South Dakota handed down a decision that held that TCF's facial challenge to the statute was not ripe for adjudication, so no preliminary injunction should issue.[16] That decision was affirmed, for essentially the same reasons, by the Eighth Circuit on June 29, 2011.[17] The first point in both decisions was that TCF was not entitled to any protections afforded to public utilities, which are subject to systems of rate regulation. Judge Piersol put the point as follows:

> Under *Minnesota Association of Health Care Facilities v. Minnesota Department of Public Welfare*, rational basis review applies to this challenge because TCF's offering of debit cards is not required by the government, nor is Plaintiff engaged in the type of "continuous production of output for the benefit of the public" that commentators have identified as the hallmark of a classic utility. Likewise, there is no monopoly power assumed to be associated with issuing debit cards. Plaintiff is not a public utility under rate case jurisprudence. The case law relied upon by Plaintiff is

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proposal allowed a safe harbor of 7¢ per transaction, but no more than 12¢ if an issuer could show ACS costs in excess of 7¢; the alternative was a flat rate of 12¢. The Board found that current interchange was about 44¢ for an average-sized transaction. Thus it is clear that TCF will experience a revenue reduction under the proposed alternatives.").

12. BD. OF GOVERNERS, FED. RESERVE SYS., DOCKET NO. R-1404, DRAFT OF FINAL RULE: DEBIT CARD INTERCHANGE FEES AND ROUTING 343 (June 2011) [hereinafter FEDERAL RESERVE REPORT], *available at* http://www.federalreserve.gov/aboutthefed/boardmeetings/20110629_REG_II_FR_NOTICE.FINAL_DRAFT.06_22_2011.pdf.

13. *Id.* at 37–38.

14. *Id.* at 48; *see also* ANNE LAYNE-FARRAR, ASSESSING RETAILERS' COSTS AND BENEFITS FROM ACCEPTING DEBIT CARDS 17 (2011).

15. *Id.*

16. *TCF I*, 2011 U.S. Dist. LEXIS 45059, at *14.

17. TCF Nat'l Bank v. Bernanke (*TCF II*), 643 F.3d 1158, 1165 (8th Cir. 2011).

therefore inapplicable to its due process claim.[18]

Accordingly, the level of review of government action is conducted on the "highly deferential" rational basis test, which requires the claimant to show that the government has acted in an "arbitrary and irrational way": "Price control is unconstitutional if arbitrary, discriminatory, or demonstrably irrelevant to the policy the legislature is free to adopt."[19]

The rational basis test was also relevant to the second of the government's arguments—that TCF could not show that it had a protectable interest, given that Visa had the "unmitigated" right to change its rate structure at will:

> Although TCF has an expectation regarding future debit interchange fees based on its contract with Visa, TCF is unlikely to prevail on its due process claim because Visa retains unmitigated discretion to set debit interchange fees and there is no statutory or contractual provision guaranteeing TCF a certain level of interchange income. Fees associated with payment transactions initiated by bank customers have also been historically subject to regulation and market pressures beyond TCF's control.[20]

The government's third argument was that the system of rate regulation only covered the funds that TCF could receive from merchants through the debit card system, but did not cover the amounts that it could receive by charging its own customers, which amounts *must* be taken into account in order to determine whether the rates in question are confiscatory.

> Since TCF is free under the Durbin Amendment to assess fees on its customers to offset any losses under the Durbin Amendment, we are skeptical that the Durbin Amendment has even created a sufficient price control on TCF's debit-card business so as to trigger a confiscatory-rate analysis or that the law could, in fact, produce a confiscatory rate.[21]

Accordingly, under the stringent standards applicable to issuing preliminary injunctions, the case was dismissed.[22]

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18. *TCF I*, 2011 U.S. Dist. LEXIS 45059, at *12–13 (citing Minn. Ass'n of Health Care Facilities v. Minn. Dep't of Pub. Welfare, 742 F.2d 442 (8th Cir. 1984)).

19. *TCF II*, 643 F.3d at 1163 (quoting Pennell v. City of San Jose, 485 U.S. 1, 11 (1988)) (internal quotation marks omitted).

20. *TCF I*, 2011 U.S. Dist. LEXIS 45059, at *14.

21. *TCF II*, 643 F.3d at 1164.

22. Both courts used the standard tests for preliminary injunctions. The appellate court stated:

> In determining whether to issue a preliminary injunction against a duly enacted statute, the district court must consider: (1) whether the movant is "likely to

The short opinions of both the district and appellate courts make it appear that TCF's suit was just one more on the forlorn list of misguided challenges to the government's power to set rates and control prices. However, virtually every statement that is treated as unquestioned truth in these two opinions is in fact wrong, and demonstrably so. First, by creating the Durbin Paradox, the two *TCF* decisions get matters exactly backwards by insisting that because there is "no monopoly power" in banks that issue debit cards, the government has more, rather than less, power to regulate these entities.[23] So long as these companies have made fixed investments in the ground, they are entitled to the same protection against confiscatory rates as public utilities because they are subject to the same risk of government abuse. Second, the want of any firm contract with Visa is no more relevant to TCF's constitutional rights than the want of every public utility with its own clients. In both cases, the parties to these agreements take business risks between themselves but do not assume the risks of forcible intervention with their prospective advantage by forces beyond their control. Third, the question is not whether the regulated banks can receive some additional compensation from their own customers, as they surely can. Rather, the question is whether TCF is entitled to an injunction when there is no showing that this compensation will, or even could, equal the position that the companies had before the statute was imposed. Unless the government can show that its compensation is full and complete, it cannot go ahead with the regulation.[24] And once the structure of the industry is understood, it is clear that the compensation recoverable under the Durbin Amendment in this instance falls far short of that required under the Constitution.

> prevail on the merits"; (2) the threat of irreparable harm to the movant; (3) the state of balance between this harm and the injury that granting the injunction will inflict on other parties litigant; and (4) the public interest.

TCF II, 643 F.3d at 1162 (citing and quoting Planned Parenthood Minn., N.D., S.D. v. Rounds, 530 F.3d 724, 729 n.3, 733 (8th Cir. 2008), and citing Dataphase Sys., Inc. v. C L Sys., Inc., 640 F.2d 109, 113 (8th Cir. 1981)). The district court similarly noted:

> [T]he Court [must] examine first the likelihood that TCF will prevail on the merits of its claim that the statute is unconstitutional before the Court applies the remaining three factors of a preliminary injunction analysis: (1) whether Plaintiff will suffer irreparable harm in the absence of an injunction, (2) any harm to other interested parties, and (3) the effect on the public interest.

TCF I, 2011 U.S. Dist. LEXIS 45059, at *12 (citing Planned Parenthood Minn., N.D., S.D. v. Rounds, 530 F.3d 724, 729 n.3, 731 (8th Cir. 2008); Dataphase Sys., Inc. v. C L Sys., Inc., 640 F.2d 109, 113 (8th Cir. 1981)).

23. *TCF I*, 2011 U.S. Dist. LEXIS 45059, at *12; *TCF II*, 643 F.3d at 1164–65.

24. *See* Monongahela Navigation Co. v. United States, 148 U.S. 312, 325–26 (1893) (defining "just compensation" in the context of government takings as "a full and perfect equivalent of the property taken").

The development of an alternative approach to these issues requires a far more systematic account of these three points. First, one must give some account of the way in which these debit transactions were organized before the passage of the Durbin Amendment. Part I of this Article therefore seeks to determine 1) whether this organization represents an exercise of monopoly power (either by the debit card companies or their member banks, or both), or 2) whether such organization was actually an efficient way to handle interchange in the current network industry situation (that situation being one in which the requirement for interconnection makes it impossible to have pure competitive solutions because firms must cooperate in the set-up in order to compete). Part I concludes that the second efficiency explanation is correct and that the attempt to find subtle influences of monopoly power on debit transaction organization is not credible.

Part II examines the provisions of the Durbin Amendment, which were explicitly justified—both by Senator Dick Durbin and the merchants who supported them—by the view that the monopoly account of debit card markets was correct. Part II explores the various mechanisms used to regulate banks and the exemptions that are afforded under the Amendment for small banks, defined as those that have less than $10 billion in bank assets.[25] That group of smaller banks covers all but sixty banks and three credit unions in the United States, out of about 7,000 banks and 7,000 credit unions total. Those larger institutions, however, hold the vast majority of total bank assets.[26]

Part III then uses the information in Parts I and II to conduct a constitutional inquiry, which will necessarily face far higher hurdles if the antimonopoly rationale for the Amendment holds than it will if the efficiency explanation offered by the industry's defenders, and this Article, is correct. Accordingly, under the current tests for rate regulation, this Article argues that in principle—no matter what the regulated rates set by the Federal Reserve—the Durbin Act is unconstitutional.

I. THE ECONOMICS OF DEBIT CARD TRANSACTION

The Durbin Amendment regulates debit card interchange fees[27]—the fees that merchants, through "acquiring," pay for processing debit transactions through Visa and MasterCard, which then remit some fraction of these payments to the banks that issued debit cards to their own

25. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 723(a), 124 Stat. 1376, 1680 (2010) (to be codified in scattered sections of the U.S. Code).

26. *A Repository of Financial Data and Institution Characteristics Collected by the Federal Reserve System*, NATIONAL INFORMATION CENTER (Sept. 30, 2011), http://www.ffiec.gov/nicpub web/nicweb/top50form.aspx.

27. *See* Dodd-Frank Act sec. 1075, § 920(a)(1), 124 Stat. at 2068.

customers.[28] Before the Durbin Amendment, interchange fees for debit card use were set by the coordination of the activities of the five central players in the system: the cardholder, the bank that issued the card to that person, the network platform, the merchant bank, and the merchant.[29] At the center of the system sits the credit card company, which operates at the nexus between the customer and the merchant. The two most essential parties in this system are Visa and MasterCard, which have a combined share of about 83% of debit card transactions, with Visa having a 66% market share and MasterCard having the remaining 17%.[30] Other smaller operations control the rest of the business; however, debit cards occupy only part of the payments system, which includes an ever broadening set of payment methods—PayPal, mobile phone payments, prepaid cards, and the like.[31]

On one side of this payment platform are the customers who acquire their debit or credit cards from a bank. There is a direct contract between the customer and the bank, and that contract may include a variety of fees that the customer has to pay the bank for services, including charges for defaulting on payment obligations. As the market was organized prior to the passage of the Durbin Amendment, retail customers did not pay any interchange fees for the use of their debit cards, which they received for free. On the other side of the interchange platform is the retailer, who usually works though a merchant bank to secure connections to the platform operator, and through that platform operator to the customer and the customer's bank. The retailers and their merchant banks negotiate a contract for the services that the bank renders to the retailer, the cost of which will vary with the level of services that the retailer furnishes to itself and those furnished by the bank.

A representative set of numbers reads as follows, starting with a $100 debit transaction by a consumer. On a $100 transaction, the merchant receives back approximately $97.20. The issuing bank retains roughly $1.70 and around $0.50 is retained by the merchant or acquiring bank for the debit card company.[32]

The organization of this network takes place without any direct negotiations between the merchants on the one side of the platform and the issuing banks on the other. Rather, the rates between Visa and MasterCard and the various merchants are indeed negotiated rates, which depend on the quality of the debit card information and the volume of services that the

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28. FEDERAL RESERVE REPORT, *supra* note 12, at 60–61.

29. *See id.* at 356 n.199.

30. STEVEN C. SALOP ET AL., MERCHS. PAYMENTS COAL., ECONOMIC ANALYSIS OF DEBIT CARD REGULATION UNDER SECTION 920 10 (2010), *available at* http://www.federalreserve.gov/newsevents/files/merchants_payment_coalition_meeting_20101102.pdf.

31. FEDERAL RESERVE REPORT, *supra* note 12, at 124.

32. *See generally* LAYNE-FARRAR, *supra* note 14.

merchant supplies to the platform operator. These rates are typically below 1% for large retailers like Wal-Mart, and are far more expensive (even five or six times as high) for smaller retailers that present greater operational challenges and default risks to the banks.[33] On the other side, Visa and MasterCard negotiate standard fees with issuing banks, which fees represent what the banks are paid for the services they rendered to merchants and customers. In addition, the platform operator takes its own small cut on each transaction. In essence, once a merchant bill is presented to the issuing bank, that bank takes the appropriate sums out of the debit card holder accounts, keeps its own fee, and passes on the remainder of the money, first to the platform operator (which takes its own slice) and then to the acquiring or merchant bank.[34]

The distinctive feature of this system is the interchange fee that goes over the network from merchant to customer. The key question asks what function these fees serve. Here, the simplest explanation for the current fee structure is that it allows the issuing banks and Visa and MasterCard to provide several services of value to the merchants. To be sure, merchant groups often claim that these debit card transactions are just the equivalent of checks,[35] which generally clear "at par," meaning that the person to whom a check is made out receives the face value of the check. But one reason that debit transactions do not clear at par is that, in fact, they serve important additional functions, summarized by Anne Layne-Farrar, a TCF consultant, as follows:

> Thus far in the debate over the Durbin Amendment, to the best of my knowledge, retailers have focused solely on bank card transaction fees and have not acknowledged that cards may provide benefits that offset those bank fees. For instance, card payments can often be processed faster than cash, and are certainly faster than a check, which means retailers save labor time at the checkout station, save consumers time for their

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33. *See, e.g.*, VISA, VISA U.S.A. INTERCHANGE REIMBURSEMENT FEES (2011), *available at* http://usa.visa.com/download/merchants/visa-usa-interchange-reimbursement-fees-october2011.pdf.

34. See Richard A. Epstein, *The Dangerous Experiment of the Durbin Amendment*, REG.: CATO REV. BUS. & GOV'T, Spring 2011, at 24, 26–27, for further description.

35. *See, e.g.*, Brief of Amicus Curiae the Retail Litigation Center, Inc. in Support of Appellees and Affirmance of the District Court Order at 4, TCF Nat'l Bank v. Bernanke, 643 F.3d 1158 (8th Cir. June 29, 2011) (No. 11-1805), 2011 WL 2003118 [hereinafter RLC Brief] ("Debit cards, like checks, are merely an access device to consumers' asset accounts, usually a checking or demand deposit account (DDA). TCF admits as much: 'Today, one cannot separate out the debit service from a checking account.' TCF even refers to its debit cards as 'check cards,' as did Visa when it first marketed debit cards." (footnotes omitted) (quoting Amended Complaint at para. 48, TCF Nat'l Bank v. Bernanke, No. CIV 10-4149, 2011 U.S. Dist. LEXIS 45059, at *14 (D.S.D. Apr. 25, 2011), *aff'd*, 643 F.3d 1158 (8th Cir. June 29, 2011), and News Release, TCF Bank, TCF Bank Announces Checking Product Enhancements and Introduces Mobile Banking (Jan. 5, 2011), http://ir.tcfexpress.com/phoenix. zhtml?c=95289&p=irol-newsArticle&ID=1513371&highlight=)).

> own checkout as well as in line behind others. In addition, debit cards do not involve cash in the till and thus lower retailers' risk of employee theft or break in. Unlike checks, debit cards provide merchants (following the prescribed steps) with guaranteed payment. Moreover, debit cards can offer retailers direct benefits, such as increased incremental customer spending.[36]

It is worth explaining her conclusions in a bit more detail. The check is a "dumb" piece of paper that does not integrate easily with merchant computer systems and thus does not supply merchants with instant information of value in their own business. Use only a check, and it will not add anything to the merchant's knowledge of the financial position of the customer. The check, moreover, offers a slower form of payment, which reduces the flow of customers through checkout lines, which in turn increases the cost of processing these transactions. Even though check-imaging systems today make it unnecessary to ship checks back and forth across the country, those record-keeping devices do not allow for instantaneous examination of bank balances and credit histories while the customer is waiting in the checkout line. The risk of bad checks, moreover, remains with the retailer because the bank at the time and place of service has no direct means to determine whether the customer has sufficient funds to cover that transaction in his demand deposit account, formerly known as a checking account. (The new name reflects that the payments from this account are usually *not* made by checks, whose use, both by number and by dollar amount, has decreased sharply in recent years.)[37]

In dealing with this issue, it is critical to note that there is always a risk component with respect to debit card payments because it often makes good business sense for banks to allow customers to overdraw their accounts at the end of the month if they are confident that the next paycheck will cover the expenditure. The algorithms used to make these judgments are not perfect, such that putting the risk of loss on the bank for the debit payments it has authorized offers an effective bonding device for the reliability of the system. As with all warranties, the outsider does not need to understand how its trading partner works, so long as it receives a full warranty against its losses. This warranty is relatively easy to arrange for liquidated sums, against which a premium can provide adequate insurance; this is what happens whenever merchants electronically make contact with the bank, which immediately authorizes the payment, then clears and settles the transaction. The superior information available to the bank thus makes it rational for it to assume the risk of default—a risk that

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36. LAYNE-FARRAR, *supra* note 14, at 3. Layne-Farrar's report provides a detailed discussion of, with an effort to quantify, net benefits. *See generally id.*

37. *See* 2010 FEDERAL RESERVE PAYMENTS STUDY, *supra* note 9, at 7–8.

is one of the elements of expense covered by interchange fees that merchants pay to issuing banks. Yet these residual risks can still be high: as the Federal Reserve notes, "comparable service for checks costs merchants 1.5 percent of the transaction value,"[38] a figure which is somewhat reduced for debit card transactions, with their superior monitoring.

In addition, the convenience of debit cards means that individual customers carry less cash; there is corresponding evidence of "ticket lift," which means that customers tend to make larger purchases on debit cards than they do with cash, ranging from 5% to 20% of the purchase price. Visa and MasterCard also both promote their own brands, which brings more customers into the system, and the banks promote their own individual cards, which brings more customers to each merchant—another benefit of the cards.[39]

In assessing the uses of debit cards, these benefits to the merchant must be offset against its interchange fee. As a matter of basic economic theory, it is obvious that both customers and merchants benefit from this high volume of debit transactions. Nonetheless, that position is frequently urged by merchants[40] who purport to identify a market failure on the customer side because they do not have an explicit breakdown of debit interchange fees, which if known would lead to major protests. This information is publicly available,[41] but in most cases, the rational customer's first order of business is to compare the value of the goods and services received against the amount charged for them. Once the value received is greater than the cost, there is no more reason to inquire into the amount that goes to debit interchange than there is to ask what fraction of the sale price goes to overhead, service, and the cost of goods. None of that information will alter the basic decision point. To be sure, consumers would love to have lower prices, but they do not need full disclosure to push them down that favorable path. Let any firm raise prices so that they do not reflect underlying costs, and other firms with lower costs will fill the void. No consumer knows the cost of each component of a new computer, but competition for overall sales drives the price of the equipment down to the cost of production, as in other markets. It is not credible to find *any* form of market failure, let alone fraud or deception, in the failure to disclose information that no one wants.

Nor is the ultimate analysis different when we look at the other side of the market. It strains credulity to think that the likes of McDonald's resorts

38. FEDERAL RESERVE REPORT, *supra* note 12, at 54.

39. LAYNE-FARRAR, *supra* note 14, at 11–14.

40. *Credit Card Interchange Fees: Hearing Before the Antitrust Task Force of the H. Comm. on the Judiciary*, 110 Cong. 1 (2007) (statement of Rep. John Conyers, Jr., Chairman, H. Antitrust Task Force), *available at* http://judiciary.house.gov/hearings/ printers/110th/36785.pdf.

41. *See, e.g.*, 2010 FEDERAL RESERVE PAYMENTS STUDY, *supra* note 9.

to debit cards in desperation even though it loses money on the transaction relative to other payment forms. Rather, the continued use of these cards in all segments of the economy, including quick service restaurants, is powerful evidence to the contrary.[42] The theory of revealed preferences is too clear. As Kevin M. Murphy, a TCF expert, wrote: "It is highly unusual, indeed perhaps unprecedented, to focus regulatory scrutiny and intervention on a segment of the economy that all participants have voluntarily and enthusiastically embraced, and that has grown faster than and substantially displaced competing products or services."[43]

Yet that inference is passionately resisted by the retailers who claim that "[b]ecause the RLC's members must accept debit cards to remain competitive, they have had no choice but to pay these fees."[44] The point is absurd on its face. If these transactions cost more than they are worth, all retailers should regain the high ground by spurning debit cards and offering lower prices to customers, who should happily be willing to pay with cash or check. But of course, the reason that they do not is that the implicit costs to consumers (in terms of their time and cost) is higher with cash and check, so consumers prefer the same mechanism that is cheaper for the retailers using these services. There has been extensive debate in the literature as to which form of payment subsidizes which other forms of payment, but that debate is ultimately futile.[45] Murphy has rightly noted that some form of cross-subsidy is ubiquitous in all retail markets, if only because some customers rely more on the help of sales staff than others.[46] In general, it is difficult to charge separately for these services, so these imbalances are handled in more subtle ways, like walking away from

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42. *See id.* at 15–19.

43. Report of Professor Kevin M. Murphy at 3, TCF Nat'l Bank v. Bernanke, 2011 U.S. Dist. LEXIS 45059 (D.S.D. Feb. 15, 2011) (No. CIV 10-4149), 2011 WL 863916 [hereinafter Murphy Report].

44. RLC Brief, *supra* note 35, at 1.

45. For a demolition of the cross-subsidy claim with respect to gasoline purchases, see Steven Semeraro, *The Reverse-Robin-Hood-Cross-Subsidy Hypothesis: Do Credit Card Systems Tax the Poor and Reward the Rich?*, 40 RUTGERS L.J. 419 (2009), which concluded:

> Although the best available evidence indicates that merchants pay more out-of-pocket to accept credit cards than they do for other forms of payment, these costs are only half the story. Credit cards provide significant benefits to merchants that could outweigh the incrementally higher out-of-pocket costs and thus lead to lower retail prices. Although the evidence is inconclusive, credit card acceptance appears to make all consumers better off than they would be if the particular merchants with whom they deal did not accept cards.

Id. at 421–22 (footnote omitted). The same observations can be made about debit cards.

For an analytical demolition of the point, see Murphy Report, *supra* note 43, at 30–31, noting that any analysis that looks only at some costs and benefits, while ignoring all others is "completely one sided."

46. Murphy Report, *supra* note 43, at 31–32.

customers who take up too much time.

The real question is whether these retail institutions can tolerate systematic cross-subsidies that do, in fact, create distortions among customer classes. Where these show up in substantial form, a merchant has an incentive to introduce differential pricing, if that could be implemented at a low enough cost. If debit cards were subsidized by cash and check customers, we should see merchants move to eliminate the subsidies in order to increase their customer base. Yet the reverse is actually true. We also know that all cross-subsidies are necessarily eliminated if debit and credit cards drive out cash and checks; this is the case with some airlines that will take only plastic for onboard transactions. More generally, the relative decline in the use of cash and checks makes it very hard to say that a smaller fraction of payment transactions subsidize the rest, when it could easily go in the opposite direction. The proper mix of payment systems for any given firm is difficult to predict in the abstract. Some small outfits take only cash, while others refuse to take cash or checks. Some accept multiple forms of payment, but may steer customers to one form of payment relative to another. These differences do not, however, supply evidence of some pervasive form of market failure. They show only that "different strokes for different folks" is appropriate for payment systems, as it is for just about every other feature of doing business.

It is, therefore, simply not tenable to accept the merchant contention that huge businesses use operations on which they lose money, when other options are available to them. Nonetheless, the rapid expansion of the debit card industry could still be consistent with the view that monopolization on the other side of the industry has made the use of debit (and credit) cards more expensive for merchants than would have been the case in a pure competitive market. In fact, much of the criticism against the debit card structure is that it in fact does facilitate monopoly practices. Once again, the RLC brief shows how the argument is made in a judicial setting: "[N]etworks like Visa fix the price of interchange for TCF and its rival issuing banks, and then [use] their market power [to force] merchants to accept debit cards with . . . anticompetitively high interchange fees."[47] These remarks are consistent with the same charges that have been levied against the debit card companies and the banks in Congressional testimony. Mallory Duncan, the General Counsel of the NRF, states that charge baldly: "Visa and MasterCard . . . are cartels whose members set the fees they will charge and all agree to charge the same fees."[48] Indeed, as the government notes in its brief, both banks and merchants have a similar

47. RLC Brief, *supra* note 35, at 13.

48. *Credit Card Interchange Fees: Hearing Before the Antitrust Task Force of the H. Comm. on the Judiciary*, 110 Cong. 54 (2007) (statement of Mallory Duncan, Senior Vice President and General Counsel, National Retail Federation), *available at* http://judiciary.house.gov/hearings/printers/110th/36785.PDF.

relationship to the credit card companies. Thus, in speaking of TCF, it observes that "[n]othing in plaintiff's contract with Visa guarantees any minimum interchange fee or even limits the circumstances in which Visa can reduce the fee schedule,"[49] which, while true, hardly shows that credit card companies and banks are in cahoots.

What is clearly lacking in these broad denunciations is a coherent account of some antitrust violation. For starters, if there were indeed cartels that operated in violation of the antitrust laws, the merchants would not need to apply to Congress for any special relief under the Durbin Amendment. Instead, they could simply file a complaint under the Sherman Antitrust Act, taking advantage of what is essentially a per se rule with respect to cartel behavior and obtaining treble damages and perhaps some form of injunctive relief.[50] Yet to this point, no merchant has attempted to file a suit of that sort. Indeed, the successful antitrust actions (the merits of which could be disputed) take exactly the opposite form. They seek to attack particular practices that each of these networks have undertaken unilaterally to show that they create, for example, some type of illegal tie-in arrangement.[51]

At this juncture, it is necessary to inquire how the cartel theory applies to Visa and MasterCard when they try to organize their vertical relationships with their own customers. It is agreed on all sides that there is no coordinated effort by the banks to set interchange rates. Indeed, as the RLC notes in connection with TCF, the evidence is unambiguous that it and all other Visa banks are rate-takers rather than rate-makers. As RLC states, "Debit networks fix the price of interchange for rival issuers, and can change it at will,"[52] and furthermore these debit "[n]etworks have used market power to force merchants to accept these high interchange fees that

49. Brief for Appellees at 16, TCF Nat'l Bank v. Bernanke, 643 F.3d 1158 (8th Cir. June 29, 2011) (No. 11-1805) [hereinafter Brief for Government].

50. *See* Sherman Act, 15 U.S.C. §§ 1–7 (2006).

51. *See In re* Visa Check/Mastermoney Antitrust Litig., 297 F. Supp. 2d 503, 506–07, (E.D.N.Y. 2003), *aff'd sub nom.* Wal-Mart Stores, Inc. v. Visa U.S.A., Inc., 396 F.3d 96 (2d Cir. 2005), *cert. denied sub nom.* Leonardo's Pizza by the Slice, Inc. v. Wal-Mart Stores, Inc., 544 U.S. 1044 (2005). The stated value of the settlement was $2 billion against Visa and $1 billion against MasterCard, but those figures do not correct for discounting. The actual practice attacked in those cases was the decision to tie the use of signature debit to PIN debit at various retail outlets. *Id.* at 507–08. In general the direct costs of PIN debit are lower than those of signature debit, but there is a large level of consumer resistance to PIN debit (especially since the theft of PIN numbers could result in fraud when the card is used elsewhere). In fact, only a handful of establishments have taken advantage of the option to break the tie, given the division of consumer sentiment on the issue. It seems incredulous for the RLF to claim that settlement contained "injunctive relief 'result[ing] in future savings to the Class valued from approximately $25 to $87 billion or more.'" RLC Brief, *supra* note 35, at 14 n.39 (alteration in original) (quoting *In re Visa Check*, 297 F. Supp. 2d at 511–12).

52. RLC Brief, *supra* note 35, at 7.

are unrelated to costs."[53] The critics of the industry take the point one step further when they note that the contracts Visa uses do not confer any strong rights on their member banks, given that Visa can simply change the rates.[54]

The question is how best to read this information. One way is to say that Visa takes it upon itself to create a cartel for the various banks it seeks to attract as customers. Yet one must pause to ask whether there could be any efficiency justification for the practice that would block the application of a per se denunciation. In this context, there clearly is, given the central role that both Visa and MasterCard play in the organization of a network industry. To see why this is the case, just assume for the moment that Visa and MasterCard did not exert any influence to standardize prices. At that point, just how would these debit interchange fees be determined? The answer is only at a far higher transaction cost. The point here bears directly on the question of antitrust liability because it is always a fair question to ask whether some supposed risk of monopolization presents a greater peril to market operation than the risk of a system paralysis brought on because the transaction costs are so high that they exceed the joint gain for all parties. In a world in which there are upwards of 5,000,000 retailers and 7,000 banks,[55] one-on-one negotiations are a dead loser for all parties. Hence, the intermediary sets the rates on both ends, passing on the savings to both parties and to the consumers who operate on both sides of the market.

The key question therefore becomes this: just how are these rates set? To answer this question, the retailers hired Professor Steven Salop of the Georgetown University Law Center, who urged that all debit interchange fees be abolished, so that these transactions, like checks, cleared at par. He noted that the Canadian interchange system was set up this way from the outset and that it could be a viable model for dealing with the exchange problem in the United States.[56] His reason for wanting this system is that he feared that the dynamics of these markets were such that Visa and MasterCard would find it in their interest to push rates to the banks as high as they could in order to attract their customers. Professor Salop concluded:

> The fact that Visa and MasterCard have market power over merchants, but compete for issuers, implies that they have strong incentives to exploit their market power over merchants in order to subsidize issuers. This dynamic has

53. *Id.* at 9.

54. VISA, VISA INTERNATIONAL OPERATING REGULATIONS: CORE PRINCIPLES 10 (2010), *available at* http://usa.visa.com/download/merchants/visa-international-operating-regulations-core.pdf.

55. *See In re* Visa Check, 297 F. Supp. 2d at 522–24.

56. SALOP ET AL., *supra* note 30, at 24–26.

> resulted in high interchange fees that are paid by merchants and received by issuers.[57]

Yet this statement, repeated many times in the study, conceals more than it raises. The initial question is why it is that Visa and MasterCard have market power only over the merchants and not over the banks. That position possibly made some sense when Visa and MasterCard were each run by a coalition of large banks, even as they supplied their services to a larger banking community. But it was precisely to avoid the antitrust risk associated with this behavior that MasterCard converted itself into an independent entity in 2007, and Visa followed in 2008. The rates charged in these cases did not change much with this reorganization. The reason why one profit-making entity should shower goods on another is not fully explained.

The second point is that it is hard to understand what the equilibrium price is under this model. Each time the interchange rates are raised with respect to the merchants by, say, Visa, it presents a profit opportunity for MasterCard to keep or even trim its rates, in order to persuade merchants to steer their customers in their direction. It would be devastating for either Visa or MasterCard to find that some large establishments would refuse to take its purchasers, especially when many customers carry both types of cards. Indeed, it is for that reason that the two companies compete up and down the market. The entire market is not as stable as the market shares suggest, for if either Visa, MasterCard, or both raised their rates, the fringe players could start to compete for a larger share of the marketplace under the price umbrella these firms create. The assertion of monopoly power that comes from the true claim that the merchants would very much like to take all cards may nudge rates above the competitive level, but if so, it is not clear by how much. Nor is it possible to think of any pricing pairing mechanism that would not be worse than the condition that it is intended to cure.

In making these claims about the peculiar structure of the market, Salop notes, correctly, that the distinctive feature of debit card markets is that they are two-sided markets.[58] A two-sided market is not one in which there are just buyers and sellers, of course; by that definition, all markets would be two-sided. Rather, the term applies to markets in which there are least three parties to the transaction, where the middle party (here, Visa and MasterCard) is there to make sure that the two opposing sides are willing to do business with each other. Kevin Murphy, in his written testimony on behalf of TCF, notes that in a two-sided market, the ability to attract customers on one side of the market depends on the ability to attract those customers to the other side of the market. The most obvious illustrations of

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57. *Id.* at 1–2.

58. *See* SALOP ET AL., *supra* note 30, at 12–13.

this are dating services, which try to attract the right proportion of men and women, and dining services, such as Groupon, which must match restaurants with customers. The point is that someone has to pay the fees to operate the matching services, and in these markets, the fees are *not* typically borne equally by both sides of the market, but rather are paid from one side of the market. With dating services, therefore, men pay higher rates in order to attract the relative paucity of women, and with food services, the payments come from the restaurants, which are anxious to fill empty tables. In all of these situations, the payment systems, in effect, introduce a conscious cross-subsidy across the two sides of the market so that the parties on the less elastic (that is, price-sensitive) side of the market pay some money over to the other side in order to keep the market alive.[59]

The key mistake in Salop's argument is that at no point does he address the potential efficiency gains that arise from these cross-market payments in two-sided markets—even when, as with restaurants and bars, none of the participants to the organization contain any element of monopoly power. Yet the theoretical foundation for this position is well laid out in the late Professor William F. Baxter's classic article on the question.[60] The clear implication of Professor Baxter's article is that, wholly apart from monopoly exploitation, there is a strong efficiency explanation as to why payments across network platforms improve the operation of the overall system. This explanation is cumulative with the transaction cost explanation given above, insofar as it offers an additional reason why the markets here converge to a competitive equilibrium. Whether this is *perfect* convergence is impossible to say, but there is nonetheless a good reason to think that the Murphy Report assesses the situation correctly when it concludes, "[P]roponents of debit regulation have not identified any market failure that justifies intervention, because there are none."[61] It is rare to find any industry that is perfectly competitive and it is always possible to postulate that any shortfall in information or transparency counts as a market failure. But even if the Murphy conclusion goes a bit too far, it is clear that the explosive growth and widespread acceptance of debit cards exhibit the signs of a vibrant, highly competitive industry, not one that is in need of a comprehensive overhaul. There is no cartel in operation and no natural monopoly—a point that becomes critical later on in the constitutional analysis.

59. Murphy Report, *supra* note 43, at 11–12, 15–17, 26 n.80.

60. William F. Baxter, *Bank Interchange of Transactional Paper: Legal and Economic Perspectives*, 26 J.L. & ECON. 541, 541–43 (1983).

61. Murphy Report, *supra* note 43, at 2.

II. THE DURBIN AMENDMENT

The subject of debit interchange received extensive general discussion before the passage of the Durbin Amendment. Thus, there were many studies of the topic by the various banks in the Federal Reserve System, hearings on the topic before various committees in the U.S. House of Representatives and U.S. Senate, and a large academic literature devoted to various aspects of the topic. In that large body of material, not a single syllable can be located addressing the highly specific proposal that was incorporated into Section 1075 of the Dodd-Frank Act.

Senator Durbin introduced the eponymous Durbin Amendment late amid the extensive deliberations over the Dodd-Frank legislation.[62] During his well-known floor speech on the Amendment, he repeated many of the arguments examined above, to the effect that his legislation was needed to help small businesses escape the dominant market position of the banks, so that these businesses could take the money that they spend on debit interchange and devote it to lowering prices and creating jobs.[63] In particular, the Senator relied on the private statements of the head of a major corporation (subsequently identified as Greg Wasson, the CEO of Walgreens[64]) that interchange fees were too high because they were the fourth largest item on the corporation's books, after salaries, plant, and health care.[65] During the course of the floor debate, the Senator constantly stressed that the costs of running a debit card system were only a small fraction of the debit interchange fees.[66]

The legislation that Senator Durbin pushed was adopted in response to these elements. The Amendment did not take Professor Salop's position eliminating all interchange fees, but it did instruct the Federal Reserve to "consider the functional similarity" to "checking transactions that are required within the Federal Reserve bank system to clear at par."[67] Immediately preceding this instruction, the Amendment prescribed that interchange fees had to be "reasonable and proportional to the cost incurred

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62. 156 CONG. REC. S3624–25 (daily ed. May 12, 2010); *see also* 156 CONG. REC. S3040–41 (daily ed. May 3, 2010).

63. 156 CONG. REC. S3129–30 (daily ed. May 5, 2010) (statement of Sen. Richard Durbin); *see also* 156 CONG. REC. S3696–97 (daily ed. May 13, 2010) (statement of Sen. Richard Durbin).

64. *See* 156 CONG. REC. S3455 (daily ed. May 10, 2010) (statement of Sen. Richard Durbin) (relating conversation with "the CEO of Walgreens"); *Gregory D. Wasson*, WALGREENS, http://news.walgreens.com/article_display.cfm?article_id=1099 (last visited Oct. 1, 2011).

65. 156 CONG. REC. 3130 (daily ed. May 5, 2010) (statement of Sen. Richard Durbin).

66. *See* 156 CONG. REC. S3695–96 (daily ed. May 13, 2010) (statement of Sen. Richard Durbin); 156 CONG. REC. S3588–89 (daily ed. May 12, 2010) (statement of Sen. Richard Durbin); 156 CONG. REC. S3455–56 (daily ed. May 10, 2010) (statement of Sen. Richard Durbin); 156 CONG. REC. S3130 (daily ed. May 5, 2010) (statement of Sen. Richard Durbin).

67. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, sec. 1075, § 920(a)(4)(A)(ii), 124 Stat. 1376, 2068 (2010) (to be codified at 15 U.S.C. § 1693o-2(a)(4)(A) (West 2010)).

by the issuer with respect to the transaction."[68] The terms "reasonable" and "proportional" were not to be read in isolation, but in turn received their own statutory definitions, which provided that, in issuing its regulation, the Federal Reserve must differentiate between:

> (i) the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction . . . ; and (ii) other costs incurred by an issuer which are not specific to a particular electronic debit transaction . . . .[69]

The implicit subtext of these provisions is that the banks can recoup the revenues they lose in debit interchange from their own customers, in the terms of higher rates for the various services they supply.

Left as a general provision, the Durbin Amendment lacked sufficient votes in the Senate, until Senator Durbin agreed to allow a small-bank exemption from the interchange fees. In his original draft, "small" banks included only banks that had assets of less than a billion dollars.[70] When the bill came up short, he substituted this for ten billion, after which the bill passed.[71] Add a zero and the job was done. Yet at no point in these frantic machinations did anyone make any effort to discuss the impact that the major changes in debit interchange would have on the long-term stability of the system, or the impact that the exemption of the small banks would have on the balance of advantage over debit card accounts. TCF chose to sue because, at $18 billion, it was too large to count as a small bank. Yet it was also heavily invested in its debit card business, which was in direct competition with smaller banks that were nearby all of TCF's locations.[72] At the same time, TCF had no credit card business to which it could shift its customers, as earlier efforts to reach that market failed in light of TCF's position as a retail bank serving many middle- and low-income customers, with high turnover and default rates.[73] It is worth noting that the class of banks considered "large" under the Amendment is quite broad, as the three largest banks in the United States, which run highly diversified operations, are Bank of America, JP Morgan Chase, and

68. Dodd-Frank Act, sec. 1075, § 920(a)(2), 124 Stat. at 2068 (to be codified at 15 U.S.C. § 1693o-2(a)(2)).

69. *Id.* § 920(a)(4)(B)(i)–(ii), 124 Stat. at 2068–69 (to be codified at 15 U.S.C. § 1693o-2(a)(4)(B)).

70. 156 CONG. REC. S3040-41 (daily ed. May 3, 2010).

71. Dodd-Frank Act, sec. 1075, § 920(a)(6)(A), 124 Stat. at 2070 (to be codified at 15 U.S.C. § 1693o-2(a)(6)(A)).

72. Brief of Appellant TCF National Bank at 9–10, TCF Nat'l Bank v. Bernanke, 643 F.3d 1158 (8th Cir. June 29, 2011) (No. 11-1805).

73. Amended Complaint at 10, TCF Nat'l Bank v. Bernanke, 2011 U.S. Dist. LEXIS 45059 (D.S.D. 2011) (No. CIV 10-4149).

Citibank, all with assets at or over $2 trillion dollars,[74] and all of which are more than a hundred times TCF's size. These differences illustrate that a statute like the Durbin Amendment could easily have a vastly differential effect on the various parties whom it governs.

The Durbin Amendment took effect on October 1, 2011.[75] In the days leading up to its implementation different banks announced that they would put different kinds of fees on debit card use, most notably the $5 per month fee that Bank of America thought was needed to restore its financial position, which is already subject to severe attack. There is also ample evidence that many banks will pull back on various services in order to rein in costs, knowing that under the current rate structure they are expected to lose about $6.6 billion a year in debit card fees.[76] Yet, although much is now known, there remains much uncertainty as to how deeply it will cut into the operation of the debit markets and as to how important the small bank exemption will prove in influencing customers to move. The most notable development is that, in its long final report, the Federal Reserve gave an expansive reading to the allowable costs, which did not limit these only to the costs of authorizing, clearing, and settling individual transactions. Instead, the Federal Reserve adopted a far broader rule, noting that "[i]n establishing the standard, the Board included *all types* of costs incurred by the issuer to effect an electronic debit transaction for which reliable data were available to the Board through its survey or through comments."[77]

The point of this Article is not to examine whether this broad reading is correct, although it is not. Rather, it is to deal with the constitutional issues of the statute, on the assumption that the rules adopted by the Federal Reserve should be treated as though they were explicitly inserted into the statute. With these understandings in place, Part III will now address the constitutional challenges to the Durbin Amendment. I stress at the outset that these are my own views and do not necessarily represent the position of TCF National Bank or indeed any of the many parties who have such a deep interest in the litigation.

74. *Top 50 Bank Holding Companies Summary Page*, NAT'L INFO. CENTER, http://www.ffiec.gov/nicpubweb/nicweb/nichome.aspx (last updated Sept. 30, 2011).

75. FEDERAL RESERVE REPORT, *supra* note 12, at 37.

76. *See, e.g.*, Tara Siegel Bernard & Ben Protess, *Banks to Make Customers Pay Fee for Using Debit Cards*, N.Y. TIMES, Sept. 29, 2011, at A1.

77. FEDERAL RESERVE REPORT, *supra* note 12, at 74 (emphasis added).

III. CONSTITUTIONAL TAKINGS CLAIMS AND THE DURBIN AMENDMENT

A. *The Case for Strict Scrutiny*

Both opinions in the TCF litigation opted for the rational basis test,[78] as if it were the only possible standard that could apply to the case. In so doing, neither the Eighth Circuit nor the district court cited or discussed the rate regulation cases governing public utilities, even though these cases were prominently featured in TCF's briefs.[79] Instead, both opinions immediately adopted the due process test that is used in many price control settings, including those schemes used for dairy products[80] and rent control.[81]

It is a common understanding among constitutional scholars that the outcome of a particular constitutional challenge depends heavily on the standard of review that is brought to a case. In approaching this question, current law has articulated three standards of review that, with many gradations, dominate constitutional law: (a) strict scrutiny of the statute or regulation, (b) intermediate scrutiny, and (c) rational basis review, which allows the legislature great deference.

The best way to understand the difference among these tests is to ask which errors of what magnitude the court is prepared to tolerate in the administration of the law. Under a strict scrutiny regime, the law attaches great weight to the constitutional claim and therefore tolerates only a low rate of error before invalidating the law. At the opposite extreme, the errors necessary to warrant invalidation under rational basis review are thought to be quite high. It is therefore the case that in all disputes, a more favorable standard of review for the challenger can increase by an order of magnitude the likelihood that a constitutional challenge will be successful.

On this issue, it is important to note the four-part classification in the current takings and economic liberties literature that frames the debate. At one extreme lie the rules dealing with the physical occupation of property, for which there is a virtually per se obligation on the part of the government to compensate, no matter for what purpose the property is used.[82] At the other extreme, most especially in land use cases, the standard of review is set by the critical Supreme Court decision in *Penn Central Transportation Co. v. City of New York*,[83] which self-consciously

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78. TCF Nat'l Bank v. Bernanke (*TCF I*), No. CIV 10-4149, 2011 U.S. Dist. LEXIS 45059, at *12–13 (D.S.D. Apr. 25, 2011), *aff'd*, 643 F.3d 1158 (8th Cir. June 29, 2011); TCF Nat'l Bank v. Bernanke (*TCF II*), 643 F.3d 1158, 1163 (8th Cir. June 29, 2011).

79. *See, e.g.*, Brief for Appellant at 20–45, *TCF I*, 643 F.3d 1158 (No. 11-1805); Reply Brief for Appellant at 6–13, *TCF I*, 643 F.3d 1158 (No. 11-1805).

80. *See, e.g.*, Nebbia v. New York, 291 U.S. 502, 537 (1933).

81. *See, e.g.*, Block v. Hirsh, 256 U.S. 135, 153–54 (1921).

82. Loretto v. TelePrompter Manhattan CATV Corp., 458 U.S. 419, 441 (1982).

83. 438 U.S. 104 (1978).

established a far more deferential standard for regulatory takings, that is, those takings that limit the use and disposition of particular property without any dispossession of the tenant. The case's key passage reads:

> While this Court has recognized that the "Fifth Amendment's guarantee . . . [is] designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole," this Court, quite simply, has been unable to develop any "set formula" for determining when "justice and fairness" require that economic injuries caused by public action be compensated by the government, rather than remain disproportionately concentrated on a few persons. . . .
>
> In engaging in these essentially ad hoc, factual inquiries, the Court's decisions have identified several factors that have particular significance. The economic impact of the regulation on the claimant and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations are, of course, relevant considerations. So, too, is the character of the governmental action. A "taking" may more readily be found when the interference with property can be characterized as a physical invasion by government, than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the common good.[84]

In using that test, Justice William J. Brennan, Jr. concluded that New York City's Landmark Preservation Council was within its rights when it blocked Penn Central's plan to build a tower over Grand Central Station: so long as Penn Central was able to cover the costs of its existing operations, no taking had occurred. For these purposes, it was irrelevant that air rights were, as a matter of state law, separable property interests that could be sold or mortgaged in standard market transactions.[85] The key point is that this is a land use case, in which the Court expressed a good deal of concern about how the construction of this tower would influence views from various locations, as well as the character of the neighborhood. These were matters to take into account in this instance, as in dealing with general zoning laws, where the same level of discretion was allowed.[86] In this case, where multiple externalities were at stake, the level of judicial scrutiny was low. The land use cases fall into this category.

84. *Id.* at 124 (alterations in original) (citations omitted) (quoting Armstrong v. United States, 364 U.S. 40, 49 (1960), and citing Goldblatt v. Hempstead, 369 U.S. 590, 594 (1962)).

85. *Id.* at 136–38.

86. *Id.* at 125 (citing Euclid v. Ambler Realty Co., 272 U.S. 365 (1926); Gorieb v. Fox, 274 U.S. 603, 608 (1909); Welch v. Swasey, 214 U.S. 91 (1909)).

The third relevant class of cases deals with general types of economic regulations, where once again a high level of deference is the order of the day under modern constitutional law. Thus, during the New Deal Revolution, the Supreme Court took it upon itself to approve of minimum wage laws,[87] general prospective rent control laws,[88] and in wartime, the Court in *Yakus v. United States* sustained a general system of prospective price controls put forward under loose guidelines that left a fair level of play in the joints.[89] The key feature of these cases is that they were surely a species of economic regulation to which a highly deferential standard of review is applied.

In dealing with the interchange issue, both courts erred in thinking that the rational basis standard applied. The challenge to the Durbin Amendment certainly does not involve a physical taking and thus looks as though it falls into either the *Penn Central* or the *Yakus* line of cases. But that analysis is incorrect under *current* law, for neither of these cases deals with the protection of financial interests in invested capital from forms of rate regulation. That law is provided by *Armstrong v. United States*,[90] which opted for a per se rule stating that disproportionate burdens should not be put on individuals who are asked to shoulder a larger share of the social burden in connection with some government venture.[91] That case dealt with neither physical occupation of property nor land use regulation. Instead, the case involved the status of a materialman's lien that Armstrong had placed on a U.S. Navy ship, a lien that promptly dissolved when the boat sailed out of Maine waters.[92] Clearly, there was no reason Armstrong should have to bear a large fraction of the cost of repairing a U.S. vessel, so the case stands for the proposition that the United States can dissolve any lien that it chooses, so long as it remains prepared under the Takings Clause to be sued by the materialman whose actions it has converted into a general creditor.

That financial context raised none of the issues that are relevant in land use planning, minimum wage, or price control cases. Indeed, the case bears the closest resemblance to the physical takings cases, precisely because the materialman could reduce his lien to possession of the property if the loan were not discharged. In essence, the case offers a per se rule that applies to financial claims against discrete physical assets.

Armstrong also ushers in a discussion of the public utility rate regulation cases that supply the closest parallel to the situation here. The key point to note about these cases is that, like the materialman's lien in

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87. W. Coast Hotel Co. v. Parrish, 300 U.S. 379, 397–400 (1937).

88. *See, e.g.*, Pennell v. City of San Jose, 485 U.S. 1, 4 (1988).

89. *See* Yakus v. United States, 321 U.S. 414, 422–23 (1944).

90. 364 U.S. 40 (1960).

91. *Id.* at 48–49.

92. *Id.* at 41–42.

Armstrong, the protection that is provided under the rule only goes to *previous* investments in specific assets that are committed to some specific economic venture. The great concern is that once the assets are so committed, the government could restrict the price for which they could be sold, so that the original investor could not recover the initial fixed costs. Once that is done, there will not be any other investments in fixed assets of the sorts that are needed to run major public utilities. Accordingly, the constitutional protection afforded in those cases departs radically from the level of protection that is afforded either in the regulatory takings cases under *Penn Central* (in which the Supreme Court did not say a word about rate regulation) or the general economic regulation of the sort at issue in *West Coast Hotel* or *Yakus*. It is therefore no simple historical curiosity that the major modern case on utility regulation, *Federal Power Commission v. Hope Natural Gas Co.*,[93] was decided in the same term as *Yakus*, yet came out exactly the opposite, affording some level of protection to assets that were invested into a business.[94]

B. *Applying Rate Regulation to Competitive Industries with Sunk Costs*

The hallmarks of the public utility regulation cases were alluded to in Judge Piersol's opinion,[95] but without any understanding of the relationship between natural monopolies and competitive industries. Owing to technical limitations on the methods of protection, many services like electric, gas, and telecommunications are industries that require huge front-end costs to get off the ground, coupled with relatively low marginal costs for each additional unit of production over some relevant range. That high fixed-cost, low variable-cost structure makes these public utilities a natural monopoly—in the sense that, over the relevant range of demand, a single supplier within a given territory is able to satisfy the market more cheaply than any two suppliers. This condition holds because the marginal cost of adding new units of capacity are below the fixed cost of starting a second plant to compete with the first.[96] To leave only one party in the marketplace, however, is to let it charge monopoly prices, which, under orthodox economic theory, results in social losses because the quantity of goods sold is restricted as the price charged increases. The theory of rate regulation is that for some limited administrative cost, the government can force the public utility to sell at something that approximates a competitive price, such that the social gains from expanded output are larger than the administrative costs expended to achieve it. That proposition can be, and

93. 320 U.S. 591 (1944).

94. *See id.* at 601–05.

95. *See* TCF Nat'l Bank v. Bernanke (*TCF I*), No. CIV 10-4149, 2011 U.S. Dist. LEXIS 45059, at *12–13 (D.S.D. Apr. 25, 2011), *aff'd*, 643 F.3d 1158 (8th Cir. June 29, 2011).

96. For further discussion, see RICHARD A. POSNER, NATURAL MONOPOLY AND ITS REGULATION 4–6 & n.6 (1999).

indeed has been, disputed.[97] But for these purposes, there is no question that the government in these regulated industries cases has the power to regulate; the only question is how.

The decision in *Hope Natural Gas* was not the first effort to develop a technique to deal with the rate regulation issue. The earlier Supreme Court decision, *Smyth v. Ames*,[98] asked the reviewing courts first to decide those assets of the business that were used and useful in service to the public, and then to calculate an appropriate rate of return on those assets, taking into account the riskiness of the business. Under *Smyth*, the public utility bore the risk that some of its investments would be disqualified, without quite knowing which ones. In exchange, it received a higher rate of return.[99] The decision in *Hope Natural Gas* was developed in reaction to the earlier test, and in it, Justice William O. Douglas iterated a different test, intended to be easier to administer. His alternative methodology simply determined the cash and other assets that were committed to the venture, after which it set a rate of return whose "end result" guaranteed a reasonable risk-adjusted return to the utility. The point of the system was to make sure that courts did not have to review each intermediate decision of the public utility, whose errors could easily cancel out. So long as the overall limitation was in place, nothing else mattered. It is critical to set out the main passage in *Hope Natural Gas*:

> The rate-making process under the Act, i.e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests. Thus we stated in the *Natural Gas Pipeline Co.* case that "regulation does not insure that the business shall produce net revenues." But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. The conditions under which more or less might be allowed are not important here. Nor is it important to this

97. *See* Harold Demsetz, *Why Regulate Utilities?*, 11 J.L. & ECON. 55 (1968) (offering a skeptical view of the question).

98. 169 U.S. 466 (1898).

99. *Id.* at 546–47.

> case to determine the various permissible ways in which any rate base on which the return is computed might be arrived at. For we are of the view that the end result in this case cannot be condemned under the Act as unjust and unreasonable from the investor or company viewpoint.[100]

This decision remains relevant today. *Duquesne Light Co. v. Barasch,*[101] the last rate case considered by the Supreme Court, held that any ratemaking agency had the choice of whether to follow the *Smyth* or *Hope* standard, but could not, of course, simply disregard the question of whether the utility had received a protected rate of return for its invested assets.[102] In applying the *Hope* standard, moreover, the subsequent case law has held that the state does not discharge its obligation by embarking on a regime of slow starvation that allows the regulated firm to stave off bankruptcy but not to get the protected rate of return.[103]

Perhaps the most instructive of the subsequent cases is *Michigan Bell Telephone Co. v. Engler.*[104] In that case, the Michigan Public Service Commission applied a methodology that allowed the telephone company to recover its costs under the so-called Total Service Long Run Incremental Cost (TSLRIC), which was defined as follows:

> Total service long run incremental costs means, given current service demand, including associated costs of every component necessary to provide the service, 1 of the

100. Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944) (citations omitted) (quoting Fed. Power Comm'n v. Natural Gas Pipeline Co. of Am., 315 U.S. 575, 590 (1942)).

101. 488 U.S. 299 (1989).

102. *Id.* at 308–10.

103. See, for example, *Jersey Central Power & Light Co. v. Federal Energy Regulatory Commission*, 810 F.2d 1168 (D.C. Cir. 1987), which stated:

> At oral argument before the *en banc* court, counsel for the Commission indicated that the "end result" test *did* allow a court to set aside a rate order when the company would otherwise go bankrupt and the Commission had refused to take that into account. The source of this constricted standard is elusive, not to say invisible. *Hope Natural Gas* talks not of an interest in avoiding bankruptcy, but an interest in maintaining access to capital markets, the ability to pay dividends, and general financial integrity. While companies about to go bankrupt would certainly see such interests threatened, companies less imminently imperiled will sometimes be able to make that claim as well. Jersey Central alleges that it is such a company. The contention that no company that is not clearly headed for bankruptcy has a judicially enforceable right to have its financial status considered when its rates are determined must be rejected.

Id. at 1180; *see also* Calfarm Ins. Co. v. Deukmejian, 771 P.2d 1247, 1253–56 (Cal. 1989) (en banc).

104. 257 F.3d 587 (6th Cir. 2001).

> following:
> (i) The total forward-looking cost of a telecommunication service, relevant group of service, or basic network component, using current least cost technology that would be required if the provider had never offered the service.
> (ii) The total cost that the provider would incur if the provider were to initially offer the service, group of service, or basic network component.[105]

The Sixth Circuit granted Michigan Bell's request for a preliminary injunction on the ground that this formula did not allow the utility to recover its constitutionally guaranteed rate of return under the *Hope* test because it made no allowance for any positive rate of return at all.[106] The difficulty with the TSLRIC standard is that it insists that, at each interval, the position of the utility be regulated as if it had just made the most efficient investment in state-of-the-art technology. In an industry in which there are high rates of technological advance, that standard means that, over the life of any particular investment, it is certain that the utility cannot recover its fixed costs, given the systematic exclusion of its front-end costs from the system. The methodology was so flawed that there was no reason to wait until the utility had lost its invested capital, and thus a preliminary injunction was granted even under the exacting standards of proving irreparable harm applicable under that standard.[107]

The precedent here is clear. The appropriate strategy in the traditional rate regulation case requires a determination of the full rate base from which the appropriate rate of return is required. At this point, it is best to think of the traditional rate regulation case as an amalgam that incorporates various standards of constitutional review. The insistence on the proper "end result" is a hard line rule that resonates with the strict scrutiny test used in both the physical occupation and the lien cases—*Loretto* and *Armstrong*, respectively—because there are none of the neighborhood effects found in the *Penn Central* line of land use cases, or the large prospective schemes of regulation at issue in cases like *West Coast Hotel, Pennell,* and *Yakus*. Hence, the correct statement of the current legal position is that, so long as the state uses the correct end point, it has some discretion in the choice of methodologies used. But once it is clear that the methodology does not allow for the recovery of the invested capital, then the statute must fail. Nothing in the *Penn Central, Pennell,* or *Yakus* lines of cases interfere with this result. Indeed, not a single ratemaking case cites *Penn Central*, precisely because it deals with a different universe of legal problems. Nor do the words "rational basis" appear in the ratemaking

105. *Id.* at 595 (quoting MICH. COMP. LAWS § 484.2102(ff)).
106. *Id.* at 594–95.
107. *See supra* note 22.

cases, even though that is the standard explicitly embraced.

The most critical question is how these public utility cases carry over to the current problem. At no point did either the District Court or Eighth Circuit address this question. Rather, they simply assumed—wrongly—that the absence of monopoly power eliminated the possibility of ratemaking abuse in the government, when the exact opposite is true. The monopoly firm has an excess cushion that gives it some protection against government abuse. The competitive firm has no such protection, for it is already at the competitive rate prior to the imposition of any system of rate regulation.

At this point, it is critical to explore two key differences between the public utility with the natural monopoly and the debit card bank with no market power. One deals with industry structure and the other with the possibility of revenue recoupment from other sources. First, TCF and the other regulated banks operate in a competitive environment in which there are no territorial limitations either on their business or on the ability of new firms to enter their markets. Second, the standard regulated utility has only one source of income, its customer base, at which point it must be treated like a competitive firm, such that it has a fair chance to earn the appropriate rate of return on its assets from that single source. The situation for TCF and the other banks under the Durbin Amendment is different because they are explicitly allowed to recoup whatever revenue loss they suffer from the loss of interchange fees from their own customers, an opportunity that is not available to standard public utilities.

The key question is how these two elements blend together, given that they cut in opposite directions. On the first point, the fact that the regulated banks are in a competitive market is a strong mark *against* the constitutionality of the legislation. Yet at the same time, the fact that there is pricing freedom between the bank and its customers cuts in exactly the opposite direction, supporting the constitutionality of the regulation. The key inquiry, therefore, is how to evaluate the combined effect of these two factors in shaping the market setting in which TCF seeks to enjoin the operation of the statute. In effect, the regulation in question imposes a real loss on the defendants which counts, this Article argues, as a taking of their property, for which the ability to recoup from customers counts as a form of just compensation.

In dealing with these twin elements, it would be necessary to calculate the precise loss in net value to the regulated banks if the issue was whether some compensation should make good their shortfall. But in this case the government does not have the slightest interest in giving compensation, so it is no longer necessary that TCF show exactly how much it loses through the imposition of the regulation. So long as it can marshal evidence that it will come up short, *even by a penny*, then it is entitled to enjoin the regulation, just as a landowner whose property is worth exactly $100 can resist a government takeover if it were prepared to pay only $99.99. In this case the calculations are not nearly so close, but in fact are likely to cause major financial dislocations even with the new and higher Federal Reserve Rate. The next section examines the two pieces of this puzzle in sequence.

C. *The Dedicated Assets of Banks in Their Debit Card Systems Are Entitled to Full Constitutional Protection*

1. The Relevance of the Public Utility Cases

TCF and other banks have dedicated specific assets toward their debit card business. Sinking those costs in that business raises questions of what items are included in the rate base, but these are not unique questions. The Federal Reserve, when it runs its own check-clearing apparatus, charges merchants for the cost of clearing checks under the regulations that it has issued pursuant to the Depository Institutions Deregulation and Monetary Control Act of 1980,[108] whose regulations are published under the heading "Policies: Principles for the Pricing of Federal Reserve Bank Services."[109] The two main purposes of this system are to "encourage competition to ensure provision of these services at the lowest cost to society," and to "ensure[] an adequate level of services nationwide."[110]

The key regulation reads as follows:

> Over the long run, fees shall be established on the basis of all direct and indirect costs actually incurred in providing the Federal Reserve services priced, including interest on items credited prior to actual collection, overhead, and an allocation of imputed costs which takes into account the taxes that would have been paid and the return on capital that would have been provided had the services been furnished by a private business firm, except that the pricing principles shall give due regard to competitive factors and the provision of an adequate level of such services nationwide.[111]

The explicit emphasis on "all direct and indirect costs" and "the return on capital that would have been provided had the services been furnished by a private business firm" echo the *Hope Natural Gas* formula for defining the rate base and calculating the appropriate return needed. For banks covered by the Durbin Amendment, that rate base includes all the

108. Monetary Control Act of 1980, Pub. L. No. 96-221, sec. 101–08, 94 Stat. 132, 132–41 (codified as amended in scattered sections of 12 U.S.C.).

109. *Policies: Principles for the Pricing of the Federal Reserve Bank Services*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., http://www.federalreserve.gov/paymentsystems/pfs_principles.htm (last updated Nov. 20, 2008).

110. *Id.*

111. 12 U.S.C. § 248a(c)(3) (2006).

costs of installation, maintenance, and upgrade of the computer system, as well as the various expenses needed to operate the system. These expenses on both physical hardware and service are included in the rate base of any regulated public utility, and should also be included here. The fact that they are explicitly excluded, even under the broad reading that the Federal Reserve Board gives to incremental costs, indicates that there is a serious shortfall that must be taken into account.

Both courts took the government's position that none of these calculations matter because none of the banks regulated under the Durbin Amendment counted as public utilities.[112] As noted above,[113] the key case was *Minnesota Ass'n of Health Care Facilities, Inc. v. Minnesota Department of Public Welfare*,[114] where the District Court addressed a question that the Court of Appeals skirted, namely whether the plaintiff nursing homes could challenge the adequacy of rates that they had voluntarily accepted.[115] The simple and correct way to turn aside that challenge was to note that contracts with the government are no different from those with private parties, such that a person could not turn around and demand compensation on a losing contract. But rather than follow that sufficient regime, the court held that the public utilities cases were not relevant at all:

> Cases concerning public utilities are inapposite, however, because the present case simply does not involve a forced taking of property by the state. Minnesota nursing homes, unlike public utilities, have freedom to decide whether to remain in business and thus subject themselves voluntarily to the limits imposed by Minnesota on the return they obtain from investment of their assets in nursing home operation.[116]

In addition, the two courts took the further position that the public utility cases are inapposite because the banks under the Durbin Amendment are entitled to withdraw from the industry altogether, and are thus not in the position of a public utility that is,[117] according to *Duquesne Light*, required to serve its customers.[118] The problem with this argument, if it is correct, is that it sidesteps the issue of whether any compensation is owed, by making the prior claim that this exhaustive scheme of regulation does not trigger any investigation under the Takings Clause. The

112. TCF Nat'l Bank v. Bernanke (*TCF I*), No. CIV 10-4149, 2011 U.S. Dist. LEXIS 45059, at *12–13 (D.S.D. Apr. 25, 2011), *aff'd*, 643 F.3d 1158 (8th Cir. June 29, 2011).

113. *See supra* note 18 and accompanying text.

114. 742 F.2d 442 (8th Cir. 1984).

115. *Id.* at 446.

116. *Id.*

117. *TCF I*, 2011 U.S. Dist. LEXIS 45059, at *12–13.

118. Duquesne Light Co. v. Barasch, 488 U.S. 299, 307 (1989).

government then bolstered this position by examining the particular clauses in the TCF contracts. Claiming that TCF's indefinite contractual terms similarly precluded a Takings Clause claim on the ground that TCF did not have any "protectable" interest under the Takings Clause, the government pointed to Visa's Core Principles, which allows Visa to alter its rates under the following contractual provision:

> Interchange is consistently monitored and adjusted—sometimes increased and sometimes decreased—in order to ensure that the economics present a competitive value proposition for all parties. Interchange reimbursement fees must encourage card holding and use, as well as expansion in the number and types of businesses that accept cards. If rates are too high, retailers won't accept cards; if rates are too low, issuers won't issue cards. Visa may establish different interchange reimbursement fees in order to promote a variety of system objectives, such as enhancing the value proposition for Visa products, providing incentives to grow merchant acceptance and usage, and reinforcing strong system security and transaction authorization practices.[119]

2. The Relevance of a Protectable Interest

It is just a category mistake to assume, as both courts inaccurately did, that the principles of rate regulation do not apply solely because banks operate in a competitive industry. The basic problem that these banks face remains the *same* as it was for public utilities: without constitutional protection of future returns, they could not sink investments today. The constitutional return thus sparks the initial investment. Banks have that problem even if they operate in a competitive industry, with only this difference: in these cases, there normally is no need for rate regulation to insure that firms in a competitive industry charge a competitive rate; that is what they will do in any event. Indeed, it is precisely because they are at a competitive rate that any system of rate regulation that fails to guarantee compensation will deprive them of their constitutional right to a competitive rate of return, i.e., a rate that allows them to attract and retain capital. Put otherwise, there is less justification for regulating a competitive firm than there is for regulating a public utility because the competitive firm has no monopoly power, when, contrary to Judge Piersol's observation, it is that element of monopoly power that justifies state

119. VISA, VISA INTERNATIONAL OPERATING REGULATIONS: CORE PRINCIPLES 10 (2010), *available at* http://usa.visa.com/download/merchants/visa-international-operating-regulations-core.pdf.

regulation of standard public utilities.[120] In other words, all rate regulation of competitive firms is unconstitutional unless there is some offsetting advantage.

In its brief, the Government argues that the key difference is that firms in competitive industries are not "obligated" to stay in that industry, which is not the case for public utilities required to serve the public.[121] As stated by Chief Justice Rehnquist, "As public utilities, both Duquesne and [copetitioner] Penn Power are under a state statutory duty to serve the public."[122] But the point is wrong on every count. First, the traditional definition of a public utility referred to a company that was the sole supplier in a given territory. It was only required to serve the public so long as it remained in business, which meant that, as the sole supplier of an essential service, it could not refuse to serve customers within its service area. The "required" element was universal service, not a duty to remain in business. Historically, public utilities were always allowed to withdraw from a given market, so long as they gave notice of their intention, which allowed for an orderly transition.[123] The modern position, which requires certain public utilities to get government approval to withdraw from the market, is a departure from the traditional rule. The distinction concerning withdrawal rights, moreover, is quite irrelevant to the issue at hand, which is whether a government maneuver on rates is constitutional, even when it makes it impossible for the firm to recoup its investment with a reasonable rate of return over the expected life of the project.

Consider first the variation where the established firm is not allowed to withdraw from the market. In these circumstances, the government is surely right to concede the risk of expropriation, for without constitutional rate protection, the firm could be forced to provide services for trifling sums that do not even cover its variable costs, which could result in losses

120. *TCF I*, 2011 U.S. Dist. LEXIS 45059, at *13.

121. Brief for Government, *supra* note 49, at 30–32.

122. *Duquesne Light Co.*, 488 U.S. at 307.

123. *See, e.g.*, H.W. Chaplin, *Limitations Upon the Right of Withdrawal from Public Employment*, 16 HARV. L. REV. 555, 555 (1903). The relevant passage reads as follows:

> It is undoubtedly true—and allusion is made to it in the opinion in Munn v. Illinois—that where a public right in property or to service arises from a voluntary holding out of the property or the service to the public, it may ordinarily be terminated by a withdrawal of the offer of public use. . . .
>
> This rule is, however, obviously subject to the qualification that one cannot abruptly, and without reasonable opportunity to the public to change their own affairs accordingly, so terminate his relations with the public. For example, an innkeeper could not lawfully put a sudden end to his business in the middle of a winter night, nor a common carrier suddenly leave his occupation and abandon his passengers or freight by the roadside . . . .

Id. (footnote omitted) (citing Munn v. Illinois, 94 U.S. 113 (1876)).

of not only its front-end fixed costs, but all variable costs as well.

Alternatively, suppose that the right to withdraw is given absolutely. The modern public utility is a far different creature than the horse and buggy that had a franchise on the road from London to Oxford. Once that team is withdrawn from public service, it has alternative private uses that effectively negate the risk that its owner will not be able to recover the cost of capital. Indeed, in these cases the risk of abuse from withdrawal lies with the franchise holder, not the government, which is why the notice requirement is imposed. But with modern public utilities that have capital in the ground, the utility would withdraw from doing business only if it could not recover its variable costs. If it could recover all of its variable costs, it would remain in business even if it could not recover all of its fixed costs plus a reasonable rate of return during the useful life of the asset. The risk of expropriation without falling into bankruptcy thus remains whether or not withdrawal is allowed. All that the exit right does is reduce the size of the potential expropriation. It does not eliminate it.

That exact same risk of expropriation faces the competitive firm that has made fixed investments in a given line of business. Once those investments are made, that firm is as vulnerable to government action as the firm that has the utility. A system of price controls that is keyed to variable (or incremental) costs, like the Durbin Amendment, does not afford the competitive firm any more opportunity to recover its fixed costs than the public utility, which is why it is entitled to constitutional protection against expropriation. That point, moreover, is explicitly recognized in the cases. The provision of automobile insurance, for example, is supplied in competitive industries from which individual insurers have a right to withdraw. Yet it is beyond doubt that the state cannot justify confiscatory rates by pointing to the ability of the firm to withdraw from the market at the cost of losing its fixed investment. Thus, *Aetna Casualty & Surety Co. v. Commissioner of Insurance*,[124] cited in TCF's appellate brief[125] but ignored by the court, put the point as follows:

> The Commonwealth's admitted power to regulate the insurance business and the rates which are charged for insurance does not permit it to limit the conduct of such business to those companies which submit to whatever rates the Commonwealth may fix, even if they be confiscatory. The writing of insurance is a lawful business and the Commonwealth may not impose unconstitutional conditions upon the exercise of the right to engage therein. While it is not constitutionally required to fix rates which will guarantee

124. 263 N.E.2d 698 (Mass. 1970).

125. Brief of Appellant TCF National Bank at 31, TCF National Bank v. Bernanke, 643 F.3d 1158 (8th Cir. June 29, 2011) (No. 11-1805), 2011 WL 1849198.

> a profit to all insurers, it may not constitutionally fix rates which are so low that if the insurers engage in business they may do so only at a loss. The insurers are not required to either submit to confiscatory rates or go out of business. They have a right to rates which are not confiscatory, or which satisfy any higher applicable statutory standards; and to a judicial review on the constitutional or statutory adequacy of such rates.[126]

It follows, therefore, that none of the regulated banks forfeit the constitutional challenge simply because they operate in a competitive market from which they have a right to leave if they so choose. The situation does not differ on the ground that none of the regulated banks have a so-called protected interest in their customer. That same point can be made with respect to all public utilities, whose customers are not bound to take their services at the stipulated rate. Public utilities receive their protection because of their interest in a rate structure that allows them, assuming the rational behavior of their customers, the opportunity to earn a constitutional rate of return. That situation does not change because the supposed vulnerability of the regulated banks comes from the core terms of the Visa contract (for which there is, of course, a close analogue for MasterCard[127]). The key point here is that any party that enters into a good faith arrangement takes at least some risk that the price fluctuations would be less than they hoped for. But those risks are offset by the possibility of price shifts in the opposite direction. In the case of the instant debit card contracts, there is a long history of acquired practice that signals a high level of stability in these arrangements between the parties. The one risk the banks did *not* assume was that some third party would use brute force to upset their private arrangements with the network platforms. When the deliberate actions of third persons disrupt these ongoing arrangements, both parties can sue the intervener for interference with prospective advantage. The power of the government to undertake actions that disrupt these relationships, but only if they are prepared to pay compensation for the losses that they engage, is exactly why confiscatory rates are enjoined: at no point has the federal government indicated a willingness to pay for the losses that it has inflicted. It follows, therefore, that the issue of protectable interest does not help the Government's case at all.

126. *Aetna Casualty & Surety Co.*, 263 N.E.2d at 703 (citations omitted).

127. *See* MASTERCARD WORLDWIDE, U.S. AND INTERNATIONAL INTERCHANGE RATES (2011), *available at* http://www.mastercard.com/us/merchant/pdf/MasterCard_Interchange_Rates_and_Criteria.pdf.

3. The Role of Good Faith Contracting

Even if some protectable interest was required, these contracts supply it. As a matter of straight contract law, Judge Piersol was wrong when he said that the provisions in the Visa/TCF contract allowed Visa "unmitigated" discretion to set whatever rates it chose.[128] The parties to the contract never conceived of their relationship in that manner during the long period during which it has been in place, and the law in these cases always circumscribes the power that the dominant party—here the rate-setter—has by imposing on it a duty to act in good faith, which essentially requires it to take steps that allow all parties to the deal to achieve a reasonable rate of return over the life of the contract.

To see why, it is critical to read the key provisions of the Visa/TCF contract in light of the problem that they seek to address. It is not possible to determine at the outset a fixed set of rates for the life of a contract, given the unexpected fluctuations that could be necessitated by shifts in supply and demand, changes in technology, or alterations in the regulatory environment. Yet at the same time Visa understands that, in order for this network to persist, each party to the transaction has to receive a net benefit from its continued participation in it. Accordingly, Visa pledges to keep rates within a range that induces all participants to remain inside the system by promising to provide net benefits to all participants.[129] It is, of course, the case that Visa cannot allow itself to be sued by either merchants or banks for each rate fluctuation, but it surely pledges to operate in good faith to achieve the desired goal. Good faith obligations of this sort are commonplace in the world of common law adjudication.

Judge Benjamin N. Cardozo wrote in *Wood v. Lucy, Lady Duff-Gordon*[130] that long-term arrangements are "instinct with an obligation," which requires one contracting party to afford the other the opportunity to recover its costs plus a reasonable return on their labor or capital.[131] In *Wood*, Judge Cardozo held that the defendant fashion-designer, who had given an exclusive license to the plaintiff marketer to promote her goods, could not terminate the arrangement at will on the blithe assumption that the plaintiff was not bound to do anything at all. Cardozo wrote:

> The agreement of employment is signed by both parties. It has a wealth of recitals. The defendant insists, however, that it lacks the elements of a contract. She says that the plaintiff

128. TCF Nat'l Bank v. Bernanke (*TCF I*), No. CIV 10-4149, 2011 U.S. Dist. LEXIS 45059, at *14 (D.S.D. Apr. 25, 2011), *aff'd*, 643 F.3d 1158 (8th Cir. June 29, 2011).

129. VISA, VISA INTERNATIONAL OPERATING REGULATIONS: CORE PRINCIPLES 10 (2010), *available at* http://usa.visa.com/download/merchants/visa-international-operating-regulations-core.pdf.

130. 118 N.E. 214 (N.Y. 1917).

131. *Id.* at 214 (internal quotation marks omitted).

> does not bind himself to anything. It is true that he does not promise in so many words that he will use reasonable efforts to place the defendant's indorsements and market her designs. We think, however, that such a promise is fairly to be implied. The law has outgrown its primitive stage of formalism when the precise word was the sovereign talisman, and every slip was fatal. It takes a broader view today. A promise may be lacking, and yet the whole writing may be "instinct with an obligation," imperfectly expressed. If that is so, there is a contract.[132]

Earlier, in *Moran v. Standard Oil Co. of New York*,[133] Judge Cardozo used that same phase—"instinct with an obligation"[134]—to prevent an employer from terminating a five-year employment agreement before the plaintiff had a chance to recover his costs by earning commissions: "An intention to make so one-sided an agreement is not to be readily inferred."[135] Judge Richard A. Posner has recently expressed that same sentiment in *Market Street Associates v. Frey*.[136] Thus, it is common to read in "the implied condition that an exclusive dealer will use his best efforts to promote the supplier's goods, since otherwise the exclusive feature of the dealership contract would place the supplier at the dealer's mercy."[137] Similar principles have also been incorporated into the Uniform Commercial Code's rules on output and requirements contracts.[138]

Visa has made just that sort of commitment in the debit interchange market. Therefore, it could not reduce the rates it pays to zero just because it decided to do so. At the very least, the bank would have the right to withdraw for a material breach of contract, and in cases of manifest bad faith, the bank could probably sue to recover its lost profits from the earlier arrangement. There are, of course, no suits of this sort involving debit card interchange because Visa and MasterCard, conscious of the importance of their reputation and customer good will, would not take irrational steps that would squander these painfully-acquired advantages. It is, therefore, wholly wrong to think that there is no protectable interest under these contracts, even if such were required to make out a takings case.

Nor is it necessary that each of Visa's customers make a gain on each transaction. As with ratemaking generally, the key issue is whether the entire relationship generates a profit, not whether each element of an

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132. *Id.* (citations omitted) (internal quotation marks omitted).

133. 105 N.E. 217 (N.Y. 1914).

134. *Id.* at 221 (internal quotation marks omitted).

135. *Id.* at 220.

136. *See* 941 F.2d 588, 595–96 (7th Cir. 1991).

137. *Id.* at 596 (citing Wood v. Lucy, Lady Duff-Gordon, 118 N.E. 214, 214 (N.Y. 1917)).

138. U.C.C. § 2-306 (2004) (noting that the quantity term in both output and requirements contracts is governed by principles of good faith).

extended package purports to do so. That rule works, moreover, to the long term advantage of all of the individual franchisees of a common vendor, who otherwise could not coordinate their promotional activities. Thus, the close affinity between good faith contract principles and generalized ratemaking principles is found in many cases that deal with disputes between franchisors and franchisees, as well.

One good example of how this process works is found in *National Franchisee Ass'n v. Burger King Corp.*[139] Burger King required its franchisees to carry a $1.00 Value Meal item, which it had to sell at a loss.[140] The court held that Burger King did not act in bad faith because it made the decision to include the Value Meal "with the honest belief that the measure it is adopting will help the company meet competition and succeed in the marketplace."[141] So long as Burger King's overall set of prices allowed its franchisees to recover their cost and make a reasonable profit, they could not complain about having to bear their fair share of the promotional costs. At this point, the uniform standards Burger King sets for its franchisees are an effort to stop a prisoner's dilemma game among franchisees, where each wants to free-ride on the promotion efforts of other franchisees. Indeed, to allow individual franchisees to opt out of the promotional events would undermine the principle of equal treatment for all franchises and allow the unilateral actions of some to undermine the collective good of all. The duty of good faith, therefore, does not require the impossible of franchisees, but rather, makes perfectly good sense in the way that the Durbin Amendment does not: it allows for the coordination of multiple franchisees in ways that advance their common interest.

In the end, therefore, we can say that there are two clear rights that inhere to TCF and other banks in these arrangements. First, if Visa set its rates so as to deprive the banks of their contract rights, they could withdraw from the arrangement even though it is for a specified term. Second, and more critically, TCF could sue Visa for damages arising from a breach of that arrangement in the same way that Wood could sue Lady Duff Gordon for her decision to withdraw unilaterally from the deal. Good faith contracts are not idle. If there were some need for a protectable interest, these contracts, which do supply meaningful business protection, offer that interest. The reason why there is so little litigation on this point is that no one ever takes the steps that both courts wrongly supposed Visa was allowed.

139. No. 09-23435-CIV, 2010 WL 4811912 (S.D. Fla. Nov. 19, 2010).

140. *Id.* at *1.

141. *Id.* at *3.

4. Just Compensation

The last piece of the puzzle is whether the constitutional test for just compensation is satisfied. In dealing with this issue generally, *Monongahela Navigation Co. v. United States*[142] sets out the standard that, "in view of the combination of those two words [—just and compensation—there can] be no doubt that the compensation must be a full and perfect equivalent for the property taken."[143] In land cases, this translates into the fair market value of the land. In cases of ratemaking, with the constitutional obligation to meet the end result, the test is the same: is the financial position in which a firm is placed one that allows it to attract and retain capital sufficient to earn a competitive rate of return?

In approaching this question, the first issue is whether TCF operates in a competitive market. Both courts assumed that it did, even though huge portions of the debate over the Durbin Amendment questioned whether this was true. As noted above, the correct answer is that the market is as competitive as it can get. Once that assumption is made, it is now possible to recast the general test for just compensation in this form: did the government regulation allow the regulated banks the same rate of return on their debit card investments as they had before the statute was put into place? The mere fact that these lawsuits were brought is evidence enough that the possibility of offsets in the form of higher fees against debit card customers is not sufficient to produce that result. Why would anyone sue if their options for mitigation were *perfect*? It is far more rational to go on with business, substituting a new income stream whose net present discounted value was equal to the one that was displaced.

It is also possible to identify a number of reasons why the net position after regulation *could not* equal the rate before regulation. In dealing with this issue it is necessary to consider two different scenarios about how the Durbin Amendment will be administered. Under the first, it is assumed that all banks will be subject to the same rate restrictions as the large banks, notwithstanding the exemption for banks with less than $10 billion in assets. Under the second, it is assumed that the smaller banks are able to collect their higher interchange fees, and thus not raise costs to their own customers.

Under the first scenario, there is no question that if these regulations were imposed on banks before they started their debit card business, they would be a prospective form of regulation that is immune from challenge under the rational basis test. But, as noted above, they were not. Instead, they were imposed after the current system was put into place by voluntary transactions. At this point, the movement to the new system is *necessarily* inefficient because it removes the use of cross-payments which increase the

142. 148 U.S. 312 (1893).

143. *Id.* at 326.

efficiency of a two-sided market. Quite simply, any system that prohibits those cross-payments is necessarily less efficient than one that allows them. The shrinkage in the pie therefore means that some party has been hurt. It is not the retailers, so the loss has to be borne by the other parties to the transaction. Detailed empirical work is needed to show the exact magnitude and incidence of this loss, but even if it cannot be measured, it is perfectly *certain* that the regulated banks have suffered some portion of it. Therefore, if the above analysis of rate regulation is correct, the banks are entitled to compensation for these losses. Note that in this form, there is complete evidence of irreparable harm to the banks, for even if they can mitigate the loss to a greater or lesser extent, that mitigation never restores them to the position they had before the regulation was imposed. Since no compensation is offered for that unmeasured loss, the act has to be enjoined. Indeed the situation is even clearer that full compensation is not provided, for it is evident that there is an additional loss to consumers, who will have to pay more in direct fees to their banks than they paid under the prior interchange system for the same services. Throw in the high administrative costs of running this system, and it is clear that a deviation from the competitive equilibrium necessarily occurs. The compensation offset falls short in all cases, and therefore cannot supply just compensation.

The second permutation requires the assumption that there is some monopoly power at play. Ironically, on this issue everyone was arguing the wrong side of the case. The experts for TCF should have insisted that they had monopoly power so as to get a competitive rate of return. The government should have insisted that the industry was perfectly competitive, even if it meant repudiating everything that Senator Durbin said to the contrary. That weird role reversal, of course, should never be expected: it is only in the judicial wonderland of these two opinions that being in a monopoly position becomes a key asset to the regulated firm.

On the usual assumption that monopoly power offers a reason to regulate, the case is far thinner here than in the standard public utility that operates a relatively static technology in an exclusive territory with a captive customer base. The debit interchange system is marked by the lack of territorial exclusivity, and the constant innovation of new technologies means that the residual level of monopoly profit must be small. As such, the regulation has to be modest lest it cut below the guaranteed rate of a competitive return. In this case, we know that the results cannot come close. In addition to all the imperfections noted above, the system of rate regulation under the Durbin Amendment does not even attempt to estimate the appropriate rate base due to its systematic truncation. It is irrelevant whether the Federal Reserve gave a more generous set of rates to the banking industry the second time round. Rather, the question is whether it tried to set those rates in a way that guaranteed the competitive rate of return on capital, to which the answer is an emphatic no. Again, there is no real debate about this point, which simply disappears from view at every stage of the proceeding: there was no effort to build up the correct rate base, to determine the extent of monopoly power, to look at risk-related returns, or anything else. The case, therefore, does not come within a country mile of meeting any of the many formulations for rate base determination set out above.

Thus, wholly apart from any reference to the $10 billion asset exemption, the Durbin Amendment is dead on arrival under any sensible rate regulation analysis that does not limit coverage only to monopoly industries. Once that new fact comes in, it only strengthens the conclusion. If the small banks continue to get their exemption, there is little question that the big banks will be at a huge competitive advantage. As Anne Layne-Farrar noted in her TCF report, the customer base of banks like TCF is fragile to begin with, as over 20% of their accounts open and close each year. A rough estimate of $100 in additional bank fees, whether by swipe or by month, will induce low income customers to close their accounts, which could lead to an erosion of the rate base.[144] The current system of charges does not require a big supplement, but again, that point hardly matters. So long as we know that the Durbin Amendment would supply insufficient protection without the $10 billion asset exemption, this is an a fortiori case against its constitutionality, even if it assumed that the equal protection challenge dies a quick death under the rational basis test.

CONCLUSION

The decisions in the TCF case offer powerful insights into the intellectual complacency that dominates judicial decisionmaking in takings cases today. It simply defies comprehension to think that a firm gets *more* constitutional protection when it has monopoly power than when it operates in a competitive industry. Outside the peculiar context of this case, no one has ever thought that competitive firms should be more vulnerable to government expropriation than monopoly firms. Yet that explicit mistaken assumption drove this case, leading to an erroneous analysis of every relevant question pertaining to rate-of-return regulation.

The short and simple statement of this case is that the strong rate regulation of the Durbin Amendment must leave the regulated firms with the same competitive rate of return with which they started. In this instance, the regulation leaves them below that level. Moreover, the option to charge customers does not restore the firms to the competitive rate of return they previously enjoyed. Surely a taking without just compensation should be enjoined. Perhaps someday the Supreme Court will repair the

144. ANNE LAYNE-FARRAR, ASSESSING TCF CUSTOMER PRICE SENSITIVITY IN RELATION TO THE DURBIN AMENDMENT (2010).

intellectual damage to the Takings Clause that the Eighth Circuit inflicted in *TCF National Bank v. Bernanke*.