

# PAYING FOR INFRINGEMENT: IMPLICATING CREDIT CARD NETWORKS IN SECONDARY TRADEMARK LIABILITY

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The advent of the Internet has dramatically freed merchants from traditional geographic constraints. From the comfort of their homes, consumers can browse and purchase goods offered by merchants around the world. The proliferation of credit cards has facilitated this, permitting convenient and secure online transactions.<sup>1</sup> This development has been positive—enabling many small-businesses to expand beyond their immediate locations.<sup>2</sup> The combined growth of the Internet and the credit card industry, however, has also allowed sophisticated merchants to establish illegitimate businesses selling counterfeit goods. By registering under false information or basing their businesses in foreign countries, these merchants are sometimes practically impervious to the reach of domestic U.S. law.<sup>3</sup> As almost eighty percent of internet retail transactions involve the use of credit cards,<sup>4</sup> trademark owners are increasingly turning their attention to members of the credit card industry when filing trademark infringement suits. The enormous growth of Visa and MasterCard (the “Association”) and their acquirers<sup>5</sup> suggests that the industry can afford to bear greater responsibility for the

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1. See discussion *infra* Section III.A.3.

2. See, e.g., *Etsy: A Site for Artisans Takes Off*, BLOOMBERG BUSINESSWEEK (June 12, 2007, 11:08 AM), [http://www.businessweek.com/smallbiz/content/jun2007/sb20070611\\_488723.htm](http://www.businessweek.com/smallbiz/content/jun2007/sb20070611_488723.htm) (describing how almost ten million dollars worth of goods, mostly made by stay-at-home moms and college students, have been sold on the website etsy.com in its two years of operation).

3. See discussion *infra* Section III.A.3.

4. Ronald J. Mann & Seth R. Belzley, *The Promise of Internet Intermediary Liability*, 47 WM. & MARY L. REV. 239, 280 (2005).

5. Acquirers are the entities which are responsible for reviewing merchant applicants and bringing the merchant into the Visa or MasterCard networks. *Infra* Part II of this Note discusses the different acquiring entities and their roles within the payment networks in greater detail.

merchants from whom they derive their profits.<sup>6</sup> Furthermore, as more traditionally cash and personal check-based companies begin to accept credit cards, the industry's growth will likely continue.<sup>7</sup>

Two recent cases, *Perfect 10, Inc., v. Visa International Service Ass'n*<sup>8</sup> and *Gucci America, Inc. v. Frontline Processing Corp.*,<sup>9</sup> address whether courts should hold payment intermediaries contributorily liable for trademark infringement by merchants and, if so, what steps the payment intermediaries can take to avoid liability. The Ninth Circuit declined to extend secondary copyright and trademark liability to the payment intermediaries in *Perfect 10*, affirming summary judgment for the Association and acquiring entities.<sup>10</sup> By contrast, the Southern District of New York in *Frontline* denied the acquirers' motion to dismiss Gucci's contributory trademark infringement claims. Consequently, *Frontline* has made waves as the first case to find that payment intermediaries may be liable for secondary trademark infringement.<sup>11</sup>

This decision's reception has been mixed. *Frontline* has generated worry and some vitriolic criticism for its extension of liability and also for its apparent departure from *Perfect 10*.<sup>12</sup> Critics expressed concern that extending

6. Merchants must pay fees in order to accept credit card payments from customers. Visa and MasterCard transactions have increased by an average of thirteen percent per year between 2000 and 2005. A paper, sponsored by the Payment Cards Center of the Federal Reserve Bank of Philadelphia and based on a January 19, 2007, workshop led by Marc Abbey, a managing partner at First Annapolis Consulting, discusses this trend. See Ann Kjos, *The Merchant-Acquiring Side of the Payment Card Industry: Structure, Operations, and Challenges*, PAYMENT CARDS CENTER, Oct. 2007, at 15, available at <http://www.philadelphiafed.org/payment-cards-center/publications/discussion-papers/2007/D2007OctoberMerchantAcquiring.pdf>.

7. *Id.* at 2. Of course, there will be periods of negative growth during market downturns. For example, during the recent recession, Visa-branded credit card volume decreased thirteen percent in 2009. PACKAGED FACTS, REWARDS CARDS IN THE U.S. 174 (3d ed. 2010).

8. 494 F.3d 788 (9th Cir. 2006).

9. 721 F. Supp. 2d 228 (S.D.N.Y. 2010).

10. *Perfect 10*, 494 F.3d at 793.

11. A search of Lexis and Westlaw within all state and federal cases for "trademark" & "credit card" & "contributor! liab!" on February 7, 2011, found only two (*Perfect 10* and *Frontline*) relevant cases which address secondary trademark liability for credit card companies.

12. See, e.g., Eric Goldman, *Payment Service Providers May Be Liable for Counterfeit Website Sales--Gucci v. Frontline*, ERIC GOLDMAN TECHNOLOGY & MARKETING LAW BLOG (June 29, 2010, 12:19 PM), [http://blog.ericgoldman.org/archives/2010/06/payment\\_service.htm](http://blog.ericgoldman.org/archives/2010/06/payment_service.htm) (arguing that *Frontline's* ruling is terrible on both a doctrinal and normative level); Mike Masnick, *Gucci Allowed To Sue Credit Card Processors For Contributory Infringement Over Counterfeit Goods*, TECHDIRT (July 6, 2010, 10:27 PM), <http://www.techdirt.com/articles/20100627/1124369974.shtml> (worrying about the chilling effects to service providers "when courts

liability to payment intermediaries will shift the policing of trademarks to service providers and create “deputization of private vendors into content cops.”<sup>13</sup> Other commentators, however, have seen this decision as a natural extension of secondary trademark liability and a reinforcement of incentives for service providers to refrain from conducting business with illegal enterprises.<sup>14</sup>

This Note argues that *Frontline* is not as shocking a departure from established case law as some commentators have posited, and that the *Frontline* court’s careful consideration of the background of the credit card industry and the realities of the internet marketplace is a more nuanced analysis than the Ninth Circuit majority’s analysis in *Perfect 10*. Part I examines the history of contributory trademark liability. It also briefly considers secondary copyright liability cases to highlight the theories that have led to the expansion of liability over time. Part II explains the complex relationship between the Association, the acquiring industry, and merchants within the financial network. Analyzing these different entities together as simply “credit card companies”—as the majority in *Perfect 10* did—obscures the parties’ very different roles within the Visa and MasterCard networks. Such obfuscation could lead to an improper assessment of whether a party truly possesses the knowledge and control elements necessary for liability. Furthermore, the existence of multiple business models within the acquiring

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start effectively demanding that third parties have detailed knowledge and understanding of their partners’ business practices”).

13. Goldman, *supra* note 12.

14. See Ronald D. Coleman, *Give the Man Credit*, LIKELIHOOD OF CONFUSION (June 28, 2010, 1:00 AM), <http://www.likelihoodofconfusion.com/?p=6035> (expressing approval for Judge Harold Baer, Jr.’s decision in *Frontline*); Jane Coleman, *Gucci v. Frontline Processing: Giving Credit for Infringement Where It’s Due*, LIKELIHOOD OF CONFUSION (July 12, 2010, 8:05 AM), <http://www.likelihoodofconfusion.com/?p=6112> (arguing that *Frontline* correctly recognizes the “essential role played by credit card companies in online trademark infringement”); Richard L. Santalesa, *SDNY Court Holds Credit Card Processors May Be Contributorily Liable for Trademark Infringement*, INFORMATION LAW GROUP (July 5, 2010), <http://www.infolawgroup.com/2010/07/articles/trademarks/sdny-court-holds-credit-card-processors-may-be-contributorily-liable-for-trademark-infringement/> (arguing that *Frontline* “is merely the natural result of a steady thirty year-old expansion in trademark infringement liability”); Robert L. Weigel & Howard S. Hogan, *Important New Decision Establishes That Credit Card Processors May Be Held Liable as Contributory Trademark Infringers for Knowingly Servicing Merchants Who Sell Counterfeits*, GIBSON DUNN PUBLICATIONS (June 25, 2010), <http://www.gibsondunn.com/publications/pages/Decision-CreditCardProcessorsMayBeHeldLiableAsContributoryTrademarkInfringers.aspx> (the writers are counsel for the plaintiffs, Gucci America, Inc., in *Frontline*) (“This decision reinforces the incentives that most credit card companies have already perceived to avoid doing business with merchants engaged in unlawful activities, and it gives trademark and copyright owners a powerful new weapon in battling counterfeiters.”).

industry necessitates a very fact-specific inquiry into any issues of secondary trademark liability. Part III considers *Perfect 10* and *Frontline* in light of the legal and payment industry backgrounds and argues that *Frontline* undertook a more nuanced analysis than *Perfect 10*, and that *Frontline* correctly denied summary judgment to the defendants. Finally, Part IV contemplates the possible administrative ramifications of extending liability to the entities within the Visa and MasterCard networks. Specifically, Section IV.B evaluates the feasibility of extending more merchant monitoring responsibilities to the Association.

## I. THE HISTORY OF SECONDARY LIABILITY IN TRADEMARKS

Trademark law developed from the Lanham Act, enacted in 1946, which forbids the unauthorized use in commerce of “any reproduction, counterfeit, copy, or colorable imitation of a registered mark in connection with the sale, offering for sale, distribution, or advertising of any goods or services on or in connection with which such use is likely to cause confusion, or to cause mistake, or to deceive.”<sup>15</sup> In order to succeed in a claim for trademark infringement, a plaintiff must be able to demonstrate (1) that it has a valid mark, which qualifies for protection under the Lanham Act, and (2) the defendant is using a similar mark in a way that is likely to cause confusion to the relevant consumer group.<sup>16</sup>

Neither the statutory nor the constitutional sources for either trademark or copyright law explicitly authorize inclusion of secondary liability.<sup>17</sup> Despite this lack of explicit authorization, courts have developed secondary liability regimes for both trademark and copyright law.<sup>18</sup> Within this sphere, the two bodies of law derive their origin from the same source: common law torts.<sup>19</sup>

### A. VICARIOUS LIABILITY

Within the tort system, there are two forms of secondary liability: vicarious liability and contributory liability. Vicarious liability focuses on the

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15. 15 U.S.C. § 1114 (2006).

16. *Id.*

17. *See, e.g.*, J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 25:17 (4th ed. 2011); ROBERT P. MERGES ET AL., INTELLECTUAL PROPERTY IN THE NEW TECHNOLOGICAL AGE 582 (5th ed. 2010).

18. *See* MCCARTHY, *supra* note 17, at § 25:17; MERGES ET AL., *supra* note 17, at 582.

19. Elizabeth K. Levin, Note, *A Safe Harbor for Trademark: Reevaluating Secondary Trademark Liability After Tiffany v. Ebay*, 24 BERKELEY TECH. L.J. 491, 504 (2009); *see also* Mark Bartholomew & John Tehranian, *The Secret Life of Legal Doctrine: The Divergent Evolution of Secondary Liability in Trademark and Copyright Law*, 21 BERKELEY TECH. L.J. 1363, 1366 (2006).

relationship between the direct infringer and the defendant, and does not contain a knowledge requirement.<sup>20</sup> For a third party to be liable for vicarious trademark infringement, a plaintiff must establish that “the defendant and the direct infringer have an apparent or actual partnership, have authority to bind one another in transactions with third parties, or exercise joint ownership or control over the infringing product.”<sup>21</sup> In copyright law, a third party could be liable if it “has the right and ability to supervise the infringing activity and also has a direct financial interest in such activities.”<sup>22</sup>

## B. CONTRIBUTORY LIABILITY

Both trademark and copyright regimes recognize the doctrine of contributory liability. Section I.B.1 traces the development of contributory liability in trademark law. Section I.B.2 then briefly compares this trademark doctrine to copyright law’s more expansive doctrine.

### 1. *Contributory Trademark Liability*

Scholars identify *William R. Warner & Co. v. Eli Lilly & Co.*<sup>23</sup> as the first case in which the Supreme Court recognized the doctrine of contributory trademark liability.<sup>24</sup> In *Eli Lilly*, the plaintiff and defendant both produced products with similar ingredients including quinine and chocolate.<sup>25</sup> Their products were respectively named Coco-Quinine and Quin-Coco. Although the Court did not find the defendant liable for direct trademark infringement, reasoning that a name that is merely descriptive of the ingredients cannot be claimed as a trademark,<sup>26</sup> the court nonetheless assessed liability based on the deceptive practices of the defendant’s salesmen.<sup>27</sup>

Two decades later, *Coca-Cola Co. v. Snow Crest Beverages, Inc.*<sup>28</sup> established the reasonable person knowledge standard that is still in force today.<sup>29</sup> In this

20. Bartholomew & Tehranian, *supra* note 19, at 1366.

21. *Hard Rock Cafe Licensing Corp. v. Concession Servs., Inc.*, 955 F.2d 1143, 1150 (7th Cir. 1992).

22. *Gershwin Publ’g Corp. v. Columbia Artists Mgmt., Inc.*, 433 F.2d 1150, 1162 (2d Cir. 1971); *see also* *Fonovisa, Inc. v. Cherry Auction, Inc.*, 76 F.3d 259 (9th Cir. 1996) (finding that the plaintiff sufficiently plead facts to meet the control and financial benefit prongs of the vicarious copyright infringement test against the owner of a swap meet).

23. 265 U.S. 526 (1924).

24. *See, e.g.*, MCCARTHY, *supra* note 17, § 25:18; Levin, *supra* note 19, at 506.

25. *Eli Lilly*, 265 U.S. at 527.

26. *Id.* at 529.

27. *Id.* at 530 (describing how defendant’s salesmen “suggested that, without danger of detection, prescriptions and orders for Coco-Quinine could be filled by substituting Quin-Coco”).

28. 64 F. Supp. 980 (D. Mass. 1946).

29. Bartholomew & Tehranian, *supra* note 19, at 1379.

case, both the plaintiff and defendant sold dark brown carbonated drinks. The defendant, Snow Crest, supplied its Polar Cola to bars. Some of these establishments unscrupulously provided Polar Cola to customers who requested Coca-Cola specifically. The court emphasized that liability would be assessed only if a “reasonable person in the defendant’s position”<sup>30</sup> would recognize that they had “created a situation likely to result in infringement or was transacting with a customer that she should know would be particularly likely to use her product wrongfully.”<sup>31</sup> Based on the facts of this case, the court determined that the defendant did not meet this standard<sup>32</sup> and ultimately held that Snow Crest was not liable for the culpable behavior of the bar owners.<sup>33</sup>

In 1982, the Supreme Court established the modern test for contributory trademark liability.<sup>34</sup> In *Inwood Laboratories, Inc. v. Ives Laboratories, Inc.*,<sup>35</sup> the Court broadened the knowledge requirement beyond that of actual knowledge.<sup>36</sup> The plaintiff in *Inwood*, Ives, filed suit against a group of manufacturers who produced generic substitutes in capsules substantially similar to Ives’s drug, Cyclospasmol.<sup>37</sup> Ives wanted the manufacturers to be held liable for the actions of certain pharmacists who dispensed generic versions under the label Cyclospasmol.<sup>38</sup> The Court reasoned that “[e]ven if a manufacturer does not directly control others in the chain of distribution,” this manufacturer can be found liable for the direct infringer’s actions in certain situations.<sup>39</sup> These circumstances are “if a manufacturer or distributor intentionally induces another to infringe a trademark, or if it continues to supply its product to one whom it knows *or has reason to know* is engaging in trademark infringement.”<sup>40</sup>

Although the Court’s test specifically addressed manufacturers and distributors, in the wake of *Inwood*, lower courts have applied the *Inwood* standards outside these narrow categories. The Seventh Circuit in *Hard Rock Cafe Licensing Corp. v. Concession Services, Inc.*, partially basing its reasoning on

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30. *Coca-Cola*, 64 F. Supp. at 989.

31. Bartholomew & Tehranian, *supra* note 19, at 1379–80.

32. *Coca-Cola*, 64 F. Supp. at 989 (stating that the defendant was “not under a duty to investigate possible passing off by bartenders, or to take steps to safeguard against such passing off, or to eliminate or curtail sales of its product”).

33. *Id.* at 991.

34. Levin, *supra* note 19, at 507.

35. 456 U.S. 844 (1982).

36. Levin, *supra* note 19, at 508 (citing *Inwood*, 456 U.S. at 861 (White, J., concurring)).

37. *Inwood*, 456 U.S. at 848–50.

38. *Id.*

39. *Id.* at 853–54.

40. *Id.* at 854 (emphasis added).

the common law duty of landlords and licensors,<sup>41</sup> determined that a flea market owner could be contributorily liable for trademark infringement.<sup>42</sup> In *Fonovisa, Inc. v. Cherry Auction, Inc.*, the Ninth Circuit relied on *Hard Rock's* reasoning to similarly find that a flea market could be contributorily liable for being willfully blind to its vendors' infringement.<sup>43</sup> Such cases have been rare, however, and scholars have suggested that courts are reluctant to extend the scope of secondary trademark liability beyond the parameters of *Inwood*.<sup>44</sup> The specter of excessively expansive liability has led to the development of an additional element in the contributory liability test for defendants outside of the products manufacturing and distribution realm: control.

In *Lockheed Martin Corp. v. Network Solutions, Inc.*,<sup>45</sup> the Ninth Circuit summarized *Hard Rock's* and *Fonovisa's* reasoning and explicitly adopted an additional control element to determine the contributory liability of service providers. The defendant, NSI, a registrar of domain names, permitted the third party registration of multiple domain names related to Lockheed's federally registered mark "SKUNK WORKS."<sup>46</sup> The district court cautioned that extending contributory trademark liability beyond the manufacturer or distributor context involves "careful examination of the circumstances to determine whether knowledge of the infringement should be imputed."<sup>47</sup> Outside of the distribution and manufacturing *Inwood* scenario, contributory liability will be assessed only if there is "[d]irect control and monitoring of the instrumentality used by a third party to infringe the plaintiff's mark . . . ."<sup>48</sup> The Ninth Circuit compared NSI's service to that of the postal service as merely a routine translation and routing procedure, and determined that NSI's rote service did not implicate the kind of direct control and monitoring necessary to extend liability.<sup>49</sup>

Over time, the courts' interpretation of the knowledge standard has evolved to reflect the basic principal that there is no affirmative duty to either investigate or adopt precautions against third-party infringement unless circumstances suggest knowledge of the underlying infringement.<sup>50</sup> These

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41. *Hard Rock Cafe Licensing Corp. v. Concession Servs., Inc.*, 955 F.2d 1143, 1148–49 (7th Cir. 1992) (citing RESTATEMENT (SECOND) OF TORTS § 877(c) cmt. d (1979)).

42. *Hard Rock*, 955 F.2d at 1150.

43. *Fonovisa, Inc. v. Cherry Auction, Inc.*, 76 F.3d 259, 265 (9th Cir. 1996).

44. *E.g.*, *Bartholomew & Tehranian*, *supra* note 19, at 1389.

45. 192 F.3d 980 (9th Cir. 1999).

46. *Lockheed Martin Corp. v. Network Solutions, Inc.*, 985 F. Supp. 949, 954 (C.D. Cal. 1997), *aff'd*, 192 F.3d 980 (9th Cir. 1999).

47. *Lockheed*, 985 F. Supp. at 961.

48. *Id.* at 984.

49. *Id.* at 984–85.

50. *Bartholomew & Tehranian*, *supra* note 19, at 1380.

circumstances involve instances where the defendant knew or was aware of facts under which a reasonable person would know about the direct infringement.<sup>51</sup>

At the same time, however, several courts have emphasized that a defendant cannot escape liability by being “willfully blind.”<sup>52</sup> The Seventh and Second Circuits defined willful blindness as suspecting wrongdoing but then failing to investigate.<sup>53</sup> Recently, in *Tiffany v. Ebay*, the Second Circuit held that generalized knowledge about the existence of infringing behavior, without more specific information as to particular infringements, is insufficient to result in liability.<sup>54</sup>

## 2. Comparing Contributory Trademark and Copyright Liability

Although trademark and copyright secondary liability both derive from common law torts, copyright’s secondary liability is more broadly drawn than the trademark equivalent. In declining to apply the *Inwood* test of inducement to a copyright case, the Supreme Court noted in *Sony Corp. of America v. Universal City Studios, Inc.*<sup>55</sup> that it has “consistently rejected the proposition that a similar kinship exists between copyright law and trademark law.”<sup>56</sup> Moreover, the Court characterized the *Inwood* trademark rule as a “narrow standard” and suggested that its application to the *Sony* facts would leave plaintiffs without much ground for a claim of contributory liability.<sup>57</sup> Lower

51. *Id.* at 1380–81 (referencing *Coca-Cola Co. v. Snow Crest*, 64 F. Supp. 980 (D. Mass. 1946)).

52. *Tiffany (NJ) Inc. v. Ebay Inc.*, 600 F.3d 93, 109 (2d Cir. 2010) (“A service provider is not . . . permitted willful blindness. When it has reason to suspect users of its service are infringing a protected mark, it may not shield itself from learning of the particular infringing transactions by looking the other way.”); *Hard Rock Cafe Licensing Corp. v. Concession Servs., Inc.*, 955 F.2d 1143, 1149 (7th Cir. 1992) (“[W]e have held that willful blindness is equivalent to actual knowledge for purposes of the Lanham Act.”).

53. *Hard Rock*, 955 F.2d at 1149.

54. *Tiffany*, 600 F.3d at 110. The Second Circuit highlighted eBay’s existing policies to detect and terminate illegal listings. For a detailed discussion about the case, see Michelle C. Leu, Note, *Authenticate This: Revamping Secondary Trademark Liability Standards to Address a Worldwide Web of Counterfeits*, 26 BERKELEY TECH. L.J. 591 (2011).

55. 464 U.S. 417 (1984).

56. *Id.* at 439 n.19 (“Given the fundamental differences between copyright law and trademark law, in this copyright case we do not look to the standard for contributory infringement set forth in *Inwood*, which was crafted for application in trademark cases.”) (internal citation omitted).

57. *Sony*, 464 U.S. at 439 n.19 (“If *Inwood*’s narrow standard for contributory trademark infringement governed here, respondents’ claim of contributory infringement would merit little discussion.”); see also *Perfect 10 v. Visa*, 494 F.3d 788, 806 (9th Cir. 2006) (“The tests for secondary trademark infringement are even more difficult to satisfy than those required to find secondary copyright infringement.”).



courts have followed the Supreme Court's dicta and have declined to apply copyright's "more expansive doctrine" to trademark cases.<sup>58</sup>

Although secondary trademark liability is narrower than secondary copyright liability, the reasoning behind the latter's history of expansion may be useful to assess the expansion of trademark liability. For example, in the 1966 case *Screen Gems-Columbia Music, Inc. v. Mark-Fi Records, Inc.*,<sup>59</sup> Judge Weinfeld expressed concern for a particular type of "fly-by-night" counterfeiters.<sup>60</sup> He was worried about the reality of enforcement against illegal operations that were "carried on by small unreliable operators of dubious financial background who stay[ed] in business only long enough to reap their ill-gotten gains and disappear[ed] when legal action against them appear[ed] imminent."<sup>61</sup> This anxiety ultimately resulted in a decision to extend liability to the advertising agency and radio stations which broadcast the advertisements for counterfeit records. Almost half a decade later, Judge Weinfeld's concern may also be valid for cases like *Perfect 10*, where the direct infringers operated anonymously from foreign countries and, as a result, were practically impossible to reach for judgment.

## II. UNDERSTANDING THE VISA AND MASTERCARD "FOUR-PARTY NETWORKS"

Gaining a clear understanding of how the Visa and MasterCard networks function and the very different roles the parties within the networks perform will enable a clearer assessment of a particular defendant's connection to the infringing merchant. Section II.A examines the Association's duties and considers how it is removed from direct merchant interactions. Section II.B.1 outlines the three primary acquirer business structures which may expose the same party to different liability assignments. Section II.B.2 evaluates the high-volume profit model of the acquiring industry. Familiarity with this model is necessary to understand why the acquirers' current merchant monitoring methods primarily focus on data analysis, a topic explored in Section II.B.3.

Advances in technology have resulted in a payment market dominated by specialized entities operating in large-scale.<sup>62</sup> Although there are multiple

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58. *See, e.g.*, *Hard Rock Cafe Licensing Corp. v. Concession Servs., Inc.*, 955 F.2d 1143, 1150 (7th Cir. 1992).

59. 256 F. Supp. 399 (S.D.N.Y. 1966).

60. *Id.* at 401.

61. *Id.* at 404.

62. RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS 25 (2006); Kjos, *supra* note 6, at 7.

credit card systems, the Visa and MasterCard networks<sup>63</sup>—sometimes referred to as the “four-party networks”<sup>64</sup>—dominate the market.<sup>65</sup> Because they are the dominant networks, and because only the four-party networks are implicated in *Perfect 10* and *Frontline*, this Note’s scope is limited to those networks.

The “four-party network,”<sup>66</sup> illustrated in Figure 1, *infra*, includes the following key participants:

- (1) The cardholder;
- (2) The network authorized *merchant*;
- (3) The *issuing bank*<sup>67</sup> that has the relationship with the consumer and issues the cards to the consumer;
- (4) The *acquirer*<sup>68</sup> that reviews merchant applicants, brings the merchant into the network, and coordinates processing for the merchant.<sup>69</sup> In the Visa and MasterCard payment networks, only banks can technically qualify to be “acquirers.”<sup>70</sup> These banks are called the “*acquiring bank*” because the term “acquirer” has been used broadly to apply to other merchant service providers. Some banks will enter into joint ventures or sponsor *third-party firms*. These firms provide such an extensive scope of services that they are often known as “acquirers” even though some of them are simply third-party processors.<sup>71</sup> This

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63. The merchant acquiring industry is generally associated with the Visa and MasterCard four-party network. See Kjos, *supra* note 6, at 3. For purposes of this note, the payment cards under discussion are general purpose cards such as Visa and MasterCard. Private-label cards issued by retailers such as Macy’s or Nordstroms will not be discussed.

64. Ramon P. DeGennaro, *Merchant Acquirers and Payment Card Processors: A Look Inside the Black Box*, 91 FED. RES. BANK OF ATLANTA ECON. REV. 27, 31 (2006), available at [http://www.frbatlanta.org/filelegacydocs/erq106\\_degennaro.pdf](http://www.frbatlanta.org/filelegacydocs/erq106_degennaro.pdf). In the three-party network, the card issuer and the merchant acquirer is the same entity, such as American Express and Discover. *Id.* at 28; see also Kjos, *supra* note 6, at 3. For a quick summary on the American Express system, see PACKAGED FACTS, *supra* note 7, at 115–16.

65. Visa had 52.12% of the U.S. market share and MasterCard had 27.47% as of 2005. THE NILSON REPORT, No. 863, at 1 (2006).

66. There are more than four parties within the “four-party network.” Various scholars selectively highlight different entities within the network. For example, some scholars identify the four parties as: The (1) cardholder, (2) card issuer, (3) merchant, and (4) acquirer. See Howard H. Chang, *Payment Card Industry Primer*, 2 PAYMENT CARD ECONOMICS REVIEW 29, 37 (2004), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=653882](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=653882); MANN, *supra* note 62, at 20.

67. Sometimes referred to as the “card issuer.”

68. Sometimes called the “merchant acquirer.”

69. MANN, *supra* note 62, at 20.

70. DeGennaro, *supra* note 64, at 31.

71. Kjos, *supra* note 6, at 2–3. Most large-scale acquirers provide processing services in-house. DeGennaro, *supra* note 64, at 30–31. Other times the acquiring bank contracts out

Note uses “acquirers” as an all-encompassing term, indicating the entire category of nonbank and bank acquirers. When distinction is needed, this Note uses specific terms such as “acquiring bank,” “third-party firm,” or “processor.” Section II.B.1, *infra*, discusses this in greater depth;

- (5) The *processors*<sup>72</sup> that are responsible for transaction authorization. They electronically route a transaction from the point of sale to the network.<sup>73</sup> Later, processors use this point of sale electronic information to deposit funds in the merchant’s account.<sup>74</sup> Acquiring banks may perform payment processing in-house or contract the work out. Section II.B.1, *infra*, discusses this in greater depth;
- (6) The *service providers* that are third-party specialized companies such as independent sales organizations. They provide additional services to merchants via contract with acquirers and are discussed in greater depth in Section II.B.1, *infra*; and
- (7) *The Association*<sup>75</sup> consisting of the network providers Visa and MasterCard.

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the processing services to third parties. These third parties are called “third-party processors.” As previously mentioned the latter party will be covered under the umbrella term “acquirers.” Chang, *supra* note 66, at 45 n.48 (“The available statistics on acquirer shares report the volume of processors such as FDC as though they were acquirers, even though technically the acquirer is the bank member of the card associations that signs up the merchant.”) (referencing THE NILSON REPORT, No. 783 (2003)).

72. Processors are sometimes referred to as “card processor” or “payment processor.” DeGennaro, *supra* note 64, at 27–28. At times the term “third-party processor” is used if the processing service is contracted out by an acquirer to a third party. *Id.* at 31.

73. This process is called “front-end processing.” *Id.* at 31–32.

74. This process is called “back-end processing.” *Id.* at 30–31. Processors may perform both front-end and back-end processing, or only one.

75. Various terms are used interchangeably with “the Association.” Visa and MasterCard are frequently referred to as the “network providers,” “card association,” or “credit card association.” See e.g., MANN, *supra* note 62, at 20–21; Joshua S. Gans & Stephen P. King, *The Neutrality of Interchange Fees in Payment Systems*, 3 TOPICS IN ECON. ANALYSIS & POLICY 1, 1 (2003), available at <http://www.bepress.com/cgi/viewcontent.cgi?article=1069&context=bejeap>.

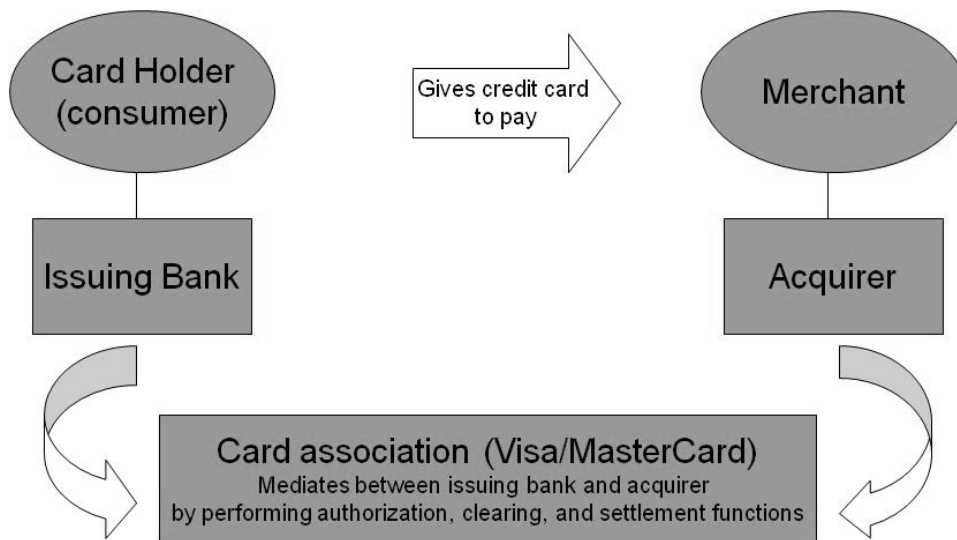


Figure 1: Four Party Visa/MasterCard System

A. THE ASSOCIATION: ATTENUATED MERCHANT CONTACT

Visa and MasterCard administer four primary functions within the system. First, they establish the ground rules, including liability assignments, for the transactions involving their brands.<sup>76</sup> Second, the Association mediates between the issuing banks and acquiring banks by performing the authorization, clearing, and settlement functions.<sup>77</sup> Third, the Association establishes the main fees—such as the interchange fee—that affect acquirers’ and issuers’ profits.<sup>78</sup> Lastly, the Association promotes and develops network innovations to improve processing services for customers and merchants.<sup>79</sup>

These duties suggest that Visa and MasterCard do not personally screen which merchants enter their networks.<sup>80</sup> Even after the acquirers perform the initial screening, the Association assigns many aspects of continual monitoring and disciplining to the acquirers or third parties.<sup>81</sup> For example,

76. MANN, *supra* note 62, at 21.

77. DeGennaro, *supra* note 64, at 31; *see also* Kjos, *supra* note 6, at 2. Visa, for example, requires acquirers to use VisaNet to communicate with the issuing bank when a transaction involves Visa cards. MANN, *supra* note 62, at 20–21.

78. The card networks set the interchange fee that acquirers must pay issuers per transaction. Although network providers do not set the acquirers fees, this interchange fee affects the minimum that acquirers will charge merchants. *See* Chang, *supra* note 66, at 43; *see also* Adam J. Levitin, *Payment Wars: The Merchant-Bank Struggle for Control of Payment Systems*, 12 STAN. J.L. BUS. & FIN. 425, 444 (2007).

79. Chang, *supra* note 66, at 43.

80. That is primarily the acquirer’s responsibility and will be discussed in detail *infra* Section II.B.

81. *Infra* Part IV.

the Association's current complaint system for illegal merchant activity assigns the burden of initiating the process to the complaining individual or business.<sup>82</sup> The complainant needs to approach the payment system with clear, documented, and substantial evidence of illegal activity that adequately identifies the responsible merchant.<sup>83</sup> The network provider then assesses the legality of the activity under issue.<sup>84</sup> Because the network provider does not have the expertise of courts, they usually only determine illegality for the clearest cases of violations.<sup>85</sup> As the Association does not work directly with merchants, they usually contact the acquirer and pass on the duties from there.<sup>86</sup> Typically, the acquirer will bring the merchant into compliance or will terminate the business relationship.<sup>87</sup> If the merchant thinks that its activity is legal, the merchant can go to court to establish legality.<sup>88</sup>

#### B. ACQUIRERS: DIRECT RELATIONSHIPS WITH MERCHANTS

Acquirers bring merchants into the card network, have primary merchant vetting responsibilities, and are direct liaisons between merchants and the Association. Section II.B.1 introduces the primary acquiring organizational structures. Section II.B.2 discusses the acquiring industry's standardized services and its influence on a business model focused on maximizing economies of scale. Section II.B.3 then examines how these factors contribute to the industry's data-centered merchant monitoring programs.

##### 1. *Multiple Acquirer Organizational Structures*

A complicated entanglement of relationships has developed as a result of Visa and MasterCard's bank-centered networks. Because of the Association's requirement that only acquiring banks can be "acquirers," a number of third-party specialized processing services and other merchant service providers have formed alliances with sponsoring acquiring banks in order to participate in the Visa and MasterCard networks.<sup>89</sup> However, regardless of any other third-party firm that the acquiring bank may contract with, the Association

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82. Mark MacCarthy, *What Payment Intermediaries Are Doing About Online Liability and Why It Matters*, 25 BERKELEY TECH. L.J. 1037, 1091 (2010).

83. *Id.*

84. *Id.* at 1091–92.

85. *Id.* at 1092.

86. *Id.*

87. *Id.*

88. *Id.*

89. DeGennaro, *supra* note 64, at 31; *see also* Kjos, *supra* note 6, at 2–3.

holds the acquiring bank ultimately responsible for both direct and indirect merchant transactions.<sup>90</sup>

There are numerous structural combinations possible for performing acquiring responsibilities.<sup>91</sup> Depending on the organizational model, the acquiring bank and any additional service providers may be responsible for different degrees of merchant oversight. Three basic models are illustrated, *infra* Figure 2. One such model is an acquiring bank that administers most of the relevant merchant services and, as a result, has a direct relationship with the merchant.<sup>92</sup> There are also firms, jointly owned by banks and nonbank acquirers, where the bank is the banking sponsor for Visa and MasterCard.<sup>93</sup> At the other end, a nonbank acquirer may provide access to the card networks and almost all other relevant merchant services under contract with a sponsoring bank.<sup>94</sup> Under this last scenario, the acquiring bank will probably have very little direct exposure to merchants.<sup>95</sup>

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90. See Kjos, *supra* note 6, at 2–3 (referring to “member financial institution” as the acquiring banks); see also Meeting Documents, Federal Reserve Staff and the Electronic Transactions Association, Aug. 18, 2010, at \*4 (citing FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL, RETAIL PAYMENT SYSTEMS IT EXAMINATION HANDBOOK 68 (Feb. 2010), available at <http://ithandbook.ffiec.gov/it-booklets/retail-payment-systems.aspx> (“Regardless of the presence of . . . third parties, the credit card networks expect the acquiring bank to be the risk-controlling entity throughout the credit card process.”)), available at [http://www.federalreserve.gov/newsevents/files/eta\\_20100818.pdf](http://www.federalreserve.gov/newsevents/files/eta_20100818.pdf).

91. The market used to be run by acquiring banks but now has become dominated by large technology companies with contract with acquiring banks. MANN, *supra* note 62, at 25. First Data Corporation is an example of such a large technology company. See generally FIRST DATA CORPORATION, [http://www.firstdata.com/en\\_us/home](http://www.firstdata.com/en_us/home) (last visited Feb. 9, 2011).

92. Chase Paymentech is an example of a merchant service subsidiary of a bank, JP Morgan Chase Bank. See PACKAGED FACTS, *supra* note 7, at 139; see also *How Chase and First Data are Splitting Chase Paymentech*, DIGITAL TRANSACTIONS (May 27, 2008), <http://www.digitaltransactions.net/index.php/news/story/1796>. Some scholars have also listed Fifth Third as an example of a merchant service subsidiary of a bank. See e.g., Kjos, *supra* note 6, at 7. However, Fifth Third appears more similar to the second model. Fifth Third Bank offers merchant services via Fifth Third Processing Solutions, a joint venture with private-equity firm Advent. See generally FIFTH THIRD PROCESSING SOLUTIONS, <http://www.ftpsllc.com/> (last visited Feb. 9, 2011). The company appears to be expanding its service efficiency as it is planning on buying National Processing. See *Fifth Third Processing Buying National Processing*, BLOOMBERG BUSINESSWEEK (Sept. 15, 2010, 6:58 PM), <http://www.businessweek.com/ap/financialnews/D9I8KV000.htm>.

93. Kjos, *supra* note 6, at 7. Kjos lists Paymentech as an example but the company announced in 2008 that Chase Merchant Services and First Data Corporation were ending their joint venture. Paymentech is now the merchant services subsidiary of JPMorgan Chase Bank and operated in-house. See *How Chase and First Data are Splitting Chase Paymentech*, *supra* note 92.

94. Kjos, *supra* note 6, at 7. Heartland Payment System, for example, is sponsored by the Bancorp Bank. *The Bancorp Bank to Provide Sponsor Bank Services for Heartland Payment*

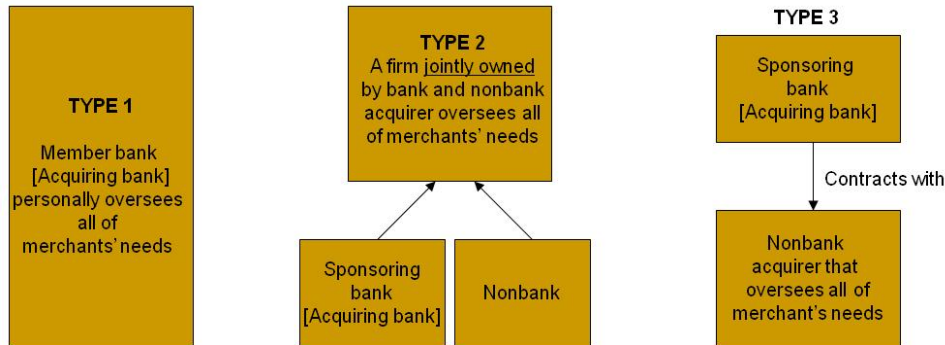


Figure 2: Three Basic Acquirer Structures

Specialized third-party service providers support these main business models via contract. Figure 3 illustrates how a business model may look if it contracts out certain services to third-party service providers. The inclusion of these latter groups in a business model provides yet another layer of buffered interaction with merchants. In particular, acquirers often contract with *independent sales organizations* (“ISOs”). ISOs solicit new merchants, sign up merchants for network access, and manage merchant relationships.<sup>96</sup> Carmody & Bloom, a management consulting firm, conducted a study for MasterCard and determined that 1,800 to 2,700 U.S. ISOs were responsible for sixty to eighty percent of merchant sign-ups.<sup>97</sup> The study highlighted three primary areas where ISOs and acquirers share risk managing duties: (1) “[s]creening of ISOs prior to entering a business relationship[;]” (2) “[s]creening of merchants’ financial and credit information as part of making the ultimate underwriting decision[;]” and (3) “[p]erforming back-end risk monitoring, which involves tracking merchant-level and ISO-level transaction data to identify out-of-pattern transactions that may be signs of merchant fraud or credit problems.”<sup>98</sup>

*Systems*, PYMNTS.COM NEWS (Apr. 19, 2010), <http://www.pymnts.com/the-bancorp-bank-to-provide-sponsor-bank-services-for-heartland-payment-systems-20100419005763>.

95. Issues of formation may complicate liability assessments. For example, whether an acquirer is a corporation, a limited liability company, or etc. may affect liability.

96. Kjos, *supra* note 6, at 8. See, e.g., MASTERCARD MEMBER SERVICE PROVIDER RULES MANUAL (Apr. 7, 2006), [http://www.mastercard.com/us/wce/PDF/13000\\_MSP-Entire\\_Manual.pdf](http://www.mastercard.com/us/wce/PDF/13000_MSP-Entire_Manual.pdf).

97. *MasterCard Research Outlines Best Practices to Help ISOs and Acquirers Attain New Business Opportunities*, BUSINESS WIRE (Apr. 11, 2002), <http://www.thefreelibrary.com/MasterCard+Research+Outlines+Best+Practices+to+Help+ISOs+and...-a084661996>.

98. *Id.*

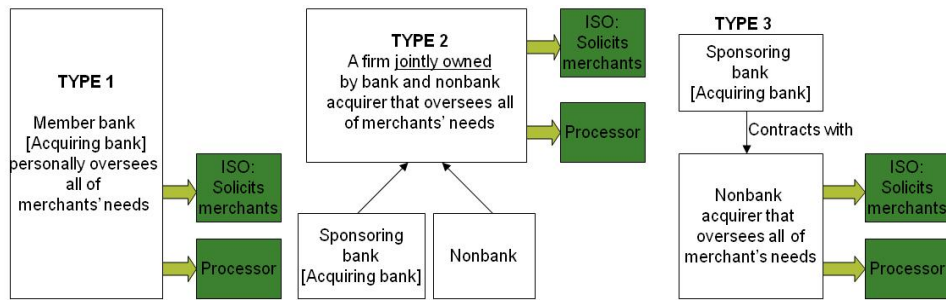


Figure 3: Three Basic Structures May or May Not Contract Out Certain Services to ISOs or Third-Party Processors

## 2. *The Acquiring Industry's Focus on High-Volume Processing*

The acquiring industry is fractured, specialized, and highly competitive.<sup>99</sup> This environment may provide incentives to service illegal, yet profitable, merchants.

Large-scale banks and third-party processors, whose profit margins are primarily affected by the volume of transactions they process, have come to dominate the acquiring industry due to economies of scale, technological advances, and the low-risk business model of acquiring institutions.<sup>100</sup> Acquirers derive almost all their revenue from standard processing functions.<sup>101</sup> Because of this, they do not have the ability to significantly differentiate their services, and as a result, the services they provide are akin to commodities.<sup>102</sup> Moreover, “[b]ecause commodities compete solely on price, their sellers tend to have low margins and rely on volume for profit.”<sup>103</sup> These operating models have spurred the development of large firms with enormous processing power that can maximize “economies of scale.”<sup>104</sup> By comparison, issuing banks profit mostly from the credit they extend to

99. Meeting Documents, Federal Reserve Staff and the Electronic Transactions Association, *supra* note 90, at \*2.

100. MANN, *supra* note 62, at 25 (pointing to First Data Corporation as an example); *see also* Chang, *supra* note 66, at 31, 45; Kjos, *supra* note 6, at 11.

101. Kjos, *supra* note 6, at 10.

102. *Id.* at 8–10.

103. Levitin, *supra* note 78, at 443. Because price is a big factor for acquirers in winning merchant accounts, acquirers operate on a relatively small profit margin. Chang, *supra* note 66, at 44; *see also* Levitin, *supra* note 78, at 444. The acquirers’ relationship with the merchant extends beyond the basic processing services previously described. Due to the competitiveness of the industry, and the increasing complexity of the fee structure from the card networks and issuing banks, most major acquirers provide services such as transactional data analysis. Kjos, *supra* note 6, at 6; *see also* DeGennaro, *supra* note 64, at 34. Merchant acquirers may also install card terminals, record transactions, provide reports, and handle other card processing problems. Kjos, *supra* note 6, at 19.

104. MANN, *supra* note 62, at 25; *see also* Kjos, *supra* note 6, at 10.



customers because they compete for customers through differentiated credit product services.<sup>105</sup>

Acquirers cannot differentiate their credit services because they have learned to manage the primary merchant risk—chargebacks. Chargebacks are customer transactional disputes that result in a reversal of the transaction.<sup>106</sup> The Association established liability rules where merchants, and ultimately acquirers, are responsible for absorbing the costs involved with chargebacks.<sup>107</sup> If the merchant cannot pay, the acquirer is responsible for paying.<sup>108</sup> This exposes acquirers to a high risk of fraud.<sup>109</sup> But, the industry has generally learned to manage this primary risk<sup>110</sup> through financial vetting processes discussed *infra* Section II.B.3.<sup>111</sup> Its success, though, has left few options for risk-based pricing and contributes to a lack of service differentiation.<sup>112</sup> Ultimately, this has helped shape the industry's bottom line emphasis on maximizing economies of scale.<sup>113</sup>

### 3. *Merchant Vetting Focuses on the Merchant Applicant's Financial Health*

Because of the industry's central risk, chargebacks, the acquirers typically focus their screening efforts on assessing factors relevant to the individual merchant's financial health.<sup>114</sup> The acquirer's careful evaluation of the merchant applicant's credit and financial statements, and continual monitoring of the credit quality of its current merchant clients protects the acquirer from the risk of chargebacks if the merchant defaults. Such evaluation usually comprises of assessing firm-specific effects and the nature of individual transactions.<sup>115</sup>

When evaluating firm-specific effects, the acquirer will use general methods such as analysis of financial ratios.<sup>116</sup> The acquirer also considers the

105. Kjos, *supra* note 6, at 10.

106. DeGennaro, *supra* note 64, at 34.

107. *Id.*

108. *Id.* at 35.

109. DeGennaro discusses an example where a merchant fraudulently accepts payments without the intention of delivering goods. As a result, when customers challenge the transaction, the acquirer is left with the responsibility of compensating the customers. *Id.*

110. Kjos, *supra* note 6, at 11 (“[T]he cost of chargebacks has been consistently around 1.5 to 2.5 basis points (0.015–0.025 percent) of volume.”).

111. DeGennaro, *supra* 64, at 34–41.

112. Kjos, *supra* note 6, at 11.

113. *Id.* at 10.

114. *See* DeGennaro, *supra* 64, at 34–41.

115. *Id.* at 37.

116. *Id.* at 39. DeGennaro explains that:

For unincorporated businesses, financial statements are often unaudited, so acquirers might use business tax returns to supplement the unaudited

nature of individual transactions such as whether purchases are made in-person or over the Internet.<sup>117</sup> Person-not-present transactions pose a higher risk of fraud and result in a higher likelihood that a customer will contest the transaction.<sup>118</sup>

The acquirer's initial financial assessment, however, does extend beyond data analysis. A careful screening factor is the nature of the merchant's type of industry—described as “industry effects.”<sup>119</sup> The merchant's type of industry is important because some industries are more prone to chargebacks than others. For example, a health club membership is more likely to result in “buyer's remorse.”<sup>120</sup> Also, merchants selling high-priced goods with uncertain or debatable value usually have a higher rate of chargebacks.<sup>121</sup>

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statements. Especially for small firms, acquirers even proceed beyond the firm level and use information about the owners and managers of companies, especially for unincorporated businesses. Acquirers can use credit scores from the Fair Isaac Corporation, commonly known as FICO scores, at the personal level as well as at the business level. Acquirers also use credit report information and the number of years that a potential customer has been in business to gauge risk.

*Id.*

117. DeGennaro discusses this more in a section on “transaction-related risks.” *Id.* at 40–41.

118. *Id.* at 41. Acquirers help deal with this problem by giving merchants discount rates depending on the number of “hurdles” the merchant sets up during the check-out process. The more “hurdles,” the higher the discount rate. A common hurdle, for example, is requiring entry of the billing address for the credit card. This ostensibly gives more assurance that the actual cardholder is completing the transaction. In this realm, the hand of the card associations can be seen again. The Association has established procedures to improve network efficiency which acquirers must follow. For example, Visa and MasterCard have a MATCH list (Member Alert to Control High Risk Merchants) of “problem” companies. An acquirer would be liable for losses of another acquirer if the former withholds services from a merchant because of “adverse processing behavior” and does not add that merchant to the MATCH list. *Id.*

119. *Id.* at 37. Also, merchant acquirers charge merchants different fees based on merchant compliance with transaction procedures. *Id.*

120. *Id.*

121. Internet Secure—an acquirer—lists a number of “prohibited businesses” that they will not establish a relationship with. The list includes businesses prohibited by law, such as gambling and drugs. The list also includes businesses which are legal but have a high risk of “buyer's remorse,” such as fortune telling, which lead to chargebacks. INTERNET SECURE, <http://www.internetsecure.com/solutions-faq.htm#2> (last visited Feb. 9, 2011).

a) Continual Merchant Monitoring: Predominantly Data and Pattern Based

The industry is aware of and attempts to self-police merchants who have fraudulently gained access to the card networks.<sup>122</sup> Outside of the initial screening, though, only certain data patterns or deviations from the respective merchant's usual business patterns triggers a closer investigation. The Electronic Transaction Association's ("ETA")<sup>123</sup> trade publication warns against "bait and switch criminal fraud," where merchants set up seemingly legitimate businesses for a few months and then switch to processing fraudulent transactions once the acquirer's scrutiny lessens.<sup>124</sup> ETA recommends prevention through careful initial screening of financial statements and continual monitoring of changes in transaction patterns.<sup>125</sup>

ETA also advises that random customer calls, "ghost shopping,"<sup>126</sup> and transactional monitoring techniques<sup>127</sup> may prevent "business format change," where merchants lie about the format of their company in order to gain access to the networks.<sup>128</sup> ETA's recommendation, however, does not note "ghost shopping's" effectiveness. For an industry so dependent on volume transactions, acquirers may face difficulties in ghost shopping all of their merchants.

The acquirer's risk department is responsible for this monitoring.<sup>129</sup> Acquirers review most merchants' financial accounts at least once a year.<sup>130</sup> As previously discussed,<sup>131</sup> the risk department tracks certain patterns and uses specific criteria in order to monitor each merchant's transactions.<sup>132</sup>

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122. See generally 2:1 ELECTRONIC TRANSACTIONS ASSOCIATION: WHITE PAPER, RISK MANAGEMENT 11 (April 2006) [hereinafter *White Paper*] (industry publication that published articles regarding combating merchant fraud), available at [http://www.electran.org/docs/whitepapers/White%20Paper%20\\_Spring%2006\\_%20Final.pdf](http://www.electran.org/docs/whitepapers/White%20Paper%20_Spring%2006_%20Final.pdf).

123. ETA is a trade association that primarily represents companies involved with merchant services and the distribution and sale of electronic payments products.

124. *White Paper*, *supra* note 122, at 4.

125. *Id.*

126. An acquirer, without disclosing its official purpose, can order a product or service from the merchant. *Id.* at 9.

127. For example, if a merchant initially processes larger payments but then many of the payments become smaller and consistently appears once a month on cardholder records, this may suggest a subscription to an adult website has been sold. *Id.* at 5.

128. *Id.* at 4–5.

129. *Id.* at 6.

130. DeGennaro, *supra* note 64, at 37.

131. *Supra* Section II.B.3.a.

132. *White Paper*, *supra* note 122, at 11.

Typically, such monitoring includes processing limits, average tickets, chargebacks, credits, and batch monitoring.<sup>133</sup>

### III. EXAMINING *FRONTLINE* AND *PERFECT 10*

#### A. *PERFECT 10*: DOES NOT DISTINGUISH BETWEEN THE ASSOCIATION'S AND ACQUIRERS' DIFFERENT FUNCTIONS

In *Perfect 10, Inc., v. Visa International Service Ass'n*,<sup>134</sup> the Ninth Circuit granted summary judgment for all the defendants, dismissing the plaintiff's secondary copyright and trademark infringement claims.<sup>135</sup> The plaintiff, Perfect 10, distributed "adult-oriented" images through magazines and a subscription website.<sup>136</sup> The company owned the copyright to these images of "the world's most beautiful natural models"<sup>137</sup> and held the federally registered trademark "PERFECT 10" and "PERFECT10.com."<sup>138</sup> Several hundred websites (the "Stolen Content Websites") directly infringed Perfect 10's copyright and trademark rights by publishing Perfect 10's copyright images while also using Perfect 10's mark.<sup>139</sup> Perfect 10 filed lawsuits against the Association, acquiring bank, third-party processor, and ISO<sup>140</sup> responsible for soliciting and processing the Stolen Content Websites' credit card sales, instead of the direct infringer, because of the alleged difficulty involved with filing lawsuits against the Stolen Content Websites.<sup>141</sup>

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133. Acquirers place a monthly *processing limit* on merchants that permits the merchant to accept credit card transactions up to that limit. The acquirer is able to monitor the merchant's transactional volume during the month to ensure that the merchant does not exceed the approved limit. An *average ticket*, which is an average of the merchant's product price, is calculated during the merchant account approval process. The acquirer conducts an investigation of any transactions which exceed the average ticket. Acquirers also monitor the number of *chargebacks*, percentages and reason codes in order to profile merchants' business practices. At the conclusion of each day, acquirer's risk department reviews each batch of submitted processing for transactions exceeding the average ticket, chargebacks, excessive authorization, and many other items. *Id.* at 11.

134. 494 F.3d 788 (9th Cir. 2006).

135. *Id.* at 792–93.

136. Plaintiff and Appellant Perfect 10, Inc.'s Opening Brief at 6, *Perfect 10*, 494 F.3d 788 (No. 05-15170).

137. *Id.* at 1.

138. *Id.* at 6.

139. *Id.*

140. Defendants are Visa, MasterCard, First Data Corporation and its wholly-owned subsidiary CardService International, as well as Humboldt Bank. Plaintiff and Appellant Perfect 10, Inc.'s Opening Brief, *supra* note 136, at 1. CardService International has since merged and is now "First Data Independent Sales." See CARDSERVICE INTERNATIONAL, <http://www.cardserviceinternational.com/> (last visited Feb. 9, 2011).

141. Plaintiff and Appellant Perfect 10, Inc.'s Opening Brief, *supra* note 136, at 2.

The majority dismissed Perfect 10's claim for contributory trademark infringement because the defendants supposedly lacked "[d]irect control and monitoring of the instrumentality used by a third party to infringe the plaintiff's mark."<sup>142</sup> The majority was not persuaded by Perfect 10's argument that the credit card payment network, which processed the sales of the infringing material, was the "instrumentality" in question.<sup>143</sup> Instead, the Ninth Circuit took a very literal view, focusing on the fact that direct infringement—the illegal websites' use of the Perfect 10 mark—could and did occur without involving the payment intermediaries.<sup>144</sup> The court reasoned that even though the defendants' refusal to process payments might have the "practical effect" of reducing or halting the infringing activity, it did not by itself constitute "direct control."<sup>145</sup> Thus, the majority reasoned, as Perfect 10 did not allege that the defendants had the direct ability to remove infringing material from the website, or the ability to "directly stop" the distribution of such material over the Internet, the financial intermediaries did not have sufficient control to be liable.<sup>146</sup>

1. *Secondary Liability May Not Require Absolute Control over Direct Infringer*

The cases discussed in Part I, *supra*, extended liability to indirect actors without considering if the indirect actors were an *essential* factor for the direct infringement. *Fonovisa*<sup>147</sup> and *Hard Rock*,<sup>148</sup> for instance, extended liability to the flea market owners despite the fact that the flea market owners could not absolutely prevent the direct infringers from selling and using the mark elsewhere. This case law complicates the majority's finding in *Perfect 10* that the defendants did not have sufficient control because the direct infringement could theoretically take place without credit cards.

In addition, although *Perfect 10*'s majority attempted to distinguish *Perfect 10* from *Fonovisa* and *Hard Rock*, their analysis may be further complicated by the majority's failure to consider the unique features of the payment industry. To support its departure from *Fonovisa* and *Hard Rock*, the majority relied on *Lockheed Martin*'s statement that "[w]hile the landlord of a flea market might

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142. *Perfect 10, Inc., v. Visa Int'l Serv. Ass'n*, 494 F.3d 788, 807 (9th Cir. 2006) (citing *Lockheed Martin Corp. v. Network Solutions, Inc.*, 194 F.3d 980, 984 (9th Cir. 1999)).

143. *Id.*

144. *Id.*

145. *Id.* at 807 (citing *Lockheed*, 194 F.3d at 985).

146. *Id.*

147. *Fonovisa, Inc. v. Cherry Auction, Inc.*, 76 F.3d 259 (9th Cir. 1996).

148. *Hard Rock Cafe Licensing Corp. v. Concession Servs., Inc.*, 955 F.2d 1143, 1150 (7th Cir. 1992); *see also supra* Section I.B.1.

reasonably be expected to monitor the merchandise sold on his premises, [the defendant] . . . cannot reasonably be expected to monitor the Internet.”<sup>149</sup> For two key reasons, monitoring the legality of the merchants within the four-party network is very different from “monitoring the Internet.” First, Perfect 10 only sought to extend liability to merchants whose businesses were solely based on infringement, not to persecute predominantly legitimate merchants who may have had a few false transactions. The network entities, then, would not be required to guarantee the legality of every internet transaction. Second, as *supra* Section II.B demonstrates, each acquirer already supposedly conducts a legitimizing review of merchant applicants before admitting them into the payment network. This review is manual, personal, and very different from the automatic registration system at issue in *Lockheed Martin*. Thus, the majority’s comparison of *Perfect 10* to *Lockheed Martin* highlights the precipitous dismissal of claims when the payment intermediary’s individual role in the network is overlooked. In his dissent, Judge Kozinski noted that treating the Association the same as acquirers and payment processors is simplistic.<sup>150</sup> Such generalized categorization, Kozinski surmised, may obscure the assignment of liability since the defendants with little merchant interaction may be absolved of liability.<sup>151</sup>

2. *Plaintiff Failed to Consistently Maintain Distinctions Between the Defendants*

The Ninth Circuit’s treatment of all the defendants under one analysis may have been influenced by Perfect 10’s inconsistent evaluation of the defendants. In its opening brief, Perfect 10 at times distinguished between the Association and the acquiring entities—Humboldt Bank, First Data Corp. and CardService International, Inc.—stating that the acquirers are supposed to “verify and process” the credit card charges according to network rules.<sup>152</sup> However, Perfect 10 inconsistently maintained these distinctions and its brief intermingled allegations against the Association and the acquirers. For example, in the control element section of its opening brief, Perfect 10 jumps from a description of MasterCard’s Black List, which

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149. *Perfect 10*, 494 F.3d at 807 (citing *Lockheed*, 192 F.3d at 985).

150. *Perfect 10*, 494 F.3d at 810 n.2 (Kozinski, J., dissenting) (arguing that referring “to defendants collectively as credit card companies or credit cards . . . adopt[s] the same simplifying assumptions as the majority”).

151. *Id.* (“I am aware that Visa and MasterCard don't deal directly with merchants . . . . It may well be that some of the defendants will be absolved of liability because they have no direct contact with merchants or consumers . . .”).

152. Plaintiff and Appellant Perfect 10, Inc.’s Opening Brief, *supra* note 136, at 7.

essentially bans all listed merchants from acquiring reputable credit card processing services, to listing the requirement that “defendants” must inspect merchants’ websites, premises, financial statements, and other information before accepting them into the payment network.<sup>153</sup> From Perfect 10’s description of these powers and responsibilities, it is unclear whether the Association or the acquirers are responsible for such an inspection.<sup>154</sup> The Black List’s possible illustration of control would arguably only implicate the Association. Similarly, the acquirers’ merchant review function arguably only implicated the acquirers. Subsuming these facts under a discussion about all the defendants clouds the issue of liability. As discussed, *supra* Section II.B, if the Ninth Circuit had considered the acquirer’s merchant vetting duties, *Perfect 10* may have been more difficult to distinguish from *Fonovisa* and *Hard Rock*.

Additionally, in its allegations intended to demonstrate knowledge, Perfect 10 failed to consistently distinguish between the defendants. For example, Perfect 10 alleged that “the defendants” charged higher rates for the Stolen Content Websites.<sup>155</sup> A reader, relying solely on the pleadings, would be hard-pressed to guess whether the Association, the acquiring bank, the processor, or the ISO was responsible for this categorization. Also, Perfect 10 ambiguously alleged that they notified “the defendants” about the infringing content of particular websites but the “defendants” failed to act.<sup>156</sup> This language fails to clarify which of the defendants actually received notification from Perfect 10.

### 3. *Online Marketplace Reality: Credit Cards are Prerequisite for Profitability*

The Ninth Circuit’s dismissal of secondary liability claims based on the defendants’ lack of literal direct control over the contents of the Stolen Content Websites ignores the reality of the internet marketplace. These

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153. *Id.* at 9.

154. Perfect 10 stated that the Association “imposes many rules and regulations on merchants, which they require acquirers and ISOs to enforce.” *Id.* at 8. Asides from this statement, however, the control element section of the brief does not consistently and clearly delineate between the Association’s acts and the acquirers’ acts. *See id.*

155. *Id.* at 11. Although Perfect 10 does specify that Visa charged “High Risk” merchants an additional \$500 to join the network, Perfect 10 does not clarify how Visa knows that the Stolen Content Websites are “High Risk.” The brief also alleges that “Association members” are supposed to perform a review of the website and financial statement, and specifies that acquirers are supposed to investigate and terminate merchants known to be engaging in infringing activity. *Id.* However, Perfect 10 fails to clearly piece together the relevance of these different points and also fails to consistently maintain distinctions between the different roles of the defendants.

156. *Id.* at 2–3, 13; *see also Perfect 10*, 494 F.3d at 793.

websites are primarily set up to be profitable ventures. Credit card networks provide an essential function for businesses to enter this marketplace because they make transactions significantly easier for consumers. Removing the ability to process transactions through credit card payment systems would threaten the commercial viability of the Stolen Content Websites.<sup>157</sup> For example, the instant gratification of accessing images after payment would be hampered by the use of personal checks.<sup>158</sup> Consumers might also doubt the security of mailing cash or sending money orders. Another payment option, PayPal, is becoming an increasingly important alternative online payment player. PayPal, however, has been more diligent than the Association in severing ties with illegal merchants.<sup>159</sup> Thus, although the majority argued that Perfect 10 “conflate[d] the power to stop profiteering with the right and ability to control infringement,”<sup>160</sup> this distinction seems thin given that: credit cards facilitated almost all the direct infringers’ transactions; the acquirers play[ed] a gatekeeping role in reviewing merchant applications; and the Association and acquirers could have discontinued service at any time and thus cut off financial incentives for the direct infringers.<sup>161</sup>

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157. See Alex Kozinski & Josh Goldfoot, *A Declaration of the Dependence of Cyberspace*, 32 COLUM. J.L. & ARTS 365 (2009), for a general discussion about how cyberspace crimes’ “real-life motives” and fulfillment of “real-life needs” expose online criminals’ key weakness—a dependency on real-world institutions to achieve their aims. Kozinski and Goldfoot argue that without real-world institutions such as banks and credit card companies to transform online transgressions into cash, online criminals would not be able to benefit from cyberspace crimes in the real world.

158. Perfect 10 discusses the example of a website which is hosted in a foreign country in their opening brief. The consumer would need to send a personal check and wait several weeks for the check to clear before gaining access to said website. Plaintiff and Appellant Perfect 10, Inc.’s Opening Brief, *supra* note 136 at 32.

159. For example, PayPal stopped processing TheBagAddiction.com’s sales when they found out that the website sold counterfeit goods. See Plaintiff Gucci Am., Inc.’s Memorandum of Law in Support of A Motion for Summary Judgment Against Defendants Durango Merchant Services, LLC and Woodforest National Bank at 6, Gucci Am., Inc. v. Frontline Processing Corp., 721 F. Supp. 2d 228 (S.D.N.Y. 2010) (No. 09-CV-6925-HB) [hereinafter *Gucci’s Motion for Summary Judgment*].

160. *Perfect 10*, 494 F.3d at 806. This is under the court’s vicarious copyright liability analysis of defendants’ “right and ability to control the infringing activity.” However, although this may be a different standard from contributory trademark liability’s control prong, the quote highlights the court’s consistent distinction between financial control and the direct ability to control the websites’ stealing and infringing use of Perfect 10’s images and mark.

161. For a discussion on why the *Perfect 10* defendants may be secondarily liable for *copyright* infringement, see Bryan V. Swatt, Pamela C. Laucella & Ryan M. Rodenberg, *Perfect 10 v. Visa, MasterCard, et al.: A Full Frontal Assault on Copyright Enforcement in Digital Media or a Slippery Slope Diverted?*, 8 CHI. KENT J. OF INTELL. PROP. 85 (2008); see also Jonathan Lee, *Piracy by Plastic: Why the Ninth Circuit Should Have Held Credit Cards Liable for Secondary Copyright*



In addition, although credit cards have contributed to the increasing globalization of commerce, they have also shielded some direct infringers from legal judgment. As was the case in *Perfect 10*, direct infringers are often based overseas, are judgment proof, and may not even be identifiable because they disguise their true identities with false contact information.<sup>162</sup> As discussed, *supra* Section I.B.2, copyright law's expansion of secondary liability to include third parties that lacked the ability to directly stop the infringing behavior partly reflected concern with the realities of enforcement against illegal operations.<sup>163</sup> Although secondary trademark liability is more narrowly drawn than that of secondary copyright liability, the reasoning behind the history of expanding copyright law's scope may be useful to assess the expansion of trademark liability.<sup>164</sup>

B. *FRONTLINE: EXTENDING BEYOND THE NETWORK PROVIDER AND ACQUIRER BINARY SPLIT*

In *Gucci America, Inc. v. Frontline Processing Corp.*,<sup>165</sup> the Southern District of New York granted the defendants' request to dismiss Gucci's charge of direct and vicarious liability, but held that Gucci had stated a cause for contributory liability under the Lanham Act.<sup>166</sup> The direct infringers operated a website, "TheBagAddiction.com," that sold counterfeit luxury products using Gucci's registered trademarks for a significantly lower price than the authentic version.<sup>167</sup> The website explicitly noted that their products were "replicas" and not authentic.<sup>168</sup> Gucci pursued litigation against the companies affiliated with the website (Laurette), and Laurette ultimately admitted liability for Gucci's counterfeiting claims.<sup>169</sup> *Frontline* is an extension

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*Infringement*, 2 J. BUS. ENTREPRENEURSHIP & L. 211 (2008). *But cf.* Robert A. McFarlane, *The Ninth Circuit Lands a "Perfect 10" in Applying Copyright Law to the Internet*, 38 GOLDEN GATE U. L. REV. 381, 405–06 (2008) (arguing that the Visa case is consistent with policy goals and highlights the importance of balancing copyright protection against public interest in "unfettered access to information and ideas").

162. Plaintiff and Appellant Perfect 10, Inc.'s Opening Brief, *supra* note 136, at 2.

163. *See* Peter S. Menell & David Nimmer, *Unwinding Sony*, 95 CALIF. L. REV. 941, 1005 (2007) ("[C]ourts . . . [wove] a sophisticated web of indirect liability doctrines to address the distinctive challenges of enforcing copyright law.").

164. *Id.* at 1004 (referencing *Screen Gems-Columbia Music, Inc. v. Mark-Fi Records, Inc.*, 256 F. Supp. 399, 404 (S.D.N.Y. 1966)).

165. 721 F. Supp. 2d 228 (S.D.N.Y. 2010).

166. *Id.* at 246–47.

167. *Id.* at 237.

168. *Id.* at 249.

169. *Id.* at 237.

of the Laurette case. In *Frontline*, Gucci sought to extend liability to Laurette’s acquiring bank, processor, and ISO.<sup>170</sup>

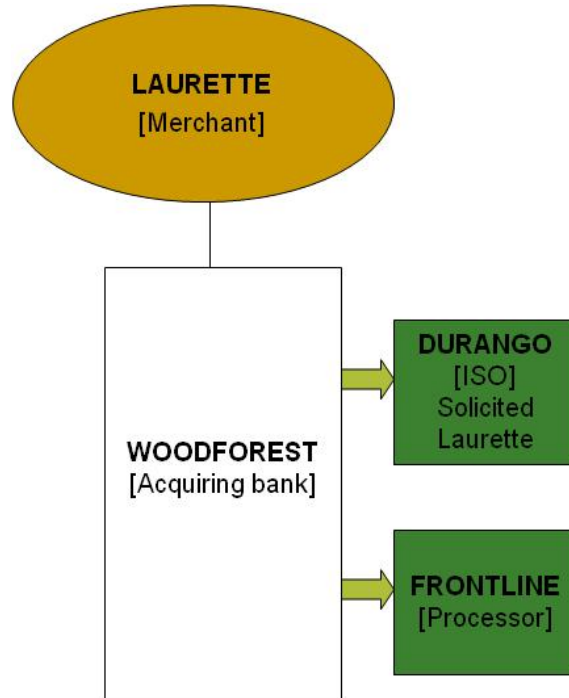


Figure 4: The *Frontline* Acquiring Entities

The Southern District of New York dismissed the claims for direct liability because the court determined that there was no proof that the defendants “used the mark in commerce.”<sup>171</sup> Gucci’s claim for vicarious trademark infringement also failed because the facts pleaded did not demonstrate that the defendants had the “type of control over a company like Laurette as a whole, i.e. akin to joint ownership, necessary for vicarious liability.”<sup>172</sup>

However, the court found that the ISO (Durango),<sup>173</sup> the processor, and the acquiring bank could be held contributorily liable based on different

170. *Id.*

171. *Id.* at 247 (“Knowledge alone of another party’s sale of counterfeit or infringing items is insufficient to support direct liability.”).

172. *Id.*

173. *See* NATIONAL BANKCARD SYSTEMS OF DURANGO, <http://durangomerchant services.com/> (last visited Feb. 9, 2011). Durango lists on the bottom of its webpage that it is a registered ISO for Wells Fargo. It is not clear whether Durango still acts as an ISO for Woodforest.

prongs of the test.<sup>174</sup> The court found that Durango may have intentionally induced Laurette to infringe based on evidence that Durango assisted Laurette in establishing a system where customers had to check a box that said: “I understand these are replicas.”<sup>175</sup> The court reasoned that such assistance suggested “affirmative steps taken to foster infringement” or “that [d]efendants promoted their payment system as a means to infringe.”<sup>176</sup> Ultimately, the court held that these actions suggested Durango’s liability for intentional inducement because the company “crafted ‘advertisement[s] or solicitation[s] that broadcast[] a message designed to stimulate others to commit violations.’”<sup>177</sup>

Although the court determined that the acquiring bank (Woodforest) and processor (Frontline) did not intentionally induce Laurette’s illegal behavior,<sup>178</sup> the two defendants may be contributorily liable based on the second prong of the synthesized test: control and knowledge.<sup>179</sup> To constitute the necessary knowledge, “a service provider must have more than a general knowledge or reason to know that its service is being used to sell counterfeit goods . . . [s]ome contemporary knowledge of which particular listings are infringing or will infringe in the future is necessary.”<sup>180</sup> Evidence of willful blindness also fulfills this element. For Frontline<sup>181</sup> (the processor), the court reasoned that the company’s alleged understanding of replica companies’ difficulty in obtaining services coupled with Frontline’s investigation of the website’s products as part of its chargeback reviews are enough to suggest that Frontline knew or was willfully blind to the illegal nature of the website’s business.<sup>182</sup> Frontline, although a registered ISO, in this situation appears to have primarily provided only data processing services.<sup>183</sup> The court reasoned

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174. *Frontline*, 721 F. Supp. 2d at 249–53.

175. *Id.* at 249.

176. *Id.*

177. *Id.* (citing *Perfect 10, Inc., v. Visa Int’l Serv. Ass’n*, 494 F.3d at 801).

178. *Id.*

179. *Id.* at 249–53.

180. *Id.* at 249 (citing *Tiffany (NJ) Inc. v. Ebay Inc.*, 600 F.3d 93, 107 (2d Cir. 2010)).

181. See FRONTLINE PROCESSING, <https://www.frontlineprocessing.com/Information> (last visited Feb. 9, 2011). Frontline is a registered ISO and MSP with Visa and MasterCard. However, in this situation Frontline appears to have primarily performed just data processing functions for Laurette.

182. *Frontline*, 721 F. Supp. 2d at 250.

183. Defendants’ Reply Memorandum in Support of Motions to Dismiss Under FED. R. CIV. P. 12(b)(6) and 12(b)(2) at 3, *Gucci Am., Inc. v. Frontline Processing Corp.*, 721 F. Supp. 2d 228 (No. 09-6925-HB) [hereinafter *Defendants’ Reply Memorandum*] (“There is no dispute that, in their processing of the credit card transactions, defendants [Woodforest] and Frontline do no more than transmit authorization requests from the merchant’s terminals to a network.”).

that Woodforest<sup>184</sup> (the acquiring bank) could be similarly liable because Woodforest reviewed the website and “even a cursory review of the TheBagAddiction.com would indicate that they claimed to sell replica Gucci products.”<sup>185</sup> Moreover, like Frontline, Woodforest also investigated chargeback disputes.<sup>186</sup>

The court also determined that Frontline and Woodforest had sufficient control over Laurette.<sup>187</sup> The court reasoned that the credit card processing services were “a necessary element for the transaction of counterfeit goods online, and were essential to sales from TheBagAddiction.com.”<sup>188</sup> For example, the counterfeit items were “delivered to the buyer only after [the acquirers] approve[d] the transaction . . . . This [was] not just an economic incentive for infringement; it’s an essential step in the infringement process.”<sup>189</sup>

The district court distinguished *Frontline* from the Ninth Circuit’s *Perfect 10* by emphasizing that the infringing conduct in the latter case was the website’s unauthorized publication of trademarked images, and that the distribution was simply any individual’s viewing and/or downloading of such images.<sup>190</sup> Thus, the *Frontline* court reasoned that Perfect 10 did not allege that the defendants had sufficient authority to remove the infringing material or directly cease distribution because “the infringement occurred on the website itself and a credit card transaction was not needed for the website to continue to infringe.”<sup>191</sup> The Southern District of New York’s distinction, however, focused on the Ninth Circuit’s interpretation of the control factor being an essential element of the direct infringement. As discussed, *supra* Section I.B.1, that focus is not necessarily the correct interpretation of case law.

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184. See WOODFOREST NATIONAL BANK, <http://www.woodforest.com/business/Banking/creditCardMerchantProgram/default.aspx?id=151> (last visited Feb. 9, 2011).

185. *Frontline*, 721 F. Supp. 2d at 250.

186. *Id.*

187. *Id.* at 253.

188. *Id.* at 251.

189. *Id.* at 252 (citing *Perfect 10, Inc., v. Visa Int’l Serv. Ass’n*, 494 F.3d 788, 810 (9th Cir. 2006) (Kozinski, J., dissenting)).

190. *Id.*

191. *Id.*

1. *Frontline's Individual Analysis of Each Acquiring Defendant*

In both *Perfect 10* and *Frontline*, the direct infringers relied heavily on credit cards to make their business viable. Around ninety-nine percent of TheBagAddiction.com's transactions were processed through the credit card network.<sup>192</sup> Furthermore, when PayPal and Card Services<sup>193</sup> stopped processing TheBagAddiction.com's sales after finding out that the website sold counterfeit goods, TheBagAddiction.com had to suspend sales for several weeks since it lost its ability to process credit cards.<sup>194</sup>

The *Frontline* court recognized the complex relationships between the different acquirer organizations and focused on the fact-specific allegations at issue, leaving factual determinations for trial.<sup>195</sup> Even though *Perfect 10* involved both the Association and members of the acquiring industry—two groups that perform very different functions within the network—the Ninth Circuit subsumed both industries under the same analysis.<sup>196</sup> *Frontline's* defendants, by contrast, were all members of the acquiring industry.<sup>197</sup> But despite this general categorization, the *Frontline* court analyzed each defendant individually and relied on a very fact-specific analysis. The court not only recognized the multilayered relationships between the different acquirer entities themselves, but also acknowledged the acquirers' varied relationships with the infringing merchant. An analysis that obscures the distinctions between the defendants could lead a court to only focus on the impersonal data processing elements of the credit card industry.

*Frontline* highlights how the structural organization of acquirers may expose the various acquiring entities to different levels of merchant interaction and consequently lead to distinct liability assignments. For example, the ISO's (Durango) inclusion within the acquirer's business structure made the ISO the entity with the closest merchant ties. In this situation, the ISO should have arguably the most familiarity with the merchant's business, possibly shielding the acquirer. However, as discussed, *supra* Section II.B.1, both the ISO's and the acquirer's risk departments may

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192. *Gucci's Motion for Summary Judgment*, *supra* note 159, at 6.

193. Card Services is a company that formerly provided payment processing services for TheBagAddiction.com. *Id.*

194. *Id.*

195. The defendants, for example, argue that knowledge that Laurette's goods are "replicas" do not necessarily mean the same thing as knowing that the goods are counterfeit. This issue should be decided by the finder of fact. *Defendants' Reply Memorandum*, *supra* note 183, at 9.

196. *See generally* *Perfect 10, Inc., v. Visa Int'l Serv. Ass'n*, 494 F.3d 788 (9th Cir. 2006).

197. *See generally* *Gucci America, Inc. v. Frontline Processing Corp.*, 721 F. Supp. 2d 228 (S.D.N.Y. 2010).

be expected to share the risk managing duty of screening merchants. This industry expectation may prevent an acquirer from shirking its vetting duties and arguing that it lacks sufficient knowledge about the merchant's infringement.

*Frontline's* relationships also underscores the high level of intimacy that is possible between merchants and certain acquiring entities. These relationships are not necessarily automatic and rote. To the contrary, some of these business transactions appear very personal. In this situation, because Durango (the ISO) acted as Woodforest and Frontline's agent to solicit potential customers,<sup>198</sup> Durango had the most direct contact with the infringing merchant. For example, Gucci alleged that Durango's sales agent Nathan Counley exchanged confidences with Jennifer Kirk, one of the owners of TheBagAddiction.com.<sup>199</sup> Kirk allegedly confided to Counley that TheBagAddiction.com "had to close because we were selling replicas,"<sup>200</sup> and she also informed him that other processors had terminated her account because of this fact.<sup>201</sup> A response from Counley allegedly said: "Good news! I just found out that our US bank can do replica accounts now."<sup>202</sup> It is uncertain whether the confiding nature of Kirk's and Counley's correspondences are typical of ISO and merchant relationships. However, Durango and TheBagAddiction.com's correspondences nonetheless illustrate the direct and personal contact which occurs between merchants and ISOs. Such personal business relationships may suggest that an ISO would have to be willfully blind to not know which industries its merchants belong to.<sup>203</sup>

#### IV. POLICY CONSIDERATIONS: COSTS AND BENEFITS OF EXTENDING LIABILITY TO THE ACQUIRING INDUSTRY AND THE ASSOCIATION

Although Part III argues that acquiring entities may be secondarily liable under current case law, Part IV contemplates the policy implications of extending such liability to the four-party network. Specifically, Section IV.A

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198. Plaintiff Gucci Am., Inc.'s Memorandum of Law in Support of A Motion for Summary Judgment Against Defendants Durango Merchant Services, LLC and Woodforest National Bank at 6, *Gucci Am., Inc. v. Frontline Processing Corp.*, 2010 WL 2541367 (S.D.N.Y.) (No. 09-CV-6925-HB).

199. *Id.*

200. *Id.* at 7.

201. *Id.* at 20.

202. *Id.* at 7.

203. The Southern District of New York found that Durango could be liable under the inducement prong and did not evaluate Durango under the control and knowledge prong. *Supra* Section III.B.

highlights administrative issues that ought to be considered when assessing whether the acquiring industry should be exposed to secondary liability. Section IV.B examines the possibility of assigning greater merchant monitoring responsibility to the Association.

A. ACQUIRING INDUSTRY'S LIABILITY: CONSIDERATIONS OF ADMINISTRATIVE PRACTICALITY

Considering the actual rules and mechanics of the Visa and MasterCard payment system illustrated, *supra* Part II, requiring the acquiring industry to police infringing merchants may seem to be the most practical scenario on an administrative level. The Association has already assigned acquirers the role of vetting merchants and bringing them into the networks. Furthermore, because of this system, members of the acquiring entities already have a close and direct working relationship with the merchants. Increasing the emphasis on the acquirer's gatekeeping role of screening and monitoring their merchants would cause the least disruption to the existing system.

In addition to administrative suitability, the acquiring industry's lack of coherence and focus on volume-driven transactions may suggest the necessity of legal oversight to force the industry to pay more attention to their merchants' activities. Legal oversight would push acquirers to recognize that they cannot profit from infringing merchants without costly consequences. Given the competitive nature of the acquiring industry, liability exposure will incentivize acquirers to uniformly implement more careful vetting procedures that they otherwise might not adopt.

Despite the appearance of administrative ease, however, certain aspects of the acquiring industry discussed, *supra* Section II.B, suggest that assigning consistent gatekeeping roles within this industry may be a difficult task.<sup>204</sup> First, the various acquirer business structures and the intertwined relationships between the multiple acquiring entities resist a standardized assignment of responsibility.<sup>205</sup> For any one merchant, as more acquiring entities become involved, the possibility of oversight gaps or inefficient redundancy increases. Furthermore, as the number of parties increase, any one entity's nexus to the merchant becomes unclear.

Second, the acquiring industry's high-volume profit model would mean that increased monitoring responsibilities will have far reaching implications—extending both to merchants and consumers. Partially resulting from the industry's focus on high-volume processing, the extent of

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204. If payment intermediaries are exposed to secondary trademark liability, they need to consider the assignment of consistent roles in order to prevent liability.

205. *Supra* Section II.B.1.

existing monitoring has focused on unusual changes in transaction patterns which can be managed with electronic programs that require relatively minimal individual review and company resources.<sup>206</sup> If more personal screening measures are used, such as “ghost shopping,” the cost of monitoring would likely increase. Although the acquiring industry can potentially absorb the increase in internal costs, the acquirers may also pass on the additional monitoring cost to the merchants. These increased costs would add to the already high cost that merchants incur for participating within the card networks. Merchants pay around fifty-seven billion dollars a year in the United States to accept payment card transactions.<sup>207</sup> Moreover, accepting credit card transactions has become the fastest growing cost of doing business for many merchants.<sup>208</sup> Ultimately, increased monitoring costs may create higher barriers to enter the payment networks, which in turn may be detrimental to market growth.<sup>209</sup>

If acquirers do pass the additional costs on to merchants, and merchants in turn spread the cost to consumers, it will be important to consider whether this is a justifiable solution under trademark theory. For the privilege of potentially keeping a trademark forever, would it be unfair for the trademark owner to shift the burden of policing onto someone else?

#### B. THE FEASIBILITY OF ASSOCIATION MONITORING

Another possibility, not necessarily conflicting with mandating increased responsibility for the acquiring industry, is to have the Association undertake greater *monitoring* responsibilities for merchants already in the network.<sup>210</sup> After all, the Association wields considerable power in setting and

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206. *Supra* Section II.B.2, II.B.3.

207. *See* Levitin, *supra* note 78, at 427 (“In 2006, U.S. merchants paid nearly \$57 billion to accept payment card transactions.”).

208. *Id.* at 429. For example, Levitin notes that during 2002 to 2005, the volume of payment card transactions increased forty-three percent from \$1,852.38 billion to \$2651.39 billion whereas the cost to merchants of accepting such transactions increased by sixty-seven percent, from \$29.08 billion to \$48.58 billion. *Id.* at 441 (citing THE NILSON REPORT, No. 877, at 7 (2006)). One report identified debit and credit card fees as gas stations’ and convenience stores’ fourth largest expense after labor, rent, and utility costs. DeGennaro, *supra* note 64, at 28.

209. For example start-up companies often operate at a loss in the early stages before seeing their profit margins increase. *See, e.g.,* Bryant Urstadt, *Amazon’s Challenger Is Only in Its Diapers*, BLOOMBERG BUSINESSWEEK (Nov. 15, 2010, 9:24 PM), [http://www.msnbc.msn.com/id/39633906/ns/business-bloomberg\\_businessweek](http://www.msnbc.msn.com/id/39633906/ns/business-bloomberg_businessweek) (reporting that Quidsi operated at a loss in the initial year of launching *diapers.com* before they saw a return on their investments after developing a customer base).

210. Visa and MasterCard do not actively participated in vetting merchants before they enter their networks. *Supra* Section II.A.



establishing costs and rules for the network. Consequently, the Association is the best possible entity, at least within the network, to implement system-wide uniform changes.

Some scholars have suggested that imposing a “hot-list” requirement on the Association would be effective in preventing the purchase of illegal goods.<sup>211</sup> In practice, for certain illegal businesses such as child pornography, law enforcement and the Association have already worked together to develop voluntary agreements to monitor such activity.<sup>212</sup> Most recently, MasterCard announced that it will cease processing services for sites trafficking in pirated music, movies, games, and other digital copyrighted content.<sup>213</sup> The Recording Industry Association of America applauded MasterCard for its “proactive” measures.<sup>214</sup> MasterCard’s actions in this instance may serve to deter the legislature from imposing more stringent formal regulations.<sup>215</sup> Scholars have speculated that the Association’s general proactive measures may have been motivated by this concern.<sup>216</sup>

Visa and MasterCard’s current monitoring programs suggest the feasibility of shifting greater merchant monitoring responsibility to the Association.<sup>217</sup> There are two main monitoring categories: data security monitoring and voluntary and government required regulation.

#### 1. *Data Security Monitoring:*

The Association instituted security guidelines for merchants in order to ensure a minimal level of security for cardholders when merchants store credit card and other personal information for transactions.<sup>218</sup> The major credit card companies formed The Payment Card Industry Security Standards

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211. For a discussion evaluating the imposition of “hot-lists,” see Mann & Belzley, *supra* note 4, at 269–98. A “hot-list” identifies particular businesses which payment intermediaries should not process payments for. *Id.* at 280.

212. *Id.*

213. Greg Sandoval, *MasterCard Willing to Cut Off Pirate Sites*, CNET NEWS (Dec. 16, 2010), [http://news.cnet.com/8301-31001\\_3-20025879-261.html#ixzz18hEN0q7x](http://news.cnet.com/8301-31001_3-20025879-261.html#ixzz18hEN0q7x).

214. Sandoval, *supra* note 213.

215. Mann & Belzley, *supra* note 4, at 280.

216. *Id.*

217. *Perfect 10, Inc., v. Visa Int’l Serv. Ass’n*, 494 F.3d 788, 824 (9th Cir. 2006) (Kozinski, J., dissenting) (arguing that “credit cards already have the tools to police the activities of their merchants, which is why we don’t see credit card sales of illegal drugs or child pornography”).

218. See *Requirements and Security Assessment Procedures: Version 2.0*, PAYMENT CARD INDUSTRY (PCI) DATA SECURITY STANDARD 5 (Oct. 2010), available at [https://www.pcisecuritystandards.org/documents/pci\\_dss\\_v2.pdf](https://www.pcisecuritystandards.org/documents/pci_dss_v2.pdf).

Council that established the Payment Card Industry Data Security Standard (PCI DSS).<sup>219</sup>

Under this system, though, a significant amount of responsibility is placed on acquirers.<sup>220</sup> For example, acquirers are responsible for assigning the “merchant validation level” based on the number and type of transactions processed by that acquirer.<sup>221</sup> Within this numbered validation system, merchants are separated by categories of high/low volume traffic (Visa Levels One–Four) and, depending on volume, different monitoring standards are required.<sup>222</sup> For example, acquirers must notify Visa of new Level One and Two merchants annually.<sup>223</sup> In the event of a security breach, acquirers may incur serious penalties, such as fines and restrictions.<sup>224</sup>

The success<sup>225</sup> of the data security monitoring program may not be replicable by imposing a similar system for tracking trademark infringement. Because requiring personal review of all transactions is impractical, assessors<sup>226</sup> frequently measure data security compliance by using a sampling

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219. *Visa PCI DSS Compliance Validation Framework*, DATA SECURITY BULLETIN 1 (Nov. 18, 2008), available at <http://usa.visa.com/download/merchants/cisp-bulletin-visa-pci-dss-framework-111808.pdf>.

220. See, e.g., *Cardholder Information Security Program: Merchants*, VISA, [http://usa.visa.com/merchants/risk\\_management/cisp\\_merchants.html](http://usa.visa.com/merchants/risk_management/cisp_merchants.html) (last visited Mar. 23, 2011) (“Acquirers are responsible for ensuring that all of their merchants comply with the PCI [DSS] requirements.”).

221. *Visa PCI DSS Compliance Validation Framework*, *supra* note 219, at 2.

222. *Cardholder Information Security Program: Merchants*, *supra* note 220.

223. *Visa PCI DSS Compliance Validation Framework*, *supra* note 219, at 2.

224. See *Cardholder Information Security Program: If Compromised*, VISA, [http://usa.visa.com/merchants/risk\\_management/cisp\\_if\\_compromised.html](http://usa.visa.com/merchants/risk_management/cisp_if_compromised.html) (last visited Mar. 23, 2011) (“Members are subject to fines, up to \$500,000 per incident, for any merchant or service provider that is compromised and not compliant at the time of the incident.”); *Visa PCI DSS Compliance Validation Framework*, *supra* note 219, at 2.

225. See *Silver Lining Among the Data Security Clouds: 2010 Saw Decrease in Card Data Breaches*, PCI DSS COMPLIANCE BLOG (Jan. 18, 2011, 8:55 AM), [http://blog.elementps.com/element\\_payment\\_solutions/2011/01/2010-saw-decrease-in-data-breaches.html](http://blog.elementps.com/element_payment_solutions/2011/01/2010-saw-decrease-in-data-breaches.html) (“The number of records known to have been exposed in a security breach decreased significantly, from 223.1 million in 2009 to 16.2 million in 2010.”) (The views expressed may be biased as Element Payment Services, a member of the PCI Security Standards Council, maintains this blog.)

226. Depending on the merchant’s status, PCI DSS requires Approved Scanning Vendors (ASVs) and Qualified Security Assessors (QSAs) to conduct the vulnerability scans and certify security compliance. See *Requirements and Security Assessment Procedures*, *supra* note 218. Although ASVs and QSAs primarily monitor the merchants, their methodology is nonetheless relevant to the problem of developing successful and efficient merchant monitoring models to prevent against trademark infringement.

methodology of representative systems and processes.<sup>227</sup> Industry experts note that “[a]lthough it is feasible that an assessor may detect a breach, it is not the focus of their efforts in conducting a compliance assessment.”<sup>228</sup> Instead, “incident response and security monitoring functions internal to the service provider or merchant”<sup>229</sup> bear the responsibility of prevention and/or detection.<sup>230</sup> PCI DSS’ requirements for merchants to maintain up-to-date software<sup>231</sup> (prevention), system activity logs<sup>232</sup> (documentation), and frequent “testing”<sup>233</sup> (assessing compliance) of the merchant’s components, processes, and software<sup>234</sup> support this conclusion.

The data security program appears to share many components similar to current network methods for monitoring illegal merchant activity. Scans for security breaches are like the data monitoring methods acquirers use to prevent “bait and switch criminal fraud” discussed *supra* Section II.B.3.a. In addition, sample “testing” resembles the “ghost-shopping” method used to prevent against “business format change” discussed *supra* Section II.B.3.a. These automatic and random sampling systems have little commonality with the type of individual scrutiny that would be necessary to consistently and accurately assess whether a merchant is infringing another’s trademark. Moreover, the data security program has faced criticism on many fronts. Critics argued that the system only provides baseline security that inadequately protects consumer data.<sup>235</sup> In addition, small businesses’

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227. See Peter Spier, *The QSA’s Perspective: PCI Compliance Risks Abound*, BANKING INFORMATION SECURITY BLOGS—THE EXPERT’S VIEW (Mar. 22, 2010), <http://blogs.bankinfosecurity.com/posts.php?postID=492>. For more information about ASVs and QSAs, see *Approved Companies & Providers*, PCI SECURITY STANDARDS COUNCIL, [https://www.pcisecuritystandards.org/approved\\_companies\\_providers/index.php](https://www.pcisecuritystandards.org/approved_companies_providers/index.php) (last visited Mar. 23, 2011).

228. Spier, *supra* note 227.

229. *Id.*

230. *Id.* Spier goes on to state that “[i]t is the QSA’s role to conduct this point-in-time assessment[,] . . . it’s the service provider’s and merchant’s responsibility to achieve, demonstrate and maintain their PCI compliance at all times.” *Id.*

231. See *Requirements and Security Assessment Procedures*, *supra* note 218, at 38. Requirement Six specifies that “[a]ll critical systems must have the most recently released, appropriate software patches to protect against exploitation and compromise of cardholder data.” *Id.*

232. *Id.* at 55.

233. Scans and “physical/logical inspections” may be used to fulfill the “testing” requirement. *Id.* at 59. In fact, no particular methodology is specifically required. *Id.* PCI DSS only specifies that “[w]hichever methods are used, they must be sufficient to detect and identify any unauthorized devices.” *Id.*

234. *Id.*

235. See Spier, *supra* note 227 (referring to the criticism voiced during a U.S. House of Representatives hearing).

compliance remains questionable as they can perform “self evaluations”<sup>236</sup> in lieu of third-party assessments. Acquirers also may not rigorously police small businesses’ compliance because of concern that this may drive the latter out of business and affect profit margins.<sup>237</sup> This issue may be particularly important when assigning primary vetting duties to acquirers who are mostly concerned with volume processing. The combination of these factors suggest that there are serious complications with implementing a broad sweeping program that aims to monitor *all* merchants.

## 2. *Voluntary and Government-Required Regulation of Criminal Activities*

To monitor child pornography, acquirers are responsible for the initial screening to prevent such merchants from entering the network.<sup>238</sup> However, child pornography merchants can often deceive financial institutions and gain access to the payment systems.<sup>239</sup> To remedy this, the Association developed a follow-up monitoring program to find any merchants that have entered the networks fraudulently.<sup>240</sup> This process has detected nine sites since 2006.<sup>241</sup>

The monitoring of controlled substances involves an initial screening and follow-up monitoring that is similar to child pornography detection.<sup>242</sup> The follow-up monitoring was implemented because coding the nature of the transaction to block did not work.<sup>243</sup> This is because available codes can only identify the business of the website and does not determine the nature of the pharmaceuticals.<sup>244</sup> Since implementing this program, MasterCard has shut down 500 websites selling illegal substances.<sup>245</sup>

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236. For example, Visa merely “recommends” that Level Four merchants perform an Annual Self-Assessment Questionnaire and a quarterly scan by ASVs “only if applicable.” *See Cardholder Information Security Program: Merchants*, *supra* note 220. *See also* Sherri, *PCI Threatens Small Business and Web Hosting Companies*, PHILOSECURITY (Feb. 8, 2010), <http://philosecurity.org/2010/02/08/pci-stresses-small-business-and-web-hosting-companies> (arguing that small businesses would lie about their compliance in order to avoid paying the heavy cost of actual compliance and avoid being kicked out of the credit card networks).

237. *See, e.g.*, Sherri, *supra* note 236 (discussing the acquirers’ financial incentive to believe small merchants and not revoke credit card processing privileges).

238. MacCarthy, *supra* note 82 at 1076.

239. *Id.*

240. *Id.* Visa uses an advanced web crawling and filtering technology to detect such websites. *Id.*

241. *Id.* at 1078.

242. *Id.*

243. *Id.* at 1079.

244. *Id.*

245. *Id.* at 1080.

The Association tracks online gambling through a merchant coding and manual blocking scheme.<sup>246</sup> Congress has provided a statutory safe harbor for “reasonably designed” procedures.<sup>247</sup> The Association’s methods have been hypothesized to be effective in cutting down on internet gambling.<sup>248</sup>

For tobacco, the Association has relied on law enforcement notification to cease financial relationships.<sup>249</sup> Visa and MasterCard do not conduct their own investigations.<sup>250</sup>

The Association’s methods for tracking the above areas suggest that continual monitoring, not initial screening, may be an area that the Association can feasibly undertake more responsibility for. However, child pornography, controlled substances, gambling and tobacco are specific goods categories. Monitoring for the sale of counterfeit goods—which can exist in a broad range of categories—may be significantly more burdensome and require additional monitoring procedures than those currently in practice. Whether this is a desirable outcome may be an interesting question to explore for future scholarship.

## V. CONCLUSION

The Internet has become a bustling marketplace where online merchants offer practically every conceivable consumer good.<sup>251</sup> Just a few strokes of the keyboard can connect consumers to counterfeit products. For instance, a quick Google search for “replica Chanel bags” returns links for dozens of merchants that sell “replica” designer handbags.<sup>252</sup> These illegal merchants

246. *Id.* at 1064.

247. *Id.* at 1065. For an in-depth treatment of the current state of internet gambling laws, see Charles P. Ciaccio, Jr., Note, *Internet Gambling: Recent Developments and State of the Law*, 25 BERKELEY TECH. L.J. 529 (2010).

248. MacCarthy, *supra* note 82 at 1069.

249. *Id.* at 1082–83.

250. *Id.* at 1083.

251. See, e.g., Erick Schonfeld, *Forrester Forecast: Online Retail Sales Will Grow To \$250 Billion By 2014*, TECH CRUNCH (Mar. 8, 2010), <http://techcrunch.com/2010/03/08/forrester-forecast-online-retail-sales-will-grow-to-250-billion-by-2014/> (discussing Forrester Research’s five-year forecast predicting steady ecommerce growth).

252. A Google search for “replica Chanel bags” on Mar. 6, 2011, returned <http://www.runwayhandbags.net/>, <http://www.echanelbags.com/>, and <http://www.hichanelbags.com/chanel-handbags-c-1.html> as its top three results. The runwayhandbags.net website has since ceased sales and has a notice posted stating: “The previous operators of this website were found to be selling replica goods in violation of Federal laws. A Court ordered this domain name transferred to Chanel and Louis Vuitton and awarded damages of more than \$1,000,000.00 against the website operators.” RUNWAY HANGBAGS, <http://www.runwayhandbags.net/> (last visited Mar. 16, 2011).

are not only prolific, but oftentimes are near-impossible to identify and reach for judgment. Thus, for trademark owners such as Perfect 10 and Gucci America, targeting the payment entities that facilitate these merchants' businesses may become a necessary method for trademark enforcement.

For many, the commonsense reaction to extending secondary trademark liability to financial intermediaries may be a visceral negative. The Ninth Circuit, for example, attempted to highlight the absurdity of this scenario by analogizing credit card entities to the electric company.<sup>253</sup> This Note, however, argues that a careful assessment of the four-party network may result in a different conclusion. Although the Association may be removed from direct merchant interaction, depending on the business structure at issue, liability exposure levels varies for the different acquirers involved. Many entities within the acquiring industry, such as ISOs, maintain close working relationships with merchants. For example, the alleged correspondence between Durango (the ISO) and Laurette (the merchant) in *Frontline* illustrates how intimate these relationships can be. Moreover, the level of personal review merchant applicants such as Laurette undergo before admission into the Visa and MasterCard networks contrasts sharply with the type of automatic registration system that was crucial to the Ninth Circuit's analysis in *Lockheed Martin Corp. v. Network Solutions, Inc.*<sup>254</sup> As a result, a failure to consider the relevant defendant's role within the four-party network may result in an improper comparison of the four-party network to dissimilar processing platforms.

Despite the industry's apparent susceptibility to secondary trademark liability based on current case law, careful consideration should be given to the policy implications of this result. Although legal oversight may be necessary to counter the competitive and volume-driven acquiring industry's incentives to sign on infringing merchants, those same industry characteristics may implicate an undesirable increase in merchant operating costs that will ultimately be filtered down to consumers. Furthermore, the variety within acquirers' business structures prevents an easy standardized assignment of responsibility. These characteristics and other administrative difficulties suggest that if liability is to be assessed, separate duties of initial merchant applicant screening versus continual merchant monitoring may

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253. See *Perfect 10, Inc., v. Visa Int'l Serv. Ass'n*, 494 F.3d 788, 800, 806 (9th Cir. 2006). Although the Ninth Circuit's reference to the electric company takes place within its secondary copyright infringement analysis, the reference is applicable to its trademark discussion.

254. 192 F.3d 980 (9th Cir. 1999).

need to be assigned to acquirers and the Association respectively.<sup>255</sup> Ultimately, the decision to hold payment intermediaries secondarily liable for their merchant's trademark infringement should be guided by case law, the payment industry's unique dynamics, and a careful balancing of the relevant policy implications.

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255. Consideration should also be given to whether the courts or Congress ought to be responsible for defining the legal liability boundaries of the payment networks.

