

## CASE 12

# Joint Venture Membership: Visa and Discover Card (1993)

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### INTRODUCTION

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Visa is a joint venture of financial institutions that persuade consumers to use credit cards with the Visa name (the issuing function), persuade merchants to accept those cards (the acquiring function), and process transactions involving those cards using a shared network. Two years after Dean Witter Financial Services Group (then owned by Sears, Roebuck and Co.)<sup>1</sup> successfully launched the Discover Card in 1986, it sought membership in Visa. Visa refused and then passed a rule—Bylaw 2.06—that expressly excluded issuers of Discover or American Express cards from Visa membership. In May 1990, Dean Witter bought a Visa membership as part of its purchase of the defunct MountainWest Savings and Loan from the Resolution Trust Corporation. When Dean Witter tried to issue a Visa card through its new bank, Visa invoked Bylaw 2.06 and refused to print the cards. Dean Witter sued in federal district court. It claimed, among other things, that Visa's Bylaw 2.06 was an unreasonable restraint of trade that violated Section 1 of the Sherman Act.

A jury agreed with Dean Witter. They would have required Visa to accept Dean Witter (and presumably American Express) as members. The

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David S. Evans and Richard Schmalensee were retained by Visa, USA in this litigation, and Richard Schmalensee offered expert testimony. They thank Stephen Bomse and Laurence Popofsky for numerous valuable conversations and Howard Chang and Daniel J. Hassan for effective assistance.

<sup>1</sup>After the trial Sears spun off its Dean Witter subsidiary, which then merged with Morgan Stanley in 1997. Throughout this chapter, we refer to Dean Witter as the plaintiff for simplicity.

Tenth Circuit Court of Appeals reversed the decision. It rejected Dean Witter's arguments that Visa had market power and that Visa's Bylaw could have a substantial effect on competition in the relevant market. It accepted Visa's arguments that Bylaw 2.06 was reasonably related to Visa USA's operation and no broader than necessary. After reviewing briefs written by Robert Bork (supporting Dean Witter) and Phillip Areeda (supporting Visa), among others, the Supreme Court declined to hear Dean Witter's appeal.

The *MountainWest* case added fuel to debates regarding standards for evaluating the conduct of joint ventures and on the proper roles of evidence on efficiencies and on consumer harm in that context. This case also illustrates how different approaches to the analysis of market power can lead to opposite results. Dean Witter argued, and the trial court and jury accepted, that Visa had market power because its members collectively had a large share of the relevant market. Visa argued, and the Tenth Circuit accepted, that Visa's exclusion of Dean Witter could not have an appreciable effect on prices or output because card issuing is an almost atomistically competitive market.

In this chapter we describe the payment card industry, describe the progression of *MountainWest* from the trial court to possible review by the Supreme Court, discuss the arguments presented by both sides at trial, and then examine the ultimate resolution of the case by the Tenth Circuit.

## INDUSTRY BACKGROUND<sup>2</sup>

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The parties stipulated that the relevant antitrust market consists of payment cards that could be used in a variety of merchant locations throughout the United States. From the standpoint of the consumer and merchant, payment cards provide a straightforward service. The consumer pays with the card and gets a bill some weeks later, which he or she pays in full or in part depending on the type of card (charge or credit) and preference for financing the transaction. The merchant runs the card through a terminal and receives payment into its depository account generally one to three days later.<sup>3</sup> Competition in the payment card industry takes place at two levels: the system level and the issuer level.<sup>4</sup>

### Competition Between Systems

There are four major payment card systems in the United States: American Express (started in 1958), Visa (1966), MasterCard (1966), and Discover

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<sup>2</sup>For further details see Evans and Schmalensee (1993).

<sup>3</sup>A small and decreasing fraction of transactions is still paper based.

<sup>4</sup>There is also competition in the payment card industry for signing up merchants and processing merchant transactions. We do not discuss this competition further because it was not an issue in the case.

(1986).<sup>5</sup> Each system consists of a “brand” and a “network” for processing transactions between consumers using cards of that brand and merchants that accept those cards. “And they don’t take American Express”—the well-known Visa ad—is an example of the competition that takes place at the system level. There are two types of systems: Open systems consist of many members issuing cards and acquiring transactions on a shared network; closed systems consist of a single entity that issues all cards and acquires all transactions on a proprietary network.

Visa and MasterCard are open systems. Visa is a joint venture of financial institutions that issue Visa cards to consumers and acquire transactions from merchants who accept Visa cards. It operates pursuant to a system of rules, adopted by its board of directors, that govern and facilitate operation of its interdependent financial exchange network. Aside from administering this system of rules, it also (1) maintains computer networks for processing transactions between cardholders, the bank whose name appears on the cardholder’s card (“the issuing bank”), merchants, and the merchant’s bank (“the acquiring bank”); (2) establishes brand image; and (3) conducts research and development for the benefit of members. Its members are individually responsible for setting prices and other terms and conditions for card holders and merchants.

There are several important differences between Visa and a typical firm. Visa earns no profits and pays no dividends. Visa provides services for its members, and they in turn use those services as inputs into their own credit card businesses. The members elect the Board of Directors, which must approve major decisions at Visa. Visa members, including those who serve on the Board, compete with each other in issuing cards and acquiring transactions from merchants.

MasterCard is also a joint venture of financial institutions and operates much like Visa. Until the mid-1970s, Visa and MasterCard had different members. That changed in 1976 when the U.S. Department of Justice refused to support Visa’s request to support its exclusion of MasterCard members.<sup>6</sup> Faced with significant antitrust exposure, Visa and MasterCard allowed dual membership and soon had almost completely overlapping membership. Although duality, as this pattern of membership is called, reduces incentives for system competition in advertising or product development, the organizations act differently because of different membership shares (and resulting influence on decisions), because members cannot have representatives on both boards, and because the managements of the two associations have incentives to compete with each other. Relatively poor performance by one of the associations is likely to lead issuers to emphasize the other’s brand in their marketing

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<sup>5</sup>Two other card systems—Diner’s Club and Carte Blanche—have a small share of cards issued in this country. Both of these systems were owned by Citibank during the period under discussion here.

<sup>6</sup>See Baker and Brandel (1988, pp. 23ff) and *Worthen Bank and Trust Co. v. National Bank-Americard Inc.*, 185 F. 2d 119 (1973).

Discover and American Express are closed systems and, unlike Visa and MasterCard, are organized as traditional businesses with shareholders, a board of directors elected by those shareholders, and management appointed by the board. Discover operates the computer systems and back-room operations necessary for completing the following essential steps of any card transaction: (a) verifying credit when the customer presents the card to a merchant; (b) crediting the value of the transaction less service charge (i.e., less the merchant discount) to the merchant's account; (c) debiting the value of the transaction to the consumer's card account; and (d) billing and subsequent collection of card balances. Discover shapes brand image through product development and advertising, and it engages in research and development to enhance card products and features as well as the system for processing transactions. Finally, Discover—unlike the Visa system but like the Visa members—issues cards to consumers, signs up merchants to take its cards, processes transactions from those merchants, and determines all prices and other terms and conditions affecting cardholders and merchants. American Express operates in a similar way.

The payment card systems compete by making their brands more appealing to consumers and merchants. For example, system decisions affect various aspects of card processing (e.g., the speed of approval and fraud detection) that in turn affect the value of the payment card brand to consumers and merchants. Similarly, by encouraging relatively low merchant discounts—the price merchants have to pay Visa banks for each transaction—Visa built a high rate of merchant acceptance.<sup>7</sup> American Express maintained relatively high merchant discounts and had a lower rate of merchant acceptance. Its charge card appealed to a segment of consumers that some merchants were willing to pay high merchant discounts to attract. In the mid-1980s, Visa began its hugely successful “And they don't take American Express” advertising campaign. It appears that this campaign curtailed the growth of American Express cards and encouraged American Express to lower its merchant discount to increase merchant acceptance.

In addition to the four main systems described above, there are two additional card brands in the United States: Diner's Club and Carte Blanche. Diner's Club was bought by Citibank in 1981, and Carte Blanche was bought by Citibank in 1978. Both have been niche products in the United States for some time.<sup>8</sup> A large portion of Diner's Club cards, for example, are simply corporate accounts at travel agencies.

Table 12-1 shows the shares of the payment card systems based on

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<sup>7</sup>Visa itself does not determine the merchant discount. It does, however, determine the “interchange fee” that acquiring banks pay issuing banks as a percentage of each transaction, and the interchange fee places a floor on the merchant discount. The legality of collective determination of interchange fees was upheld in the *NaBanco* case: *National Bancard Corp. (NaBanco) v. VISA USA, Inc.*, 596 F. Supp. 1231 (S.D. Fla. 1984), *aff'd.*, 779 F.2d 592 (11th Cir.), *cert. denied*, 479 U.S. 923 (1986).

<sup>8</sup>Diner's Club is successful in some foreign markets. For example, it has the largest share of the Greek payment card market.

**TABLE 12-1**  
**Market Share of Major Brands by Charge Volume, 1991**

Visa	41.9%
MasterCard	25.8%
American Express	24.6%
Discover	5.4%
Diners/Carte Blanche	2.2%
HHI:	3060

1991 charge volume data that were presented at trial. Visa has the largest share, 41.9 percent, followed by MasterCard, American Express and Discover. The Herfindahl-Hirschman Index (HHI) at the system level is 3060 based on charge volume.

### Competition at the Issuer Level

For brand positioning, research and development, and operation of the computer systems that, among other things, determine how long the consumer has to stand around waiting for his or her card to be approved, the system level is where competition occurs. For the prices, card attributes, and other features that are directly relevant to the cardholder, competition occurs at the issuer level. That is because Visa and MasterCard have about 6000 members, each of whom independently sets prices and other card features. These issuers compete with each other and with cards issued by Discover and American Express.

Table 12-2 lists the largest twenty issuers of payment cards as of 1990 based on transaction volume. The largest single issuer of payment cards was American Express with a 24.6 percent share; Discover was the third largest issuer with a 5.4 percent share. The largest ten issuers accounted for approximately 58 percent of the payment card market in 1990.<sup>9</sup>

Entry and exit at the issuer level within MasterCard and Visa are relatively easy. The open membership policies of Visa and MasterCard permit entry by both traditional financial institutions and financial institutions that specialize in issuing credit cards, many of which are owned by or affiliated with nonbanks such as retailers, investment firms, insurance companies, and automobile manufacturers. As shown in Figure 12-1, substantial entry took place into the Visa system between 1981 and 1991. The existence of markets for card issuers' portfolios has made exit easy as well, since exiting issuers can sell their portfolios to entering or expanding issuers.

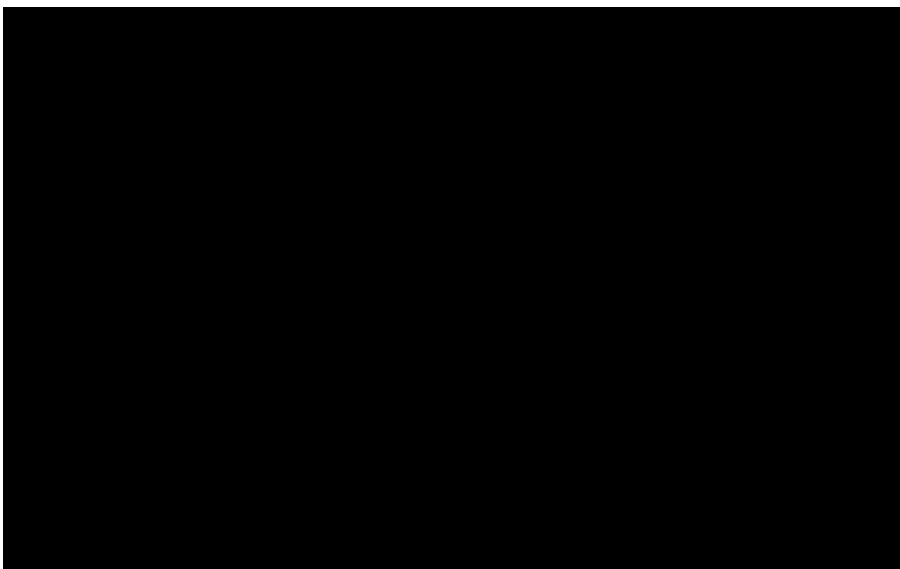
<sup>9</sup>The HHI based on transaction volume was approximately 850. The HHI based on outstanding balances was approximately 450.

**TABLE 12-2**  
**Top Twenty Issuers of Payment Cards, 1990**  
**(Based on Charge Volume)**

Issuer	Volume (\$ billions)	Market Share (%)
1 American Express	\$88.30	24.6
2 Citicorp	\$40.30	11.2
3 Discover	\$19.40	5.4
4 First Chicago	\$12.95	3.6
5 Chase Manhattan	\$11.36	3.2
6 MBNA Corp.	\$11.04	3.1
7 Bankamerica Corp	\$10.40	2.9
8 Wells Fargo	\$4.80	1.3
9 AT&T Universal	\$4.40	1.2
10 The Bank of New York	\$4.01	1.1
11 USAA Fed. Savings	\$3.95	1.1
12 Manufacturer's Hanover	\$3.69	1.0
13 NCBN Corp.	\$3.46	1.0
14 Security Pacific Corp.	\$3.28	0.9
15 Chemical Banking Corp.	\$2.90	0.8
16 First Deposit Bank	\$2.75	0.8
17 Marine Midland Bank	\$2.73	0.8
18 Seafirst Bank	\$2.68	0.7
19 Household Intl	\$2.55	0.7
20 Colonial National	\$2.50	0.7

Source: *Nilson Report*, March 1991, issues 495, 496.

**FIGURE 12-1** Number of Visa Issuers.



## THE ANTITRUST REVOLUTION

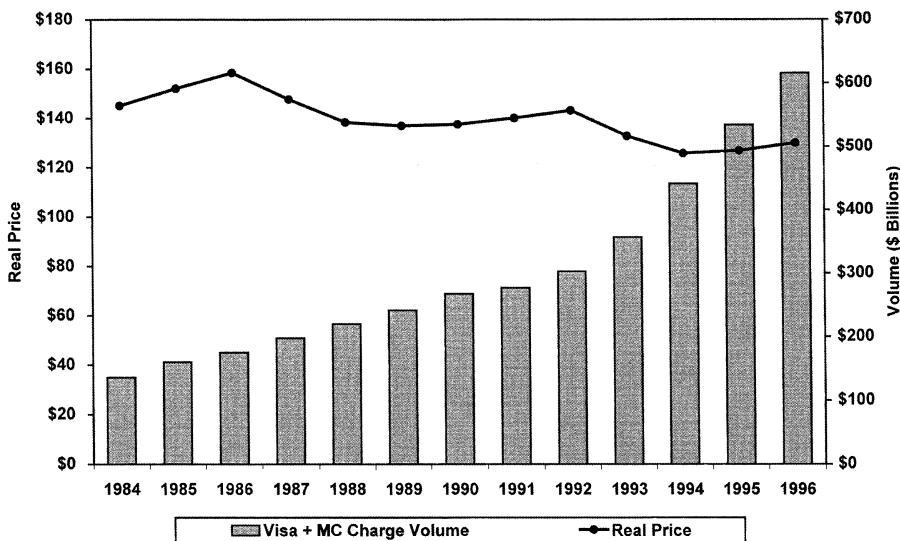
Portfolio sales enable issuers to recover the capital value of having developed relationships with a set of creditworthy consumers.

Through the expansion of payment card issuers and the entry of new ones, output of the payment card has grown rapidly over the years. Figure 12-2 shows the growth of output measured by transactions. Figure 12-2 also shows that real prices have not increased.<sup>10</sup> During this time, the quality of payment cards improved dramatically because they became more widely accepted by merchants, the waiting time at merchants for acceptance declined, and cards offered more features such as credits toward frequent flier programs.

Accounting profits have fluctuated over time with the state of the economy and other aspects of the industry evolution. Profits were relatively low in the late 1970s and early 1980s during inflation and a credit crunch and were relatively high in the late 1980s as interest rates (and thus a significant portion of the costs of financing consumer credit) declined and credit card usage expanded rapidly. Figure 12-3 shows the trend.

More controversy surrounds the measurement and interpretation of economic profits. Lawrence Ausubel argues that the payment card industry has had relatively high economic profits that have persisted in the face of entry.<sup>11</sup> It is thus, he contends, a paradox—an almost atomistically com-

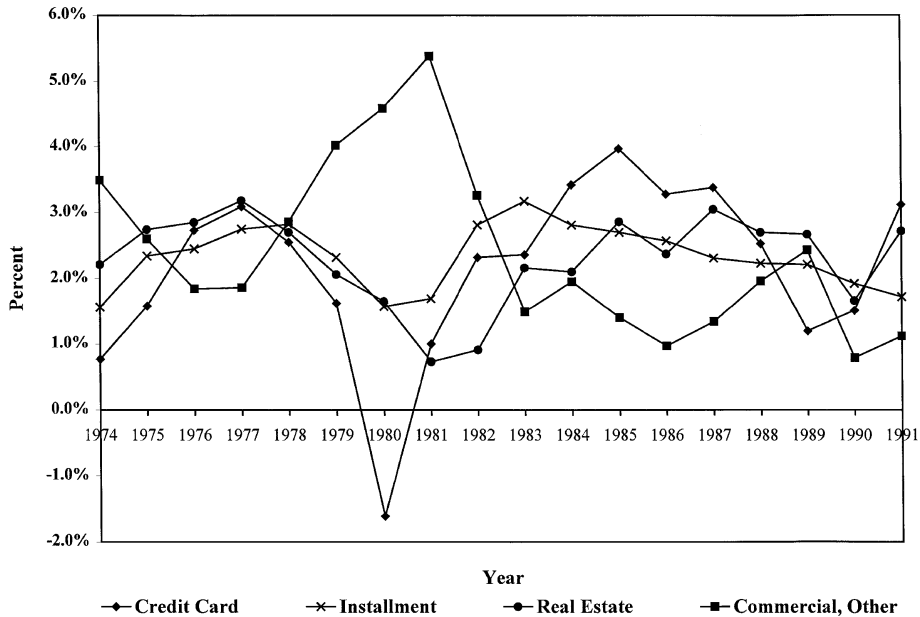
FIGURE 12-2 Real Price Index Versus Charge Volume for Visa and MasterCard Credit Cards (1992 Dollars).



<sup>10</sup>The real price is based on the real cost of annual fees, service fees, and finance charges. It is based on transactions for only the Visa and MasterCard systems. For a discussion of real prices see Evans, Reddy, and Schmalensee (1997b).

<sup>11</sup>Ausubel (1991).

FIGURE 12-3 Net Before-tax Earnings as a Percent of Outstanding Balances for Selected Types of Bank Credit 1974–1991.



Sources: Federal Reserve Banks (1991); and Canner and Luckett (1992).

petitive industry in which the firms earn supracompetitive profits. His explanation for this phenomenon is that consumers are irrational—they think they are going to pay off their credit card debts, but do not, thereby enabling payment card issuers to charge high interest rates despite the availability to the consumer of other alternatives. Stewart Myers and Carlos LaPuerta, who were experts for Visa, have noted that payment card credit is more risky than many other lines of credit because it is not secured.<sup>12</sup> They find that conservative adjustments for risk reduce estimated rates of return in the unusually prosperous period analyzed by Ausubel almost to competitive levels. Similarly, Myers and LaPuerta argue that Ausubel estimated extremely high rates of return on portfolio sales because he ignored the investment in identifying creditworthy customers—by buying a card portfolio the purchaser avoids the cost of having to prospect for creditworthy customers and the seller realizes a return for identifying customers and ascertaining their payment patterns. Finally, at the level of theory, Ausubel’s model does not explain why competition in annual fees, which consumers are not likely to misperceive, does not suffice to eliminate excess profits.

Ausubel also pointed to “sticky” interest rates as evidence that the

<sup>12</sup>LaPuerta and Myers (1997).



payment card industry does not function as competitively as economists would expect on the basis of its structure. It takes some time for card rates to respond fully to changes in market rates.<sup>13</sup> However, the cost of funds comprises only 41.5 percent of the variable cost of a payment card operation.<sup>14</sup> Other major costs are processing costs and the costs of fraud and bad debt. Given this, it is not surprising that card rates do not fluctuate in tandem with market rates.<sup>15</sup>

To summarize, there is no controversy that at the issuer level the payment card industry has a highly competitive structure. There is some controversy over whether this structure has resulted in the performance that one would expect from a highly competitive industry.

## LEGAL AND PROCEDURAL BACKGROUND

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Sears and its Dean Witter subsidiary considered entering the payment card industry in the early 1980s.<sup>16</sup> Sears was the largest payment card issuer as a result of its store card—\$11.6 billion outstanding in 1984 (the second largest issuer, Citibank, had only \$4.4 billion)<sup>17</sup>—and had extensive experience in evaluating the creditworthiness of prospective cardholders and processing transactions. Dean Witter considered two different methods of entering: joining the open payment card systems or starting its own system. After detailed internal review, it decided to start its own: the Discover Card, which it first issued nationally in 1986. While this strategy was widely derided by observers, it proved remarkably successful. Dean Witter incurred substantial initial losses as it spent money prospecting for cardholders and increasing merchant acceptance. But the Discover Card soon turned into a highly profitable product and garnered 6.6 percent of all credit card outstandings less than five years after its start.

In the face of the first new system entry in a decade, Visa responded in a number of ways. For example, it encouraged its members banks not to let their merchant terminals take Discover Cards, which forced Dean Witter to develop its own terminals.

Dean Witter, in turn, applied for Visa membership in late 1988. Visa's board rejected this application. At the same time, the Visa board adopted Bylaw 2.06 that denied membership to

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<sup>13</sup>Stavins (1996).

<sup>14</sup>Visa USA, *Profit Analysis Report*, quarter ending June 30, 1992; includes both issuing and acquiring.

<sup>15</sup>See, for example, Raskovich and Froeb (1992). For a discussion to the contrary, see Calem and Mester (1995).

<sup>16</sup>See *SCFC ILC, Inc. v. VISA U.S.A., Inc.*, 819 F. Supp. 956 (D. Utah 1993), pp. 5ff for more details.

<sup>17</sup>DeMuth (1986), p. 223.

## Case 12: Visa and Discover Card (1993)

any applicant which is issuing, directly or indirectly, Discover cards or American Express cards, or any other cards deemed competitive by the Board of Directors; an applicant shall be deemed to be issuing such cards if its parent, subsidiary or affiliate issues such cards.<sup>18</sup>

Dean Witter complained but did not sue.

A year later Dean Witter purchased the assets of an insolvent thrift institution, MountainWest Savings and Loan in Utah, from the Resolution Trust Corporation (RTC). Those assets included a Visa membership and a small payment card portfolio. Dean Witter intended to use this membership to launch Prime Option, a Visa card to be issued nationally. MountainWest requested the printing of 1.5 million Prime Option Visa cards without letting Visa know that it was now owned by Dean Witter. A small Utah thrift preparing a major national launch piqued Visa's curiosity. When its investigation revealed Dean Witter's ownership, Visa refused to print the cards. In January 1991, Dean Witter filed a lawsuit in the Federal District Court for the District of Utah, complaining that Visa had violated Section 1 of the Sherman Act among other things, and sought damages and a permanent injunction ordering Visa to admit MountainWest as a member.

Several skirmishes took place before a trial on the merits of the case commenced. Dean Witter moved for a preliminary injunction to allow it to launch Prime Option. The District Court agreed, but the Tenth Circuit reversed. Congress then appeared to come to Dean Witter's rescue, passing a law requiring the continuation of contracts with thrifts after their subsequent takeover and sale by the RTC. Dean Witter sought summary judgment under the new statute, but the District Court refused because Dean Witter did not comply with all the terms and conditions of the original contract—Bylaw 2.06 in particular—as required by the statute. Visa, for its part, sued Dean Witter for fraud, violation of Section 7 of the Clayton Act, and other miscellaneous claims.

After the judge denied both parties' motions for summary judgment, the trial began in October 1992. Dean Witter's Sherman Act claim was tried by a jury, and Visa's Clayton Act counterclaim was tried by the judge only. The nonantitrust claims and damages were to be tried later.

After a three and one-half week trial, the jury found for Dean Witter. Visa asked the judge to overturn the jury verdict and had some hope for optimism. In oral arguments after the verdict, the trial court judge had said, "I would have hung the jury before I would have come back with that verdict" (transcript, p. 1592).

Nonetheless, on April 1, 1993, the judge denied Visa's motions for a decision in its favor or for a new trial. He rejected Visa's proposed legal standard and concluded that under the correct standard the jury did have a

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<sup>18</sup>See Visa U.S.A. Inc., "By-Laws/Operating Regulations," May 1, 1992, p. 7.

reasonable basis, given the evidence, for reaching their conclusion. He also ruled against Visa on its Clayton Act claim, finding that the harm from reduced intersystem competition was not sufficient to outweigh the benefits from increased intrasystem competition through Dean Witter becoming a Visa issuer.

Visa appealed. In September 1994, a three-judge panel of the Tenth Circuit decided in Visa's favor. The Tenth Circuit refused Dean Witter's motion for a rehearing, and the Supreme Court declined to hear Dean Witter's appeal.

## THE PARTIES' ARGUMENTS

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When do the antitrust laws compel a joint venture (e.g., Visa) to admit a direct competitor? That was the key question raised in the legal proceedings described above. Dean Witter thought the answer was:

A joint venture that (a) has a large share of the relevant market and (b) cannot show that the exclusion is necessary for the efficient operation of the joint venture must admit any applicant for membership. Moreover, admission into an open joint venture or network joint venture is presumptively efficient.<sup>19</sup>

Dean Witter argued that Visa had a large share of the relevant market and that Visa's efficiency justifications were mere pretexts for an anticompetitive exclusion.

Visa thought the answer was:

A joint venture may have to admit a direct competitor only if its participation in the joint venture is essential for competition in the relevant market. Moreover, forced admission is presumptively bad because it is tantamount to the forced sharing of property with a competitor—a policy that would reduce the long-term incentives for the creation of property through investment and innovation.<sup>20</sup>

Visa argued that Dean Witter had demonstrated its ability to compete in the relevant market through its successful Discover Card and that it should not get to use Visa's property just because it could compete better that way. It also argued that letting Dean Witter into the tent would allow Discover to gain competitive intelligence on its system competitor, to free-ride on Visa investments and innovations, and to disrupt competitive decision making.

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<sup>19</sup>See Responding Brief of Appellee MountainWest, 10th Circuit Court of Appeals, October 15, 1993; also see Carlton and Frankel (1995a) and Pratt et. al. (1997).

<sup>20</sup>See Opening Brief of Appellant Visa U.S.A., Inc., 10th Circuit Court of Appeals, and Evans and Schmalensee (1995).

In addition to these polar opposite legal views, the two parties had quite opposing views of the economic effects of exclusion on intrasystem and intersystem competition. Dean Witter claimed that its Prime Option Card would expand output and would cause lower prices as a result of increased intrasystem competition and that its presence in Visa would not have any significant effect on intersystem competition. Visa argued that Prime Option would have a negligible effect on intrasystem competition because of the highly unconcentrated structure at that level but that Dean Witter's presence in Visa would hinder intersystem competition. We now consider Dean Witter's and Visa's arguments in more detail.

## Dean Witter's Case

### Background

According to Dean Witter, Visa's members collectively control over 70 percent of the relevant antitrust market—general purpose payment cards in the United States. The Visa joint venture has two important characteristics. First, it is a network in which firms work interdependently to provide a service. As with many networks, the value of the network service increases with the number of network participants; economists say there are “positive network externalities.” Payment cards are more valuable to merchants if more consumers hold those cards and are more valuable to consumers if more merchants accept those cards. Second, it has been an open joint venture. Historically, virtually any financial institution could join the Visa system. It made sense that Visa was open because it was more “efficient” with more members—more members, more positive network externalities.

Before passing Bylaw 2.06, Visa did not demand exclusivity. It allowed members to issue MasterCard beginning in 1976. Citibank, which issues Visa cards, owns two competing payment card systems—Diners Club and Carte Blanche. Visa's exclusion of Dean Witter was therefore not only historically unprecedented, it was discriminatory and unfair. Existing members could issue competing cards (MasterCard in the case of all members and additionally Diners Club and Carte Blanche in the case of Citicorp). As Dean Witter's trial attorney put it in his closing arguments,

based on the rules that the Visa member banks have decided to set for themselves you're not disqualified from Visa simply because you offer a competing card. . . . [T]hose are the rules that Visa members have chosen to play by. . . . Those should be the same rules that apply to everybody in the market in particular in this case the same rules that apply to Dean Witter and MountainWest. [Tr. 2673–2674]

Dean Witter executives testified that they had planned to enter the payment card industry by first introducing its proprietary Discover Card

and then adding their own Visa and MasterCard.<sup>21</sup> Indeed, Dean Witter’s president testified that it would not have launched the Discover Card had it known it could not later introduce a Visa card.

### Market Power

When Dean Witter sought to become a Visa member, Visa exercised market power through its collective rule-making ability. According to Dean Witter, a proper measure of this market power is the aggregate share of the relevant market held by the members who adopt rules. Collectively, the members who adopted Visa Bylaw 2.06 had a 45.6-percent share of the payment card market through their membership in Visa and an additional 26.4-percent share of the payment card market through their dual membership in MasterCard, for a total market share of 72-percent, all based on transaction volume. Visa therefore had market power because its members who adopted the exclusionary rule collectively had a 72-percent market share. This high market share gave Visa’s members significant incentives to keep interest rates and profits high.

Dean Witter’s market power theory was explained by its economic expert:

. . . we have a collective rule, By-Law 2.06, and that led me to look at then [sic] collective share. . . . I found that the collective share was very large, and as a consequence my conclusion was that the collective rule was an exercise of market power. It is an exercise of market power because the members of the Visa association acting collectively have both the incentive and the ability to exercise that market power. They have the incentive because this market share was large and they want to protect that market share. And they also have the incentive because since this is large, if they can keep prices up or from falling they can make a lot of money. . . . [T]here is nothing here that can prevent the exercise of market power. . . . (Tr. 1594–1595)

The economic proposition that apparently underlies this testimony is that the aggregate market share is a predictor of the effect of an exclusionary rule, adopted by a collective of firms, on output and prices in the relevant market. A joint venture with a large market share has an incentive to adopt an exclusionary rule because it can thereby prevent prices (and profits) from falling as a consequence of entry by new participants within the joint venture. Only competition outside the joint venture could prevent this effect from taking place. Dean Witter argued that competition from nonbank cards (e.g., Discover and American Express) was not sufficient because, for example, the Discover Card is considered a “second card” for most consumers, to be carried only after they have first obtained a Visa or

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<sup>21</sup>The claim that Dean Witter intended to add a Visa card was never mentioned in pretrial proceedings or discovery and was hotly disputed by Visa.

MasterCard. It is this economic proposition that became the focus of the Tenth Circuit decision.

Aside from the high market share, Dean Witter's economic expert cited three other key pieces of evidence to support the claim that Visa has market power. First, Visa's members, especially its top-ten issuers, have enjoyed "high profits" for many years. For example, a Visa consulting study was cited that found: "The 'quick and dirty' analysis determined that [Visa] Members have received a high return on their historic investment, considering the extremely high profitability of Members' credit card businesses in recent years" (plaintiff's exhibit 761). For procedural reasons, Dean Witter's economic expert was precluded from testifying on whether payment card issuers earned "excess profits," that is, additional profits that exceed the level required for a normal rate of return.<sup>22</sup>

The second piece of evidence was that substantial entry had taken place in the payment card industry.

And there was substantial entry but that substantial entry continued over a full decade. And what we know now is that there are still large firms that are announcing that they are coming into this market and that suggests to me that profits are remaining high in this market. (Tr. 1605)

Thus the fact of substantial entry was taken as evidence that Visa and MasterCard members had high profits that were not competed away through entry.

The third piece of evidence was that payment card issuers engaged in price discrimination. Two examples of prices discrimination were offered: (1) prices have declined subsequent to entry by issuers but not to all cardholders and (2) issuers were willing to waive card fees for cardholders who called to close their accounts (Tr. 1658–1659).

### **Competitive Effect of Bylaw 2.06**

Dean Witter argued that Bylaw 2.06 harms competition and consumers by providing an "enormous disincentive for firms that might enter the market by developing new proprietary cards" and excluding a "large low cost new Visa Card" (Tr. 1592). According to the "disincentive theory," Bylaw 2.06 reduced the incentives to start a new proprietary card because the entrant would not be able then to issue Visa cards. Existing Visa issuers were discouraged from starting their own proprietary systems because they

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<sup>22</sup>The Ausubel studies cited above were not discussed by Dean Witter's expert. However, the results of these studies were introduced by Dean Witter through their cross-examination of Visa's expert. Visa's expert noted that Ausubel had focused on a short period of time and that profits were lower before that period and were heading down at the end of that period. He also noted that if Ausubel were right, the payment card market exhibits supracompetitive profits with almost atomistic competition and entry. Adding another firm to the fray would be unlikely to remedy that problem.

would have to leave Visa (i.e., sell off their portfolios) to do so. Dean Witter argued that the fact that no proprietary system had been started since the enactment of Bylaw 2.06 was evidence of this disincentive.<sup>23</sup>

Dean Witter's economic expert argued that the top-ten issuers of Visa cards had been slow to change their prices in response to the substantial entry that had taken place during the 1980s. That fact, along with the existence of "high profits" and "price discrimination," led him to conclude that entry by Prime Option, as a "large, low cost Visa card" (TR. 1603), would reduce prices. Consumers would benefit from Prime Option's low-priced card, and this option would place pressure on other issuers to lower their prices as well.

### **Possible Benefits of Bylaw 2.06**

Dean Witter also considered whether Bylaw 2.06 provided any economic benefits that could offset the economic harms described above. The expert found no basis for believing that Bylaw 2.06 would decrease costs to members. He then examined whether Bylaw 2.06 was necessary to prevent outsiders from "free-riding" on the joint venture. The fact that Visa had operated as an open joint venture was critical to his conclusion that free-riding was not a concern:

Visa is an open association. It was completely open until the passage of the amendment to bylaw 2.06. It remains open except for those firms that are targeted in that bylaw. Firms come into this association all the time. The firms in the association remain profitable and output has increased in this market as firms have entered under this open rule. And for all those reasons I conclude that output has increased, it has not gone down, and there is not a free-riding problem in this market with entry. (Tr. 1669)

### **Summary of Dean Witter's Evidence**

In rejecting Visa's motion for a directed verdict or a new trial, the judge provided a useful summary of Dean Witter's evidence.<sup>24</sup>

1. Testimony of Sears' [economist]. . . . on the appropriateness of calculating Visa USA's market power by aggregating the individual market shares of Visa USA and MasterCard; and his conclusion that Visa USA exercised market power through its collective power to make rules; and testimony about "the presence of high profits."<sup>25</sup>

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<sup>23</sup>See Responding Brief of Appellee MountainWest, 10th Circuit Court of Appeals, October 15, 1993.

<sup>24</sup>For the Appeals Court summary see *SCFC ILC, Inc. v. Visa USA, Inc.*, 36 F.3d 958, 962 (10th Cir. 1994).

<sup>25</sup>*SCFC ILC, Inc. v. Visa U.S.A., Inc.*, 819 F. Supp. 956, 985 (D. Utah 1993).

2. Dean Witter's president, Phillip Purcell's, testimony that had Sears known that developing the Discover Card would disqualify it from Visa USA entry, it would not have placed a new proprietary card in the market.<sup>26</sup>
3. Testimony that no new proprietary card had been introduced in the relevant market since Bylaw 2.06 was enacted although memberships in Visa USA and MasterCard increased.<sup>27</sup>
4. Testimony that Prime Option "would be a low-cost card which would be supported by powerful marketing and advertising strategies on a national level."<sup>28</sup>
5. Testimony by Sears' executives that Discover Card, in the face of Prime Option's entry, would remain an aggressive competitor.<sup>29</sup>
6. Testimony that intersystem competition would not be harmed "because Prime Option Visa was designed to reach that part of the market that Discover does not reach."<sup>30</sup>
7. Testimony that "Sears would benefit significantly from issuing Prime Option Visa as opposed to Prime Option Discover or another proprietary card."<sup>31</sup>

## Visa's Case

### Background

While Visa responded to the arguments presented above, it placed a great deal of weight on the importance of property rights. As Visa saw it, their members had engaged in significant innovation and investment to develop the Visa system. The Visa brand name, and the rights to use this brand name and the other Visa property associated with it, belonged to Visa. Thus, unless Visa were declared an essential facility and sharing its property were deemed essential to competition, Visa alone had the right to decide who it was going to share its property with. Discover was a successful system competitor. Visa decided that it did not want a system competitor in the tent. Dean Witter, in Visa's view, was trying to trespass on its property.

Visa tied this property rights argument to what Philip Areeda (1990) has described as the "macro level" implications of antitrust policy. Forcing

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<sup>26</sup>Ibid., 986.

<sup>27</sup>Ibid., 986.

<sup>28</sup>Ibid., 986-987.

<sup>29</sup>Ibid., 987.

<sup>30</sup>Ibid., 987.

<sup>31</sup>Ibid., 988.



Visa to share its property with a competitor not only harmed Visa, it reduced the incentives for other firms to come together and engage in innovation and investment through the joint-venture form of organization. Joint-venture property would be less immune to encroachment by competitors and therefore less valuable to prospective investors and innovators.

According to Visa's legal argument—which, despite its rejection by the trial court, was the subtext for much of the Visa testimony and summations—the property of joint ventures should be treated no differently from that of a single firm. Single firms are required to share their property only under extreme circumstances—generally only when access to that property is “essential” for competition—and joint ventures should be required to do so only under those same extreme circumstances. Membership in Visa was not essential for Dean Witter to compete—it was already in the relevant antitrust market with its Discover Card. And, since the payment card market was highly competitive, granting Dean Witter membership was not essential to competition either.

Thus, Visa argued—explicitly to the court and implicitly to the jury—that it should not be required to admit Dean Witter even if it had market power and if the other facts alleged by Dean Witter were true. Visa should be no more required to admit Dean Witter than McDonald's should be required to admit a Burger King franchisee or than Microsoft should be forced to integrate a competitor's product in Windows. The courts generally do not second-guess decisions by businesses on what to do with their property—even if that business is a monopolist—except possibly when that property is “essential” for other firms to compete. The courts should not second-guess joint ventures like Visa either.

### **Market Power**

Market power in antitrust analysis refers to the ability of a firm (or group of firms) to increase price (or reduce output) significantly above competitive levels.<sup>32</sup> Visa and its economic expert argued that the entry of another issuer into a highly unconcentrated and competitive market would not result in a significant increase in price or reduction in output. As discussed above, the payment card industry has over 6000 issuers, an HHI below 500, and easy entry at the issuer level. Dean Witter estimated that Prime Option would achieve a 5-percent share of the payment card market in seven years. As a relatively small firm in a highly competitive industry, its entry was unlikely to have any discernible effect on prices even if, as claimed by Dean Witter, it was a low-cost card.<sup>33</sup>

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<sup>32</sup>Carlton and Perloff (1994, p.8).

<sup>33</sup>Moreover, the actual effect of the exclusion is the difference between the quantity of output that would be added as a result of Dean Witter's issuing a Prime Option Visa card and the quantity of output that would be added as a result of Dean Witter's pursuing its next best alternative—perhaps another brand of Discover Card or further investment in Discover.

The aggregate market share of Visa issuers is not an appropriate measure of market power according to Visa. In and of itself, that share provides little economic information on whether the exclusion of a competitor would have a significant effect on price. For example, the exclusion of only a small quantum of output, no matter how large a share the excluding entity has, cannot possibly have any effect on price or output. Conversely, the exclusion of a large quantum of output could have a large effect on price or output even if the excluding entity does not have a dominant market share. Price effects depend on what is added to or subtracted from a market, not on the aggregate share of the firms making the decisions.

The aggregate market share would be an appropriate measure of market power if Visa had agreed to fix prices. But there was a fundamental mismatch between the measure of market power proposed by Dean Witter and the alleged anticompetitive practice being addressed. As Visa's economic expert testified,

. . . if they had . . . done collective rule making that had fixed prices or fixed fees or fixed features, that would have been an exercise of market power. But they didn't. The case is not . . . about price fixing by Visa. They passed bylaw 2.06 and they presumably also agreed on the lunch menu at the annual meeting. The question is not might they have done something . . . , but did what they did actually affect competition or harm consumers. (Tr. 2285–2286)

Visa did not agree that other evidence cited by Dean Witter established the existence of market power. “High” accounting profits do not establish supracompetitive economic profits. Moreover, even supracompetitive economic profits over a short period of time do not necessarily establish that there is any market imperfection. High short-term profits can result from short-term market developments, such as a spurt of demand or a sudden reduction in input costs. There was rapid expansion of the use of payment cards following the end of the 1981–1983 recession. Finally, Visa cited a Federal Reserve Bank study that found that credit card profitability was lower than other bank lending for the longer period 1974–1991.<sup>34</sup>

The fact of entry is ordinarily taken as the best evidence that entry barriers are low. Low entry barriers make markets more competitive, since entry reduces and may eliminate the ability of incumbent firms to exercise market power. So, Visa argued, it was odd that Dean Witter would point to entry as evidence of market power.<sup>35</sup>

<sup>34</sup>Canner and Luckett (1992, p. 661); and Federal Reserve Banks (1991).

<sup>35</sup>In pretrial motions, Dean Witter argued that prices fell after AT&T entered the payment card market with its own Visa and MasterCard program in early 1990. This claim was supported by trade press observations that AT&T's entry with a no-annual-fee card had forced other issuers to reduce or eliminate annual fees as well. Visa's economic expert prepared an econometric study of the effect of AT&T's entry on the average real cost to consumers of using credit cards and found no evidence that AT&T's entry was correlated with a reduction in that cost. Annual fees accounted for only about 10%

Finally, while price discrimination is evidence that a market is not perfectly competitive in the textbook sense, economists recognize that price discrimination, like imperfect competition, is widespread in the economy. Price discrimination alone, without more, proves essentially nothing.<sup>36</sup>

### **Competitive Effects of Bylaw 2.06**

Visa argued that the primary effect of repealing Bylaw 2.06 would be to reduce intersystem competition. The admission of Dean Witter into the Visa system would have resulted in a partial integration of Discover and Visa (and presumably MasterCard). If Dean Witter were a significant Visa issuer, it would have a seat on the Visa Board of Directors and as a result of that, and its projected size, would have influenced Visa decisions. In particular, it would be in a position to influence Visa decisions concerning competition with Discover.

Visa argued that there was no evidence that Bylaw 2.06 was a disincentive for the entry of proprietary systems. Dean Witter did not identify any prospective entrant who was deterred as a result of the Bylaw or any firm that indicated it might be deterred. There was no evidence that any member of Visa had contemplated starting a proprietary system. Between 1966 when Visa and MasterCard both started and 1989 when competing systems were excluded from membership, only one proprietary card system was started—Discover in 1986. The fact that no proprietary system was started between 1989 and 1992, the time of trial, did not show that there was a disincentive. There was testimony that starting a proprietary system was a highly risky and expensive undertaking. Given that entry through Visa or MasterCard is much easier, it is not surprising that most entrants have chosen that course of action.

Finally, Visa argued that Dean Witter was not excluded from the relevant antitrust market at all. It could not issue Prime Option under the Visa “brand,” but it could issue Prime Option under the Discover “brand.” Both brands were in the market as defined by both sides. If Prime Option were a particularly innovative product desired by consumers, in principle it could be attractive if issued through the proprietary Discover system. Dean Witter presented no evidence that access to the Visa brand was necessary for the success of Prime Option, only that it would have been helpful.

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of the average real cost at the time of AT&T’s entry; they were trending downward before AT&T entered and continued to do so after AT&T entered. Dean Witter’s economist did not mention AT&T in his testimony, and Visa therefore chose not to present the results of its own rebuttal study. The effect of AT&T’s entry on payment card prices has taken on somewhat a life of its own after trial. The Visa study was summarized in Evans and Schmalensee (1993). Carlton and Frankel (1995b) then claimed that the entry of AT&T and GM resulted in a statistically significant reduction in annual fees. We have argued that the Carlton-Frankel work is flawed [Evans, Reddy, and Schmalensee (1997)].

<sup>36</sup>For a discussion of price discrimination as a common practice see Carlton and Perloff (1994, ch. 11) or Scherer and Ross (1990, ch. 13).

### **Benefits of Bylaw 2.06**

Visa witnesses identified several benefits of Bylaw 2.06. As discussed above, Bylaw 2.06 preserved intersystem competition by erecting a wall between system competitors. Visa executives testified at trial that duality had resulted in a reduction in competition between Visa and MasterCard and that Dean Witter's participation in Visa would tend to reduce competition between Visa/MasterCard and Discover. They also testified that Bylaw 2.06 prevented a system competitor from obtaining valuable information from Visa through its participation in Visa business decisions and through its receipt as a member of confidential data. Apparently, Dean Witter thought that by becoming a member it could curtail Visa competition with the Discover Card and learn more about a system competitor.<sup>37</sup>

### **Mismatches**

According to Visa, the antitrust problem identified by Dean Witter and the remedy it proposed were inconsistent with each other. The essential antitrust problem was that Visa allegedly had market power derived from its ability to engage in collective rule-making. According to Dean Witter, the extent of that problem—the degree of market power—was properly measured by the aggregate shares of the members involved in that collective rule-making. Dean Witter's proposed remedy was the admission of Dean Witter and, if it wished, American Express to Visa. Under that remedy, Visa could be forced to raise the aggregate shares of its members to 100 percent of the market, thus increasing the system's market power. As Visa's economist put it, “. . . if [Dean Witter's] diagnosis is right, then [Dean Witter's] prescription would make things worse. It is like my doctor saying to me as he does every once in a while that I'm a little bit too heavy and so I should eat a lot more ice cream” (Tr. 2331).

There was also a fundamental mismatch between Dean Witter's argument that Bylaw 2.06 discourages the entry of proprietary systems and its argument that Bylaw 2.06 should be repealed so that proprietary systems could join Visa. If the market problem is that there are too few proprietary systems, the solution should be to *close* the door at Visa—not to *open* the door more as desired by Dean Witter. Closing the door would encourage companies like AT&T and GM to start their own proprietary systems (AT&T had considered doing so). Keeping the door largely open encourages firms to enter as Visa issuers, not as proprietary systems.

## **THE APPEAL TO THE TENTH CIRCUIT**

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After losing the jury verdict and failing to convince the District Court to declare a mistrial or overrule the jury, Visa appealed to the Tenth Circuit.

<sup>37</sup>See Opening Brief of Appellant Visa U.S.A., Inc., 10th Circuit Court of Appeals, p. 15.

Both parties sought to frame the appeal in terms of the proper legal rule toward joint ventures. Visa argued that it should not have to admit Dean Witter unless Dean Witter could prove that it could not compete successfully without access to Visa's property. Dean Witter argued that joint ventures should not be allowed to impose membership conditions that have the purpose and effect of restraining competition and that are not ancillary to any legitimate purposes of the association.

After summarizing the existing case law, the appellate court set the stage for a rule-of-reason analysis that ultimately imposed the burden on Dean Witter to show that the Bylaw would harm consumers:

We do not read the Court's precedent involving joint ventures to imply any special treatment or differing antitrust analysis. Indeed, aside from clarifying the inappropriateness of automatically invoking *per se* scrutiny of a joint venture's alleged antitrust violation, the Court has not articulated a different rule of reason approach. . . . To be judged anticompetitive, the agreement must actually or potentially harm consumers. . . . That concept cannot be overemphasized and is especially essential when a successful competitor alleges injury at the hands of a rival.<sup>38</sup>

Dean Witter ultimately lost because the court rejected the collective rulemaking analysis proffered by Dean Witter. The court found that "it is not the rule-making *per se* that should be the focus of the market power analysis, but the effect of those rules—whether they increase price, decrease output, or otherwise capitalize on barriers to entry that potential rivals cannot overcome"<sup>39</sup> (APP. 24–25). The court noted that there was no evidence presented (other than the unconvincing aggregate market share analysis) that the Visa rule had any anticompetitive effects on consumers. The court went on to say

Thus, without any eye on effect, the very exercise of rule-making became the factual basis for rule of reason condemnation of Bylaw 2.06. Consequently, rule-making was not only divorced from its functional analysis but also from the facts of the case. . . . We believe the evidence cited by the district court to conclude Visa USA possessed market power is insufficient as a matter of law. [That] conclusion set the path for its uncharted journey upon a landscape of speculation, conjecture, and theoretical harm. The consequence is the finding of liability based on tendentious and conclusory statements, none of which amounts to evidence of restraint of trade. [In a footnote the court remarked] Sears' disincentive argument [regarding Bylaw 2.06 and the entry of new systems] provides the widest array of speculation. . . .<sup>40</sup>

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<sup>38</sup>*SCFC ILC, Inc. v. Visa USA, Inc.*, 36 F 3d 958, 964–965.

<sup>39</sup>*Ibid.*, 968.

<sup>40</sup>*Ibid.*, 968–969.

The court also rejected Dean Witter's view that, in effect, Visa had to show that the "selective exclusion imposed by Visa's Bylaw 2.06 is ancillary to Visa's legitimate purpose as an open industry association."<sup>41</sup> The appellate judges observed that the Bylaw does not bar Dean Witter access to the payment card market and pointed out that there was no evidence that the Bylaw precluded Dean Witter from introducing Prime Option through Discover or any other means. They did not believe that the Sherman Act required the admission of Dean Witter into Visa so that it could compete more effectively. But the court stopped short of an explicit endorsement of Visa's "essential facility" standard for forced admission to a joint venture.

## CONCLUSION

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Business A, which competes with Business B, decides that it could make more money if it could sell B's product line in addition to its own. Business B says no. Can Business A make a claim under Section 1 of the Sherman Act? The general answer is clearly no, and this answer does not depend on whether Business B has market power, whether it let Business C sell the product line three days before, or whether it says that it would like to drive Business A into the dirt. Businesses do not have to share their property with anyone, let alone direct competitors, except under highly restrictive circumstances.

How then did Dean Witter's claim—which has almost exactly this fact pattern—survive summary judgment? The answer lies in the courts' long-standing hostility to joint ventures. Joint ventures are typically agreements between competitors, and it is well known that such horizontal combinations can do bad things: cartels can fix prices; trade associations can set standards that can block entry; and colluding firms can sometimes exclude competition by locking up essential inputs.<sup>42</sup> The courts therefore scrutinize joint ventures more closely than they do other forms of business organizations. Dean Witter could fashion an antitrust claim only because Visa was organized as a joint venture, and Dean Witter could therefore argue that Visa's exclusionary rule was enacted by a horizontal combination of competitors.

This higher level of scrutiny is somewhat paradoxical, since there is generally more competition when firms operate through a joint venture than when they merge. That is especially true for joint ventures that share input production and costs but then compete in output markets. If Visa and MasterCard had organized themselves as proprietary systems (e.g., with member banks having equity shares) in which members did not compete with

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<sup>41</sup>*Ibid.*, 971.

<sup>42</sup>See Kwoka (1994) for a discussion of the antitrust issues involved in the joint venture of GM and Toyota for manufacturing automobiles.

each other, there would have been far less competition in the payment card industry than there is today. This is not to say that joint ventures cannot provide a vehicle for anticompetitive behavior, but so can trade associations, industry conferences, and Sunday golf outings.

Not content with just having gotten to court, Dean Witter wanted (and needed) an even higher standard of scrutiny to win its case: a joint venture with a large market share would have to admit all comers unless it could show that exclusion was necessary for efficiency. And if it was admitting other new members or had recently done so, the exclusion of any applicant was presumptively not efficient. According to this view, large, open joint ventures must admit all applicants even if they are direct competitors of the venture. That view was rejected by the Tenth Circuit. Had the Tenth Circuit instead accepted Dean Witter's arguments, it would have made joint ventures, especially joint ventures that had admitted members in the past because of network externalities, a second-class form of business organization with attenuated property rights. Such a ruling would discourage the formation of joint ventures and would encourage resorting to mergers to exploit gains from cooperation.

Although its imagery could use work, the Tenth Circuit reached a sensible conclusion concerning Dean Witter's proposed revision to joint venture antitrust law and the result it would have required:

Given Visa USA's justification the bylaw is necessary to prevent free riding in a market in which there was no evidence that price was raised or output decreased or Sears needed Visa USA to develop the new card, we are left with a vast sea of commercial policy into which Sears would have us wade. To impose liability on Visa USA for refusing to admit Sears or revise the bylaw to open its membership to intersystem rivals, we think, sucks the judiciary into an economic riptide of contrived market forces. . . . The Sherman Act ultimately must protect competition, not a competitor, and were we tempted to collapse the distinction, we would distort its continuing viability to safeguard consumer welfare.<sup>43</sup>

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<sup>43</sup>*SCFC ILC, Inc. v. Visa USA, Inc.*, 36 F. 3d 958, 972.

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