

CREDIT CARD FRAUD LOSSES: A CASE STUDY ON CREDIT CARD CHARGEBACKS

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I. INTRODUCTION

A. Background and Statistics

This article addresses losses sustained in connection with credit cards, as distinguished from debit cards. Debit cards are used to withdraw monies from an account owned by the cardholder. This article addresses bank credit cards (such as VISA, MasterCard, American Express, Discovery and Diners Club) rather than cards issued by, for example, department stores and petroleum companies. The primary emphasis will be on bank credit card fraud losses involving dishonesty on the part of one or more employees of the insured.

VISA maintains the largest bank card system in the world. The following statistics regarding VISA's transaction volume demonstrate the rapid growth of this industry, as well as bank credit card fraud, over the twenty-five year period from 1971 to 1996.¹ In 1971, VISA recorded sales volume in the USA of \$1.5 billion. In 1996, VISA recorded sales volume in the United States of \$447 billion. This represents almost a three hundred-fold increase over twenty-five years. For the twelve months ended March 31, 1997, VISA—Worldwide posted sales volume of just over \$1 trillion.

1. All of the following figures were obtained in a telephone interview with Allan Trosclair, CFE, Vice President, Fraud Control, VISA USA, Inc. (July 22, 1997).

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The sales volume of the top five major bank credit card systems (in billions of dollars) in the United States in 1996 was as follows:

Visa	\$447.4
MasterCard	229.2
American Express	131.3
Discover	53.6
Diners Club	9.3
Total	<u>\$ 870.8</u>

The volume of transactions was not the only change in bank credit card transactions over the last twenty-five years. In 1971, most credit card transactions were made in person at the point of sale. In 1996, a large portion of bank credit card transactions are made over the phone, through the mail or even over the Internet, where the merchant never sees the credit card or the card holder and does not have the benefit of “swiping” the credit card or taking an imprint of the card. Mail order, telemarketing and Internet credit card fraud are, therefore, subject to certain additional risks of fraud.

As to bank credit card fraud, VISA tracks seven different types of fraud. VISA measures credit card fraud not in dollars, but as a percentage of fraud-to-volume. Overall, VISA’s fraud-to-volume percentage is less than one percentage point, so it is measured in basis points. Basis points are hundreds of one percentage point. In other words, one basis point is equal to 1/100 of one percentage point. In 1971, VISA USA’s fraud-to-volume ratio was 32 basis points. If you apply 32 basis points to a sales volume of \$1.5 billion in 1971, the result is \$4.8 million in credit card fraud. On a national basis, for the largest bank card system, \$4.8 million in fraud losses was fairly insignificant back in 1971.

In 1996, VISA USA’s fraud-to-volume percentage dropped to nine basis points. This drop since 1971 is attributed in large part to the use of computers to activate mailed cards and to pre-approve transactions before they are consummated. However, if you apply nine basis points to VISA USA’s 1996 sales volume of \$447 billion, the result is \$402.3 million in bank credit card fraud. If you apply VISA USA’s 1996 fraud-to-volume percentage of nine basis points to total sales volume of \$870.8 billion in 1996 for the top five bank card systems, the result is \$783.7 million in bank credit card fraud in the United States alone. In round numbers, VISA estimates the current bank credit card fraud losses in the United States at \$1 billion per year. This is a very significant amount of fraud.

VISA USA tracks seven different categories of credit card fraud and the percentage of VISA's total credit card fraud attributable to each category. Those seven categories and their respective percentage of VISA's total credit card fraud is as follows:

<u>Category of Fraud</u>	<u>% of Total Fraud</u>
Stolen card	31.6%
Lost card	22.7%
Mail order/telemarketing	11.8%
Counterfeit losses	11.7%
Card not received	10.4%
Fraudulent takeover of cards by impostors	5.9%
Fraudulent application	5.9%
Total	100%

The case study of an actual case illustrated in this article involves mail order-telemarketing credit card fraud, the third largest category of bank credit card fraud loss. The following discussion briefly describes a credit card system, and reveals how a bank can be exposed to significant amounts of fraud loss in a short period of time, often a matter of months. The following discussion also briefly sets forth the factual situation giving rise to the claim involved in the case study.

B. Overview of a Bank Card System

Although detailed definitions of the major players and other important aspects of a bank card system is contained in Section III, an overview of a bank card system at this point would be helpful.

Any merchant which wants to accept credit cards enters into a "merchant agreement" with a bank. There are banks which specialize in handling credit card transactions, and even banks which specialize in certain types of merchants, such as telemarketers. The merchant agreement typically pro-

vides that of the gross amount of credit card charges, a certain fixed percent (usually around 5 percent) is paid to the bank as a fee. Often, banks use an independent service organization (ISO) to recruit merchants for the bank's credit card business.

The merchant agreement usually provides that another fixed percentage (often as much or more than 10 percent) is set up at the bank as a reserve against chargebacks. There are often several levels of reserve accounts. One reserve account may apply to transactions of the specific merchant involved, and another may apply as an overall reserve account against chargebacks involving all merchants of the same type being handled by that bank. Further, a reserve account may be set up to handle all chargebacks involving businesses referred by a particular ISO. The exact nature of these arrangements depends upon the terms of the merchant agreement.

Typically, a merchant bank will reimburse the merchant by crediting the merchant's account for the total amount stated in the credit card receipts, minus fees and reserve amounts. The exact nature of these transactions can vary. For example, a merchant may "deposit" the receipts into its account. Sometimes all of the information is transmitted electronically. Often, the amount credited to the merchant's account is available for withdrawal after a short period of time. Typically, the merchant's deposit and reserve accounts are adjusted from time to time, perhaps on a daily basis, in response to sales volumes.

A merchant bank is also a "member" of a bank card system, such as VISA or MasterCard. VISA and MasterCard do not issue cards. They provide a system for the exchange of payments by establishing rules, referred to as by-laws or operating regulations, for the interchange of credit card transactions. As a member, a merchant bank agrees to abide by the system's rules and regulations. Among other things, the rules and regulations contain terms and conditions under which sales credit card receipts (sometimes referred to as "paper," even though paper may never be physically transferred) is exchanged between merchant banks and issuing banks.² "Issuing banks" are the banks which issue credit cards to credit cardholders. Often, a merchant bank presents the paper to a "clearing member," which in substance acts like the Federal Reserve. Because merchant banks are often issuing banks as well, the clearing member "nets out" amounts owed between the various issuing/merchant banks. As part of the process, the clearing member credits various merchant banks' accounts, and forwards the transactional data to the issuing bank. For example, the clearing member forwards to an issuing

2. In addition, the by-laws or regulations also provide rules governing approvals for particular sales transactions. For example, a merchant may be required to pre-approve all sales, or only sales above a certain dollar amount.

bank the fact that “John Smith” purchased a VCR at Wal-Mart for \$200 on January 1. The issuing bank then sends a statement to John Smith.

The regulations also provide for “chargebacks,” which essentially are reverse charges. Among other things, the regulations govern the relationship between the merchant and issuing banks for resolution of chargeback disputes. For example, John Smith may dispute the January 1 charge when it appears on his statement for any number of reasons, such as a failure to receive the product, the product was defective or the product was not as described. At the end of this article as Tables 4.1 and 4.2 is a list of 44 “Reason Codes” applicable to VISA’s bank card system. The regulations also establish time limitations pursuant to which certain types of claims for chargebacks must be made.

It is not uncommon for chargebacks to be bounced back and forth between merchant and issuing banks until one of the parties seeks arbitration of a dispute. Unfortunately for some merchant banks, they may make funds available to their merchants before the time for resolving chargeback issues expires. As is discussed below, the potential for chargebacks to exceed the amount held in reserve accounts is great.

C. Preliminary Overview of the Case Study

The case study involves an insured bank which claimed that it sustained approximately \$3.8 million in losses stemming from chargeback losses while acting as a merchant bank for several unscrupulous telemarketers. The insured, Global Bank,³ submitted a proof of loss seeking approximately \$3.8 million under a financial institution bond for losses allegedly resulting from the dishonesty of Delbert Dealman, an employee of the insured. Dealman joined Global by proposing that he could expand Global’s merchant banking business by including telemarketers.

Dealman enlisted the assistance of Florida Marketing Organization (an ISO) to help bring in business. Florida brought in approximately twenty merchants, but two of the merchants accounted for 75 percent of the business. Home Water Purifiers sold water purifiers for home use (Home sold the purifiers for \$250, but it appeared that they retailed for \$49 in local convenience stores). USA Sales sold a variety of products, many of which were “factored” sales of other merchants.

Within a few months, Home and USA ran up chargebacks which exceeded the amount in the reserve accounts by \$3,788,376. Apparently, Home

3. Although this case study is based upon a real claim, the names have been changed at the request of the surety.

and USA sold products over the telephone, which in many cases were calls made in response to direct mail advertising informing the potential customers that they had won a car or a trip or something else of value and all they had to do to claim their prize was to place a telephone call to the telemarketer. This, of course, was a come-on to get the customer to purchase something else over the phone and pay for it by using a credit card. When the customer received the product, he or she realized that the product was significantly overpriced. In addition, after reading the fine print about the so-called free trip, the customers realized that the “free” trip would end up costing several thousand dollars. After many of the customers (but surprisingly not all of the customers) realized they had been duped, the customers wrote to the issuing bank and requested that the charge be reversed.

Global eventually terminated its merchant agreements with Home and USA, and subsequently learned that Dealman had accepted kickbacks in the amount of \$200,000 from Florida. Global also learned, among other things, that Dealman knew, but failed to disclose, that (1) Home had previously been terminated as a merchant by a different merchant bank; (2) USA was factoring sales for other merchants; (3) USA and Home engaged in deceptive trade practices and were being investigated by the Federal Trade Commission, and (4) USA was selling volumes of product which it did not have in inventory and had insufficient funds to purchase.

D. Summary

As this introduction shows, credit card fraud and chargeback losses in particular costs the banking industry (and their sureties) hundreds of millions of dollars a year. Often, unscrupulous merchants set up shop, make high volume sales of worthless merchandise, and then disappear, leaving a merchant bank to suffer the chargeback loss. Due to the nature of the industry, banks and their sureties can face significant exposure in a very short period of time. Obviously, banks investigate merchants to learn chargeback histories and their business practices, but these efforts can be thwarted by dishonest employees.

This article presents a case study of an actual case that the authors jointly investigated and settled. Section II discusses the legal issues related to credit card losses in general, but primarily focuses upon chargeback losses. Section III then provides a more detailed analysis of the facts, including a glossary of terms. The heart of Section III consists of a detailed discussion of adjustments to the claim.

II. LEGAL ISSUES

Interestingly, there is very little law on the issue of bond coverage for credit card losses. Only two cases specifically discuss coverage for credit

card losses, and both cases involved claims under financial institution bonds for chargeback losses. Unlike the facts of the case study, however, neither case involved employee dishonesty. Surprisingly, neither case includes a discussion of whether credit card losses are initially covered (in the absence of employee dishonesty), but instead focus upon exclusions (which perhaps implies that such losses are covered).

In any event, the article briefly discusses coverage issues relevant to commercial fidelity bonds. Because banks normally purchase financial institution bonds, chargeback claims will likely not arise in the context of a commercial fidelity bond. Probably, the most common credit card fraud claim under a commercial fidelity bond involves misuse of a company card by an employee. An important aspect of commercial fidelity bonds is that they do not (unlike financial institution bonds) contain any specific exclusions which relate to credit card loss, and chargeback losses in particular.

The article next discusses issues related to financial institution bonds. The article briefly discusses coverage for credit card fraud under the various insuring agreements, but focuses mainly upon two exclusions. Exclusion (k) excludes losses resulting directly or indirectly from the use of credit cards, and Exclusion (o) excludes losses resulting from uncollected funds. Neither exclusion applies to loss caused by employee dishonesty, however. As a result, it is likely that the only type of credit card fraud loss which will ultimately be covered under a financial institution bond involves employee dishonesty.

Lastly, the article addresses several issues related to adjustment of a loss, assuming coverage exists. Due to the nature of credit card transactions, issues may exist concerning causation, allocation of recoveries and set-off. These issues arose in the case study because a portion of the loss claimed by Global resulted from Global's failure to abide by the regulations when processing chargebacks and because of the existence of reserve accounts.

A. Commercial Fidelity Bonds

First, if there is loss caused by employee dishonesty, the loss would potentially be covered regardless of the method used by the employee to cause the loss. Probably the most prevalent form of credit card fraud involving an employee is misuse of a company credit card. VISA does not keep track of this type of fraud because it is difficult to discern whether charges are authorized.

Second, in the absence of employee dishonesty, loss caused by credit card fraud could be subject to coverage under coverage forms typically issued in connection with commercial fidelity bonds. For example, Coverage

Form B⁴ of a standard commercial fidelity bond covers forgery or alteration of checks, drafts, promissory notes or similarly written promises, orders or directions to pay a sum certain, which are *drawn by the insured* or by someone acting or purporting to act as an agent of the insured. Thus, credit card fraud could potentially be covered by a forgery or alteration coverage form if a court were to determine that a credit card slip is a written promise to pay a sum certain.

Third, losses associated with the use of credit cards might also be potentially covered under a standard ISO theft, disappearance and destruction coverage form. The standard ISO form covers in substance a loss of “securities” inside or outside the premises from theft, disappearance or destruction.⁵ The definition of “securities,” as contained in a Crime General Provisions includes “[e]vidences of debt issued in connection with credit or charge cards, *which cards are not issued by you.*”⁶ This definition suggests that theft, disappearance and destruction coverage could apply when credit card receipts are stolen from a merchant.

Fourth, it does not appear that chargeback losses would be covered under a standard ISO computer crime coverage form, which provides coverage for:

theft of property following and directly related to the use of any computer to fraudulently cause a transfer of that property from inside the “premises” or “banking premises” to a person (other than a “messenger”) outside those “premises” or to a place outside those “premises.”⁷

It does not appear that the losses would be covered by a computer crime coverage form in a situation similar to the facts of our case study because while a computer may have been used to input data, the outflow of funds from Home’s and USA’s accounts would not have “directly” resulted from the use of the computer. Unfortunately, there are few cases construing computer crime coverage forms. The analysis is further complicated because the definitions of “property,” “securities” and “property other than money and securities” do not appear to include electronic media, and as a result appear to obviate computer coverage in general.

Fifth, in the event that coverage exists under a commercial fidelity bond, commercial fidelity bonds do not contain exclusions specifically directed

4. Form CR 00 03 01 86, *published by* INSURANCE SERVICES OFFICE, INC. (1986).

5. Form CR 00 04 10 90, *published by* INSURANCE SERVICES OFFICE, INC. (1990).

6. Form CR 10 00 06 95, Section C(4)(b), *published by* INSURANCE SERVICES OFFICE, INC. (1995) (emphasis added).

7. Form CR 00 07 10 90, Section 3(b), *supra* note 5.

towards credit card losses, although other exclusions may be applicable, such as the inventory and profit and loss exclusion or the potential income exclusion.

B. Financial Institution Bonds

Like commercial fidelity bonds, coverage for credit card losses would most likely be covered under Insuring Agreement (A) for loss involving employee dishonesty, and could possibly be covered under Insuring Agreements (D) (Forgery or Alteration) or (E) (Securities). Unlike commercial fidelity bonds, however, financial institution bonds contain two relevant exclusions. The first exclusion, Exclusion (k), addresses loss resulting directly or indirectly from the purported uses of credit cards in obtaining credit or funds. Unfortunately, the only reported case to discuss this exclusion declined to rely upon it, suggesting that it is ambiguous. The second exclusion, Exclusion (o), known as the “Uncollected Funds” exclusion, excludes loss resulting directly or indirectly from payments made or withdrawals from a depositor’s account involving items of deposit which have not been finally paid for any reason. The only two courts which have addressed the issue both held that chargeback losses are excluded from coverage under Exclusion (o). Since both exclusions apply to all insuring agreements except (A), the only way chargeback losses ultimately would be covered under a financial institution bond would be under circumstances similar to the facts which make up the case study, namely, when employee dishonesty is involved.

Coverage for employee dishonesty under a financial institution bond is very broad. If the loss is caused by employee dishonesty, the way in which the loss was accomplished generally does not matter, unless a specific exclusion applies.⁸ In addition, in the case of chargebacks, an issue exists with respect to the \$2,500 financial benefit requirement. A Standard Form No. 24 Financial Institution Bond states that “if some or all of the Insured’s loss results directly or indirectly from Loans, that portion of the loss is not covered unless the Employee was in collusion with one or more parties to the transactions and has received, in connection therewith, a financial benefit with a value of at least \$2,500.”⁹ “Loan” means all extensions of credit by the insured in all transactions creating a credit relationship in favor of the insured.¹⁰ This aspect of the definition of dishonesty is relevant to chargeback losses because the relationship established between a merchant bank and

8. For example, the Trading Loss Exclusion (Exclusion (j)) excludes losses resulting directly or indirectly from trading, even though caused by an employee.

9. Financial Institution Bond, Standard Form No. 24 (revised Jan. 1996), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS’N OF AMERICA).

10. *Id.* at Section 1(m).

the merchant is essentially one in which the merchant bank extends credit to a merchant. In our case study, this requirement was met because the principal received over \$200,000 in kickbacks from persons with whom he was acting in collusion.

In the absence of employee dishonesty, it is unlikely that credit card loss would be covered under Insuring Agreements (B) (On Premises) and (C) (In Transit), due to the Loan Loss Exclusion.¹¹ Further, credit card loss, especially loss due to chargebacks, does not appear to be covered under Insuring Agreement (D), which provides forgery or alteration coverage. The insuring agreement specifically does not include loss suffered in connection with an "Evidence of Debt." "Evidence of Debt" is defined as "an Instrument, including a Negotiable Instrument, executed by a customer of the Insured and held by the Insured which in the regular course of business is treated as evidencing the customer's debt to the Insured."¹² Although the term "instrument" is not defined, it appears that a credit card receipt may fall within the definition of Evidence of Debt. In any event, a credit card or its receipt is not specifically enumerated as a qualifying "document" in the insuring agreement. Further, as is the case with many chargeback claims involving telemarketers, the card holder may never sign any document, and may not do so with the intent to deceive.¹³ Perhaps coverage could be had under Insuring Agreement (D) if, for example, a document from the merchant to the merchant bank which sets forth amounts representing telephone orders is considered to be a qualifying document. On the other hand, credit card sales information is often electronically transferred from a merchant to a merchant bank.

Credit card losses potentially could be covered under Insuring Agreement (E) (Securities) under several scenarios. First, in the case of an individual account holder, an issuing bank may suffer loss in connection with transactions in which the cardholder signs his or her name on the sales

11. The Loan Loss Exclusion provides:

(e) loss resulting directly or indirectly from the complete or partial non-payment of, or default upon, any Loan or transaction involving the Insured as lender or borrower, or extension of credit, including the purchase, discounting or other acquisition of false or genuine accounts, invoices, notes, agreements or Evidences of Debt, whether such Loan, transaction or extension was procured in good faith or through trick, artifice, fraud or false pretenses, except when covered under Insuring Agreements (A), (D) or (E).

12. *Id.* at Section 1(h).

13. Forgery "means signing of the name of another person or organization with intent to deceive; it does not mean a signature which consists in whole or in part of one's own name signed with or without authority, in any capacity, for any purpose." Financial Institution Bond, Standard Form No. 24 (revised Jan. 1986), Section 1(i), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS'N OF AMERICA).

receipt. An issue may exist as to whether the cardholder intended to deceive the merchant or the issuing bank in so signing. Second, an unscrupulous merchant could submit fraudulent credit card receipts. With respect to chargeback losses, it would appear that a merchant's submitting credit card receipts to a merchant bank would not fall within the definition of "Evidence of Debt" because the receipts would not have been "executed by a customer of the Insured" within the definition of Evidence of Debt.¹⁴ Third, it is possible, however, that the merchant agreement may be construed as a "Security Agreement" as defined in a financial institution bond. A Standard Form No. 24 Financial Institution Bond defines "Security Agreement" as "an agreement which creates an interest in personal property or fixtures which secures payment of performance of an obligation."¹⁵ If an unscrupulous merchant executed a merchant agreement with an intent to deceive a merchant bank, and the merchant agreement is in the possession of the merchant bank, its chargeback losses could conceivably be covered under Insuring Agreement (E).

Nonetheless, there is little need to continue to speculate about whether chargeback losses not involving employee dishonesty would be covered under some insuring agreement other than Insuring Agreement (A) because such losses are clearly and specifically excluded from coverage.

As noted above, a Standard Form No. 24 Financial Institution Bond contains two relevant exclusions. The first exclusion specifically addresses credit card losses. Section 2(k) is known as the "Credit Card Exclusion." It provides as follows:

Section 2. This bond does not cover:

...

(k) loss resulting directly or indirectly from the use or purported use of credit, debit, charge, access, convenience, identification or other cards

(1) in obtaining credit or funds, or

(2) in gaining access to automated mechanical devices which, on behalf of the Insured, disburse Money, accept deposits, cash checks, drafts or other similar written instruments or make credit card loans, or

(3) in gaining access to point of sale terminals, customer-bank communication terminals, or similar electronic terminals of electronic funds transfer systems,

whether such cards were issued, or purport to have been issued, by the Insured or by anyone other than the Insured, except when covered under Insuring Agreement (A).¹⁶

14. *Id.* at Section 1(h).

15. *Id.* at Section 1(q).

16. Financial Institution Bond, Standard Form No. 24, *supra* note 13.

Prior to promulgation of the 1980 edition of the Standard Form No. 24 Financial Institution Bond, this exclusion was added by a rider.¹⁷ The current version was expanded from the 1980 version by the addition of the term “purported use” to the first clause.¹⁸ Apparently, the addition was intended to address a potential gap in the exclusion, in that the insured could have argued that a card had to actually exist for the exclusion to apply, and that the exclusion now applies to a case where a fraud involves the fraudulent use of numbers only.¹⁹

There is only one case addressing the Credit Card Exclusion, *Broadway National Bank v. Progressive Casualty Insurance Co.*²⁰ Barton Russell Corporation (Barton) entered into a merchant agreement with Broadway National Bank (Broadway). Barton represented itself as an art gallery, when in actuality it was a front for a male escort service. In addition, through the manipulation of credit cards and authorization codes, Barton employees created numerous fraudulent sales slips which they deposited in the merchant account maintained by Barton at Broadway. By taking advantage of the lag time between Broadway’s crediting Barton’s account and the issuing bank’s notification to Broadway that the sales slips were fraudulent, Barton was able to withdraw funds from the account before Broadway could act to protect its interests. Broadway alleged that after seizing the amounts in the reserve accounts, it suffered a loss of approximately \$180,000. Broadway made a claim under a financial institution bond (1986 edition), but the court does not state or otherwise address under which insuring agreement Broadway claimed coverage.

Among other defenses, Progressive denied coverage on the basis that the loss was excluded under the Credit Card Exclusion. The court acknowledged that the language of the clause was very broad, and on its face appeared to exclude recovery for any loss suffered by Broadway as a result of the use or misuse of credit cards. The court continued, however, to state that the Credit Card Exclusion “*may* be construed as susceptible to more than one interpretation” (emphasis added).²¹ Even though the court further acknowledged the change in language between the 1980 and 1986 bond forms, the court concluded that it was “*arguable* that the clause may be unclear regard-

17. James A. Black, Jr., *Exclusions*, in ANNOTATED BLANKET BOND, ch. 6, at 39 (Frank L. Skillern, Jr. ed. Supp. 1983).

18. Statement of Change, Financial Institution Bond, Standard Form No. 24, *supra* note 13.

19. David K. Kerr & Jerome M. Joseph, *The Potential Income and Principal Other Exclusions*, in FINANCIAL INSTITUTION BONDS, ch. 9 at 215 (Duncan L. Clore, ed. 1995).

20. 775 F. Supp. 123 (S.D.N.Y. 1991).

21. *Id.* at 127.

ing schemes ... whereby, rather than the actual credit cards, authorization codes and card numbers serve as the basis of fraud” (emphasis added).²² The court reasoned that the clause “lends slight support” to the view that it speaks only of cards and not of account numbers or authorization codes. The court continued that an ambiguity *conceivably could arise* from the reference to only “cards” and not to “card numbers” or a similar term, which raised the issue of whether the use of a card number is “directly or indirectly ... purported use of ... cards.” The court conceded, however, that it was at least arguable that the clause’s exclusion of losses resulting “indirectly” from the “purported use” was enough to cover situations where card numbers and codes were used to commit the fraud.

Nevertheless, the court did not base its decision upon the Credit Card Exclusion for two reasons. First, the court stated that on a motion for summary judgment it could not use extrinsic evidence (such as the Annotated Bankers Bond, the Annotated Financial Institution Bond and the supplements thereto) to clarify the meaning of a contractual provision. Second, the court stated that under New York law an insurer seeking to disclaim liability through an exclusion must prove that the loss clearly is not covered by the policy and that any ambiguities are resolved in favor of the insured. The court stated that given those rules, even if there was a “possible” ambiguity as to the applicability of the Credit Card Exclusion, summary judgment was inappropriate. The court instead held that the loss was excluded under the Uncollected Funds Exclusion.

The Uncollected Funds Exclusion, Section 2(o), provides:

Section 2. This bond does not cover:

...

(o) loss resulting directly or indirectly from payments made or withdrawals from a depositor’s account involving items of deposit which are not finally paid for any reason, including but not limited to Forgery or any other fraud, except when covered under Insuring Agreement (A).²³

Although there are a number of cases construing this exclusion in general, there are only two which do so in the context of chargeback losses.

The first case is *Bay Area Bank v. Fidelity & Deposit Co. of Maryland*.²⁴ Flynn entered into a merchant agreement with Bay Area Bank, pursuant to which Flynn was authorized to honor certain credit cards and

22. *Id.*

23. Financial Institution Bond, Standard Form No. 24, *supra* note 13, Section 2(o).

24. 629 F. Supp. 693 (N.D. Cal. 1986).

transmit the sales drafts to the bank for collection. The bank agreed to post the drafts to Flynn's account immediately upon receipt, without awaiting collection. Flynn was permitted to draw checks against the amounts so credited, but the bank retained the right to charge Flynn's account at any time without notice for any sales drafts alleged by the cardholder to have been drawn without authority. Flynn sold magazine subscriptions by means of television advertising. Viewers wishing to purchase subscriptions would telephone a number and authorize the execution of a sales draft covering the subscription price. The sales draft, without the cardholder's signature, would be deposited at the bank.

After several months, bank officers became concerned about the large volume of sales drafts that were uncollectible because cardholders claimed they were unauthorized. Although Flynn assured the bank that the problem resulted from clerical problems which had been corrected, the problem continued. At one point, the bank required Flynn to deposit \$50,000 in a separate account and maintain a minimum balance of \$150,000 in his company's account. In return, the bank continued to post sales drafts immediately on receipt and allow immediate withdrawals from the account. At one point, Flynn deposited a large amount of what turned out to be unauthorized and uncollectible sales drafts. The bank froze the account and seized the security deposit. Unfortunately for the bank, the amount of Flynn's checks it paid exceeded the amount seized by \$336,872. The bank sought recovery under a Bankers Blanket Bond. The surety denied coverage, claiming that the loss was excluded under an uncollected funds exclusion rider which provided:

Loss resulting from payments made or withdrawals from any depositor's account which are uncollected for any reason, including forgery, unless such payments are made to or withdrawn by such depositor or representative of such depositor who is within the office of the Insured at the time of such payment or withdrawal, or unless such loss is covered under Insuring Agreement/Clause (A).²⁵

The insured did not dispute that the credit card sales drafts presented by Flynn were "uncollected items of deposits" within the meaning of the uncollected funds exclusion. The bank contended that the uncollected funds exclusion was intended to cover check kiting schemes only, and as such did not apply to the credit card fraud at issue. The court rejected that argument, reasoning that by its plain terms the exclusion applied to losses resulting from items of deposit which were uncollected for *any* reason and was not limited to losses incurred through check kiting. The court held that the bank's

25. *Id.* at 695.

loss clearly resulted from payment of items of deposit which were uncollected by reason of a fraud perpetrated upon the bank, and as a result, the uncollected funds exclusion applied.

The court also held that the bank could not invoke the “on premises” exception embodied in the uncollected funds exclusion. The bank conceded that Flynn was not physically present in the bank when actual payment was made on the checks drawn against the company account, but contended that “constructive payment” of the checks was made while Flynn was present within the bank’s offices. In support, the bank argued that its agreement with Flynn to continue to sight post deposits and allow withdrawals on Flynn’s account in exchange for greater security irrevocably committed the bank to pay checks drawn against the credit card sales draft deposits, and therefore constituted a “constructive payment” of checks later drawn against the account. The court rejected this argument as well, reasoning that the bank made no such irrevocable commitment to pay checks drawn against Flynn’s account. The court also relied upon a Seventh Circuit decision construing an identical exclusion in which the court held that the on premises exception applied only when the bank customer is physically at the bank at the time of the withdrawal.²⁶ Further, the court reasoned that the account was at all times subject to the terms of the merchant agreement, pursuant to which the bank expressly reserved the right to debit the account at anytime for the amount of unauthorized credit card sales drafts credited to the account.

The *Bay Area Bank* case was followed by the *Broadway National Bank* case. The surety contended that chargeback losses were excluded from coverage under an uncollected funds exclusion identical to the provision set forth above.²⁷ The court reasoned that the sole dispute regarding the uncollected funds exclusion was whether the credit card sales slips were “items of deposit.” The court characterized as meritless Broadway’s argument that “items of deposit” did not cover credit card slips. The court concluded that like other terms in the clause, its meaning was plain, and that the ordinary and obvious meaning of the words “items of deposit” included any financial instrument accepted by a bank for deposit. The court reasoned that the unambiguous nature of the term was evident not only from the clarity of the language, but also from the accepted practice of the banking industry. The court noted that as a general practice the bank accepted credit card sales slips for deposit by a merchant, and as part of the merchant agreement, most merchants maintained a regular deposit account with the bank to which all charges and credits arising from credit card transactions were entered. The

26. *Bradley Bank v. Hartford Acc. & Indem. Co.*, 737 F. 2d 657 (7th Cir. 1984).

27. 775 F. Supp. at 128.

court also reasoned that under the Uniform Commercial Code, the term “items” is broad enough to encompass credit card sales slips, because the Code defines “items” to include “any instrument for the payment of money even though it is not negotiable but does not include money.”²⁸ The court noted that in processing credit card transactions, Broadway treated credit card slips as “items of deposit” by, for instance, crediting Barton’s account when the sales slips were redeemed. Indeed, the merchant agreement stated that Broadway would reimburse for sales slips by “credit” to Barton’s checking account with the bank. Further, the court pointed out that Broadway readily exchanged the credit card slips that it redeemed for credit to an account maintained at the issuing bank.

Consequently, there is ample authority for the proposition that chargeback losses are excluded from coverage under a Standard Form No. 24 Financial Institution Bond under the Uncollected Funds Exclusion, except when covered under Insuring Agreement A. The only court which discusses the Credit Card Exclusion, which appears to clearly address chargeback losses, refused to apply the clause in the context of chargeback losses. Unfortunately, even though the court did not hold that the clause was ambiguous, it stated that an ambiguity might *conceivably* exist.²⁹

C. Adjustment Issues

Assuming that a chargeback loss is covered, because like the facts of the case study, it involves employee dishonesty, numerous loss adjustment issues exist. While these issues can be characterized in different ways and from several points of view, this article refers to the issues as causation, allocation of recoveries and set-off. In many respects, these issues all lead down the same path, which is to calculate the insured’s net loss,³⁰ and are all supported by the principle that an insured must suffer an actual, as opposed to a bookkeeping or theoretical, loss. Although these issues can arise in any fidelity claim, they are particularly relevant in a chargeback claim because of the nature of the chargeback rules and the existence of reserve accounts. The following discussion is not intended to be an extensive exposition of the subjects, but is intended to show how these issues arise in the context of a chargeback loss. Application of the following principles will

28. *Id.* at 129 (citing N.Y. Uniform Commercial Code § 4-104(g) (McKinney 1991)).

29. It should be noted that credit card insurance is available, which in substance covers debits established against an insured resulting from counterfeited cards purportedly issued by the insured. These policies can include employee dishonesty coverage.

30. *E.g.*, Mark E. Wilson, *The Legal Boundaries of “Loss” under Fidelity and Financial Institution Bonds: Towards a Coherent Theory of Set-off and Allocation of Losses and Recoveries* (unpublished paper presented to the National Bond Claims Association, Pinehurst, N.C. on October 3, 1996).

depend upon the law of the jurisdiction governing the dispute and upon the facts of the claim.

The *first issue* which may arise in connection with chargeback losses concerns causation. This is because both commercial fidelity and financial institution bonds only cover loss “resulting directly from” employee dishonesty. The obvious intent of this language (as well as several exclusions in both bonds) is to eliminate consequential or remote damages which may arise from an intervening cause.³¹ This issue arose in the context of the case study because Global failed to abide by VISA and MasterCard Operating Regulations. In some instances, Global incurred chargeback losses because it accepted untimely chargebacks, failed to timely respond to requests for information from cardholders and accepted chargebacks when required documentation was missing. Global also violated various other rules regarding chargebacks, which will be explained in Section III. As a result, the issue became whether certain chargeback losses did not result directly from employee dishonesty, but rather from the insured’s own inept conduct. Most insureds will contend that “but for” the employee dishonesty, such as Dealman’s conduct in accepting kickbacks and failing to disclose the prior chargeback history and fraudulent practices of Home and USA, the losses would not have been sustained.

Unfortunately, some courts have applied tort causation concepts, such as “but for” and “proximate cause” analyses, to fidelity claims. These analyses are contrary to the plain language of the current commercial and financial institution bonds.³² Often, this misconception arises when courts rely upon older cases which interpret bonds which only required that loss be sustained “through” dishonest or fraudulent conduct.³³

On the other hand, some courts have strictly (and correctly) interpreted the “resulting directly from” language in financial institution bonds, and have required more than a factual causal linkage. In *Continental Corp. v. Aetna Casualty & Surety Co.*,³⁴ the Court of Appeals for the Seventh Circuit held that the “resulting directly from” language clearly requires a direct and causal connection, and rejected the idea that a “but for” analysis satisfied the causation requirement of the bond. The court addressed the issue of

31. *Christman v. United States*, 74 F.2d 112 (7th Cir. 1934). See generally William T. Bogaert and Andrew F. Caplan, *Loss and Causation: Often Ignored Prerequisites to Recovery*, in FINANCIAL INSTITUTION BONDS (Duncan L. Clore ed. 1995); ROBERT F. CUSHMAN AND CHARLES H. STAMM, HANDLING FIDELITY AND SURETY CLAIMS, § 1.10, at 15 (1984 & Supp. 1990).

32. E.g., *Jefferson Bank v. Progressive Cas. Ins. Co.*, 965 F.2d 1274 (3d Cir. 1992); *Banco de San German, Inc. v. Maryland Cas. Co.*, 344 F. Supp. 496 (D.P.R. 1972), *Hansen PLC v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 794 P.2d 66 (Wash. Ct. App. 1990).

33. E.g., *FDIC v. Fidelity & Dep. Co. of Md.*, 45 F.3d 969 (5th Cir. 1995).

34. 892 F.2d 540 (7th Cir. 1989).

whether the insured suffered a “direct loss” under a Standard Form No. 25 Insurance Companies Blanket Bond for a loss caused by a former employee. The former employee engaged in a scheme involving fraudulent title insurance policies while employed by the insured. He continued the scheme when he was thereafter employed by a second company. The insured sought recovery for liability it had incurred in settling a lawsuit brought by the second company. The court held that Aetna was not liable for the losses the insured incurred as a result of a settlement with the second company with respect to losses suffered by the second company as a result of acts of the wrongdoer while he was employed by the second company. The court reasoned that the bond covered losses resulting directly from the dishonesty of the insured’s employees and that any loss suffered by the second company resulting from acts caused by the wrongdoer as an employee of the second company were not losses to the insured resulting “directly” from the dishonest conduct of an employee. The court rejected the trial court’s reasoning that “but for” the dishonest acts committed by the former employee while employed at the insured, the insured would not have been faced with the third-party lawsuit or the need to settle the case.³⁵

When the insured’s own conduct is an intervening cause, the issue can also be viewed as one of mitigation. As with other issues, the case law is varied. In *United States Fidelity & Guaranty Co. v. Empire State Bank*,³⁶ the court held that a bond insuring against “any loss” sustained in connection with employee dishonesty included loss resulting from depreciation of the collateral held by the insured as security for a bad loan. But in a more recent unpublished decision, a federal court in *Premier Electrical Construction Co. v. United States Fidelity & Guaranty Co.*,³⁷ upheld the surety’s affirmative defense that the insured failed to mitigate damages. In support, the court relied upon the surety’s allegation that the insured failed to recover funds obtained by the principal in an unrelated litigation. Consequently, depending on the jurisdiction and the facts of the claim, the courts have presented divergent views concerning mitigation of loss, from the court in *Empire State Bank* holding essentially that an insured has no duty to mitigate, to the court in *Premier* holding that the insured was under an affirmative duty to collect assets of the principal.

35. See also *Hartford Acc. & Indem. Ins. Co. v. Washington Nat’l Ins. Co.*, 680 F. Supp. 78 (N.D. Ill. 1986) (holding that tax deductions mistakenly taken by third parties did not result in a “direct loss” to the insured but to the federal government).

36. 448 F.2d 360 (8th Cir. 1971).

37. No. 80 C 6689, 1987 U.S. Dist. Lexis 5588 (N.D. Ill. June 22, 1987).

The *second issue* involves recoveries. Due to the existence of reserve accounts, losses involving credit card chargebacks implicate allocation issues because the accounts are established for the very reason of reducing the amount of chargeback losses. Whether this issue is truly a “recovery,” “mitigation” or a “calculation of net loss” issue is debatable.³⁸ Nonetheless, this issue gives rise to two problems: (1) what is a recovery; and (2) how should the recoveries be allocated.

With respect to the first problem, since salvage provisions in commercial fidelity and financial institution bonds refer to “recoveries” made after payment of the claim, some courts have held that an insured may allocate to uncovered losses recoveries obtained prior to settlement with the surety. In *First National Bank of Louisville v. Lustig*,³⁹ the insured suffered over \$20 million in losses due to fraudulent loans issued by a dishonest loan officer. Prior to settlement with the surety, the insured sold for \$10 million real property which collateralized the loans. The insured allocated the sale proceeds to unpaid interest, recovery of which was barred by the bond’s Potential Income Exclusion. In rejecting the surety’s argument that the recoveries must be allocated against the outstanding principal balance of the loan, the court of appeals noted that Section 7 of a 1986 edition financial institution bond contemplated assignment of recovery only “in the event of payment under this bond” and that the section also addressed recoveries applied to satisfy the insured’s loss in excess “of the amount paid” under the bond. Other courts have allocated recoveries made by the insured prior to settlement with the surety to reduce the insured’s covered loss.⁴⁰ The Tenth Circuit in *FDIC v. United Pacific Insurance Co.*,⁴¹ approved a calculation by the jury to reduce the amount of the insured’s loss by the amount the insured recovered in settlement from a third party. The court did not disturb, however, the jury’s decision that collateral which is still subject to litigation could not be applied by the surety to reduce the amount of the insured’s loss.

The second problem concerns allocation of recoveries between covered and uncovered losses. The court in *City Trust & Savings Bank v. Underwriting Members of Lloyds at London*,⁴² held that when the recovery can be

38. E.g., Mark E. Wilson, *The Legal Boundaries of “Loss” under Fidelity and Financial Institution Bonds: Towards a Coherent Theory of Set-off and Allocation of Losses and Recoveries* (unpublished paper presented to the National Bond Claims Association, Pinehurst, N.C. on October 3, 1996).

39. 96 F.3d 1554 (5th Cir. 1996).

40. E.g., *FDIC v. United Pac. Ins. Co.*, 20 F.3d 1070 (10th Cir. 1994); *First Am. State Bank v. Continental Ins. Co.*, 897 F.2d 319 (8th Cir. 1990).

41. 20 F.3d 1070 (10th Cir. 1994).

traced specifically to a covered loss, it should be credited to that covered loss. Other courts have held that when recoveries cannot be traced specifically to a covered loss, and the insured also suffers an uncovered loss, the recovery should be prorated between the covered and uncovered losses.⁴³

The *third issue* involves whether a surety may set off profits obtained by the insured from the dishonest activity. This problem arises when an insured suffers a covered loss, but the activity that led to the loss generated a profit as well. Until recently, two leading cases held that a surety cannot set off profits against losses resulting from the dishonest conduct.⁴⁴ Recently, however, one court has stated that:

the detriment to the [insured] can be measured only by employing the following calculus: the totality of expenditures minus the benefit the [insured] received therefrom. In other words, as a matter of *civil* law, no harm, no foul.⁴⁵

As a result, the latter case adheres to the principle that an insured must suffer an actual loss, and not a theoretical or bookkeeping loss.⁴⁶

This issue arose in the case study because Global contended that Dealman acted dishonestly by causing Global to enter into a contract with Florida to help Global obtain merchants for its credit card business. In addition to steering Home and USA to Global, Florida also obtained legitimate merchants whose business generated profits for Global. Global also earned fees from Home and USA in connection with each of the transactions involved in the chargeback claim.

Finally, other issues which arise in a credit card chargeback case, as well as any other fidelity claim, include other forms of indirect or consequential loss, such as fees and costs (other than in collecting recoveries) and loss of potential income.

42. 109 F.2d 110 (7th Cir. 1940).

43. *James B. Lansing Sound, Inc. v. Nat'l Un. Fire Ins. Co. of Pittsburgh, Pa.*, 801 F.2d 1560 (9th Cir. 1986); *Graydon-Murphy Oldsmobile v. Ohio Cas. Ins. Co.*, 93 Cal. Rptr. 684 (Cal. App. 1971).

44. *Nat'l Surety Corp. v. Rauscher, Pierce & Co.*, 369 F.2d 572 (5th Cir. 1966); *HS Equities, Inc. v. Hartford Acc. & Indem. Co.*, 609 F.2d 669 (2d Cir. 1979).

45. *Kinzer v. Fidelity & Dep. Co. of Md.*, 652 N.E.2d 20 (III. App. Ct. 1995) (emphasis in original).

46. *E.g.*, *Cincinnati Ins. Co. v. Star Fin. Bank*, 35 F.3d 1186 (7th Cir. 1994); *FDIC v. United Pac. Ins. Co.*, 20 F.3d 1070 (10th Cir. 1994); *Everhardt v. Drake Mg't., Inc.*, 627 F.2d 686 (5th Cir. 1980).

D. Summary

There is very little law concerning coverage for credit card losses in general, and chargeback losses in particular. Financial institution bonds include exclusions which exclude credit card fraud loss and chargeback losses when not involving employee dishonesty. Commercial fidelity bonds contain no such exclusions. Generally, credit card fraud losses will be covered when they involve employee dishonesty. Yet, adjustment issues may exist which can significantly reduce the amount of the insured's covered loss. A practical illustration of such adjustments is detailed in Section III.

III. CREDIT CARD CHARGEBACKS – A CASE STUDY

A. Preliminary Background

As noted above, the case study is based upon an actual claim investigated and adjusted by the authors. Only the names have been changed at the request of the surety. There are some terms of art in the bank credit card industry that should be defined so that this case study will make more sense. The VISA By-Laws and Operating Regulations dedicate a full chapter to definitions. The Definitions and Operating Regulations referred to herein are those of VISA USA. MasterCard's By-Laws and Operating Regulations, however, closely resemble those of VISA USA. Both sets of by-laws and operating regulations are contained in manuals which look like and read like a *Federal Master Tax Guide*.

1. Definition of Terms of Art in the Bank Card Industry.

Acquirer: A Member which (i) enters into a Merchant Agreement or (ii) disburses currency in a Cash Disbursement and directly or indirectly enters such Paper into the Interchange. (An acquirer is also referred to as the Merchant's Bank.)

Arbitration: A process which decides responsibility between Members for Paper entered into Interchange that is presented and charged back.

By-Laws & Operating Regulations: When a financial institution becomes a member of VISA, it agrees to comply with and be bound by the VISA By-Laws and Operating Regulations. (In large part, these by-laws and operating regulations became the basis for adjustment of the claim.)

Cardholder: One to whom a Card has been issued or one authorized to use such Card.

Chargeback: Paper returned through Interchange by an Issuer to a Member after a Presentment.

Clearing Member: A Member or its Nonmember Agent, approved by VISA USA, which enters Paper into, and receives Paper through, Interchange.

Compliance: A process in accordance with Chapter 2 (of VISA's Operating Regulations) which resolves a complaint between Members arising from a violation of the Operating Regulations when (i) the complaining Member can certify that a financial loss was or will be incurred for a specific amount and (ii) no right of Chargeback was available. (If an item is in "pre-compliance" the item has not yet been resolved).

Factoring: A Member may not accept for processing or entry into the Interchange, directly or indirectly, any Paper from any source other than a Merchant with whom it or another Member has a currently valid Merchant Agreement or Paper received from another Member. A Merchant having a currently valid Merchant Agreement which allows another merchant (not having a currently valid Merchant Agreement) to enter Paper into the Interchange under the valid Merchant's Agreement and account is engaging in a prohibited process which is referred to as "factoring."

Independent Sales Organization (ISO): An organization or individual, which is not a Member, whose bank card related business relationship with a Member is (i) Merchant solicitation, sales or service and/or (ii) Cardholder solicitation.

Interchange: The exchange of Paper Transactions between Clearing Members in accordance with the Operating Regulations.

Issuer: A Member which enters into direct contractual relationships with Cardholders for the issuance of Cards. (In other words, the Bank that issues the credit card.)

Member: VISA defines a Member (of VISA USA) to be an organization which is a Member of VISA USA as described in Article II of its By-Laws. (For all practical purposes, to be eligible to become a Visa Member, the organization must be a financial institution eligible for federal deposit or share insurance or be a bank holding company.)

Operating Regulations: See "By-Laws & Operating Regulations."

Paper: May be either Original Paper (i.e., hard copy) or Electronic Data. Original Paper may be a Sales Draft, Transaction Record, Order Form, Credit Voucher, Cash Disbursement Draft, electronic record or other obligation arising from the use of a Card, and bearing either the imprint or other reproduction of embossed or encoded information contained on such Card. Electronic Data is data describing Original Paper, transmitted through VISANet. (For purposes of this study, "Paper" is the data entered into the Interchange to effect the processing of the telemarketing sale paid for with a credit card.)

Presentment: Paper presented initially (or after Chargeback) by a Member to an Issuer through the Interchange.

Representment: As used in this case study, Paper presented after Chargeback by a Member to an Issuer through the Interchange (as distinguished from the original presentment).

Telemarketing Merchant: VISA defines a Merchant as any person, firm or corporation which has contracted with a Member (of VISA) to originate Paper through acceptance of Cards and displays the VISA decal). (A Telemarketer, in the context of our case study, is a merchant which markets goods or/or services using the telephone, with any resulting sales being paid for over the phone by use of a credit card. Telemarketers can sell almost anything over the phone that one could buy in person. In the case study, the telemarketers sold home water purification devices and “factored” various products for other merchants not having current valid merchant agreements.)

“Working” a Chargeback: This is not a VISA or MasterCard term of art. It developed during the interview stage of the investigation. When one receives a chargeback, someone has to “work it,” meaning that someone must make sure it was, among other things: timely; had the correct reason code; the required documentation, if any, was provided either by or for the cardholder; the cardholder in fact returned the item which it alleged was “not as described”; and that those chargebacks which were deficient in any respect (in accordance with the Operating Regulations) were reversed and sent back to the Issuing Bank with an explanation of why the chargeback was being rejected by the Merchant and/or Merchant Bank.

2. *The How’s, When’s and Why’s of Chargebacks and Precompliances.*

Let us assume that a cardholder opens her monthly VISA charge card statement which she received from her bank. She sees that she has been charged twice for an item which she ordered out of an airline catalog she was reading the last time she was on an airplane.

Assume this duplicate charge was an error and did not result from fraudulent conduct on anyone’s part. What does she do? She has a choice. She can call or write to the vendor and request that it issue a credit for the second erroneous charge. However, she does not have the catalog anymore and has no idea who to call. Her second choice is to write to the bank that issued the card and ask it to process a chargeback. She can pay one of the charges, but not the disputed charge. If she paid the disputed charge, she could lose her right of chargeback. The request for a chargeback must be in writing, it must identify the reason she is requesting the chargeback and it must be done timely. The answer as to “when” is, the sooner the better, because there are deadlines (established in days) for the processing of each type of chargeback. Some chargebacks require further documentation, but many require nothing more than an initial letter.

3. What Happens after a Chargeback Is Initialed; Who Gets Left Holding the Bag on Chargebacks?

In the example above, the duplicate charge was reversed and it was removed from the statement and never reappeared, because it was merely the correction of an administrative error. Basically, the original charge was reversed in the system. In this example, no one lost any money. The cardholder bought, received and paid for one item and the vendor sold, delivered and was paid for one item. The second charge which appeared on the statement (in error) was removed and the second deposit to the telemarketer's bank account was also taken out of its account by the merchant bank.

What happens, however, when the duplicate charge was not an error, but rather was with the intent on the part of the catalog vendor to collect twice for one sale? Assume that after the cardholder purchased the item, the catalog vendor skipped town. Who ends up losing the money? The same steps described above should be followed to initiate a chargeback. The bank that issued the card would reverse the duplicate charge from the statement and through the system, the merchant bank would go to the merchant's bank account and remove the cash (by debiting the account) which was deposited in it in error. The problem now, however, is that the merchant took all of the cash out of its account, leaving nothing in the account to repay the previous duplicate deposit. As long as the cardholder initiated the chargeback timely and did not pay the second charge, she is not at risk, but the merchant bank is at risk if it is not holding enough reserves from the merchant to cover chargebacks.

Typically, in the agreement which the merchant bank entered into with the merchant, known as the merchant agreement, the merchant agreed to set aside a percentage of credit sales to cover the risk of future chargebacks. Amounts set aside for this purpose are deposited into interest bearing reserve accounts called merchant reserve accounts. The percentages of sales and dollar limits set on these reserve accounts are typically negotiated at the time the merchant agreement is entered into. The terms and conditions governing what goes into and what comes out of merchant reserve accounts, and when, are often covered by a separate reserve account agreement. In addition, the ISO which brought the merchants to the merchant bank will typically also be required to set aside a percentage of its fees in an ISO reserve account, the terms of which are negotiated up front. The ISO reserve account usually applies to all merchants brought to the merchant bank by the ISO.

So in the example of a fraudulent duplicate charge by a mail order merchant who has skipped town after the date of the original sales transactions, the merchant bank will remove the monies needed to cover the refund of the duplicate charge first from the merchant's reserve account and if needed

from the ISO's reserve account. If there are not sufficient funds remaining in the merchant's reserve account or in the ISO's reserve account, the merchant bank gets caught holding the bag on the chargeback. Undoubtedly, if the merchant double-charged one account before skipping town, it double-charged hundreds or even thousands of other cardholders as well. This example, by the way, is close to the factual situation in the case study. The merchants were telemarketers (as opposed to mail order merchants) and there were many different reasons for their chargebacks, some being outright fraudulent and others resulting from purely administrative reasons.

4. Who Can Initiate a Chargeback or Precompliance and for What Reasons?

The cardholder can initiate a chargeback for any item appearing on the cardholder's statement which falls within any one or more of the reason codes described in Tables 4.1 and Table 4.2, which is a list of the 44 VISA reason codes and the corresponding time requirements for initiating a chargeback. The clock starts ticking on the "central processing date" of the disputed sales transaction. The list is rather consumer oriented. The chargeback reason code selected must be truthful, must be timely and, as discussed earlier, must be submitted in writing to the bank that issued the subject credit card. Compliance items (or precompliance items, as they are also referred to), as the definitions indicate, involve a process by which members (not cardholders) resolve complaints or disputes arising from a violation of the Operating Regulations when (i) the complaining member can certify that a financial loss was or will be incurred for a specific amount and (ii) no right of chargeback was available.

5. What Happens after the Chargeback and/or Compliance Item Has Been Initiated?

Initially, the correspondence submitted by the cardholder will be forwarded to the merchant bank and in turn to the merchant for research and response. If the merchant agrees with the cardholder's chargeback, then the original sales transaction remains reversed. However, if the merchant bank determines that the chargeback was not timely, or was not properly documented, or that the reason code selected does not apply to the factual situation, or if the merchant can provide some factual basis to suggest that the chargeback was without merit, the chargeback can be represented to the issuer by the merchant bank. The "representation" in effect, reverses the initial chargeback through the Interchange, putting the money back into the merchant's account and again charging the cardholder's account. The cardholder receives any additional documentation which the merchant may have provided to support the representation.

The cardholder can initiate another chargeback using the same reason code or a different reason code and can submit any additional documentation in support of its new chargeback. If a second chargeback is initiated,

the chargeback procedure described earlier takes place again. The merchant and the merchant's bank's remedies described above remain available to the extent the factual situation proves it to be meritorious. This back and forth process could potentially continue until one member requests arbitration. The request for arbitration should be filed only after other remedies provided by VISA's Operating Regulations have been utilized. The request for arbitration must also be timely and be accompanied by a \$150 arbitration fee. The fee is refunded to the complaining member (and charged to the other member) if the complaining member prevails. If the complaining member loses, the \$150 fee is retained. The decision of the VISA USA Arbitration Committee is final for all arbitration and compliance cases involving amounts less than \$5,000. Cases in excess of \$5,000 can be appealed, but only if new information is developed which may have likely effected the outcome of the original arbitration. In summary, the VISA USA Arbitration Committee decides where the ultimate liability for the chargeback or compliance item shall rest.

B. The Factual Situation

1. The Parties Involved in the Case Study.

The Insured: Global Bank (hereinafter "Global") was a regional bank located in the south, was a member of VISA and MasterCard, and acted as a merchant bank. Before hiring the principal, its merchants were few in number and limited to local merchants in the city in which the bank was located. None of its existing merchants were telemarketers.

The Principal: Delbert Dealman approached Global with a proposal to expand the merchant banking department to include telemarketers, most of which were located out of state. He represented to the insured that he was experienced and knowledgeable in this area. He told the insured that with his own contacts in the business and the assistance of an ISO with whom he had worked with over the years, he could bring in sizable telemarketing volume which, in turn, would bring in sizable merchant banking fees. The principal was hired to run the bank's merchant banking department. Dealman was terminated by Global several months after Global processed paper for USA and Home.

The ISO: Florida Marketing Organization (hereinafter "Florida") operated out of another southern state and actively solicited merchants on behalf of merchant banks. Florida had in fact previously worked with Dealman to bring telemarketing merchants to other merchant banks.

The Telemarketing Merchants: Florida brought approximately twenty telemarketing merchants to Global, but the two largest merchants accounted for more than 75 percent of the sales volume of all twenty merchants. The

first, Home Water Purifiers (hereinafter “Home”), sold water purification devices for home use. The units are typically attached to the kitchen faucet and purportedly filter out impurities which are contained in water. Home sold the units for \$250, but they could be purchased in local convenience stores for \$49. The second, USA Sales (hereinafter “USA”), sold a variety of products, many of which were “factored” sales of other merchants which did not have currently valid merchant agreements with a member (a violation of VISA’s Operating Regulations).

Merchant Reserve Accounts: USA and Home executed Merchant Reserve Agreements with Global which called for a percentage of net sales to be deposited into separate reserve accounts to cover the risk of future chargebacks for the respective merchants.

ISO Reserve Account: Florida executed a reserve agreement which called for depositing twenty-five percent of the fees it earned on sales made by any merchants it brought to Global.

The Merchant Underwriting Process: Under the terms of Florida’s contract with Global, Florida was responsible for performing an underwriting investigation of the merchants to include: a review of financial statements; interviews of the principals of the merchant; a physical inspection of the merchant’s plant; a review of the telemarketing script, and a check of the merchant’s history of chargebacks. The VISA Operating Regulations require the merchant bank to perform an investigation of the merchant, in order to:

1. Ascertain that the merchant is financially responsible and will abide by the rules and regulations of the VISA Card Program;
2. Conduct an inspection of the merchant’s business;
3. Check with VISA to make sure the merchant was not previously terminated for cause;
4. Make sure no significant derogatory information existed with respect to the merchant.

2. *The Claim – Proof of Loss.*

Global alleged that as a direct result of the dishonest conduct of Dealman, Global sustained chargeback losses which had not been offset by charges to reserve accounts, in the following amounts:

USA Sales	\$ 2,290,101
Home Water Purifiers	1,498,275
Total Amount Claimed	<u>\$ 3,788,376</u>

3. *Allegations of Dishonesty.*

Global alleged that Dealman's conduct was dishonest for the following reasons:

- a. While employed at Global, Dealman received kickbacks from Florida approximating \$200,000 which Dealman concealed from Global (which the insured was able to document);
- b. Dealman knew, but failed to disclose to Global, that Home was terminated as a merchant while with a prior merchant bank for excessive chargebacks;
- c. Dealman knew, but failed to disclose to Global, that USA "factored" sales for other merchants who did not have currently valid merchant agreements with any member banks;
- d. Dealman intentionally misrepresented to Global the true volumes of chargebacks that USA and Home were experiencing with Global;
- e. Dealman knew, but failed to disclose to Global, that both USA and Home engaged in deceptive telemarketing practices and were being investigated by the Federal Trade Commission;
- f. Dealman knew, but failed to disclose to Global, that USA was selling volumes of product that it did not have in inventory and did not have sufficient amounts of cash to purchase;
- g. Dealman failed to promptly and adequately administer the "working of chargebacks" on Global's behalf;
- h. Dealman failed to adequately monitor the activities of USA and Home after Global commenced processing their Paper;
- i. Dealman failed to properly and adequately perform an underwriting of USA and Home before Global entered into merchant agreements with USA and Home;
- j. Dealman knew, but failed to disclose to Global, that the water purifiers sold by Home for \$249 could be purchased at most convenience stores for \$49, which inherently would cause a large volume of chargebacks;

- k. Dealman knew, but failed to disclose to Global, that USA and Home stopped issuing credits to cardholders who had requested credits for returned merchandise; and
- l. Dealman knew, but failed to disclose to Global, that USA and Home did little, if anything to respond to correspondence from cardholders written to describe the reason for the chargebacks.

C. The Scope of the Investigation and Findings

The scope of the investigation and findings were as follows:

1. *Interview of Delbert Dealman.*

Dealman was interviewed. He admitted to receiving approximately \$200,000 from Florida, but he contended that the money actually represented monies due from Florida for merchants which Florida and Dealman brought to other Merchant Banks prior to his employment with Global. He admitted knowing that Home was previously terminated by a former merchant bank for excessive chargebacks. Dealman's position was that it was Florida's obligation to perform the underwriting process on the merchants it brought to Global. Dealman denied that he intentionally misrepresented USA and Home's true chargeback volume. His position was that it was Florida's obligation to administer the chargebacks and monitor the merchants on behalf of Global. With respect to much of the other information which Global alleged he knew, but failed to bring to Global's attention, Dealman contended that he did not learn that information until at or about the same time that Global learned that information. Finally, Dealman indicated that taken as a whole, he made money for Global on the entire merchant banking operation, considering the fee income the telemarketers generated for Global and the reserves which Global collected from the merchants and Florida.

2. *Review of the Dealman's Bank Records.*

It was confirmed that Dealman received approximately \$200,000 from Florida and that the monies were received by Dealman (via a company he owned) *during Dealman's employment at Global*. It could not be proven definitively that the monies paid by Florida to Dealman represented a percentage of sales by USA and Home and the other merchants which Florida brought to Global.

3. *Interviews of Employees and Officers of Global.*

All bank officers and employees with relevant knowledge were interviewed. In summary, it appeared that initially Global relied heavily upon Dealman and Florida because Global had very little prior experience in merchant banking and no prior experience in merchant banking for

telemarketers. Within a few months after Global began processing USA and Home's Paper, however, an internal compliance officer at Global began reviewing chargeback reports received from the outside service bureau which Global retained to process the transactions. The Global compliance officer began writing memos to other key bank officers about his concerns regarding the chargeback ratios and the "unscrupulous" telemarketers with which Global had contracted. His memos soon suggested on-site inspections by bank officers other than Dealman. Immediately after the on-site inspections, his memos questioned why Global was continuing to do business with USA and Global at all in light of the increasing chargeback volumes and in light of the poor financial position of the merchants and the deceptive telemarketing practices in which USA and Home had been engaging. It appeared that within three to four months after processing for USA and Home, Global realized it had a major problem on its hands. Global's officers met on a regular basis thereafter to determine how to get out of the telemarketing merchant banking business without losing a large sum of money in chargebacks. Global decided to take a more active role in monitoring USA and Home by trying to encourage them to eliminate deceptive telemarketing practices and improve on timely delivery of product so as to reduce future chargeback volumes while at the same time increasing merchant reserve account balances. It appeared that Global thought that by doing this, the merchant reserve accounts on new sales volume would exceed new chargeback volume and thereby reduce Global's exposure. Unfortunately, chargeback volume did not decrease, it increased. Further, USA and Home were not "working" the chargebacks and Global apparently did not realize in time that it should have "worked" the chargebacks to minimize and mitigate its losses. By the time Global figured this out, the chargeback volume was so high that there was no alternative but to terminate the merchants. In the end, Global allegedly sustained a loss of \$3.8 million from chargebacks on USA and Home, which it attributed to the dishonest conduct of Dealman.

4. Meeting with the Local Assistant U.S. Attorney.

The local Assistant U.S. Attorney said that after he finished with a rash of local political indictments, he fully intended on seeking indictments of Dealman, the principals of Florida and the principals of USA and Home. He further stated that he was already working with prosecutors, postal inspectors and the Federal Trade Commission in other states to pursue his indictments and prosecutions in this case. He subsequently did indict the key players, including Dealman, but not until years after the claim was settled.

At this point in the investigation, it appeared that not only did coverage exist, but it also looked like the entire claim could be afforded coverage. However, since the claim amounted to \$3.8 million dollars, the surety agreed that it was necessary to determine that the insured, in fact, had sustained a

loss in the full amount of \$3.8 million and that the entire loss resulted directly from the dishonest conduct of Dealman.

5. Review of the VISA MasterCard Operating Regulations with Respect to Chargebacks and Precompliances.

As mentioned earlier, during the interview process, bank employees repeatedly stressed the importance of “working the chargebacks.” A review of the VISA and MasterCard Operating Regulations indicated that a merchant (by way of the merchant agreement) and the merchant bank (by agreeing to the VISA By-Laws) agreed to comply with the VISA or MasterCard Operating Regulations, including the Operating Regulations addressing how chargebacks are to be processed. These Operating Regulations gave Global the right to reject chargebacks if they did not meet the criteria set forth in the Operating Regulations. From the interview process, it was discovered that Global did little or nothing to “work the chargebacks” itself. It appeared that had Global “worked the chargebacks,” Global could have substantially mitigated its losses. However, at this point, the factual basis for making such a conclusion was not established, and it was not yet known by how much Global could have mitigated its losses had it “worked the chargebacks” by enforcing its rights provided by the Operating Regulations.

6. Review and Analysis of All Chargebacks and Precompliance Items Claimed as Losses.

The surety agreed that it was necessary to perform a detailed review and analysis of all chargebacks and precompliances claimed as losses for two reasons. First, it wanted assurance that Global in fact lost \$3.8 million on chargebacks and precompliance items on USA and Home. Second, it sought to quantify the dollar amount by which Global could have, and possibly should have, mitigated its losses by “working the chargebacks” in accordance with rights provided to Global by the VISA Operating Regulations. The process turned out to be more difficult than first assumed. Global’s outside service bureau, which entered all sales, chargebacks and representments on USA and Home, disclosed that the data was no longer maintained on computer nor stored in a computer readable format. It became necessary to hire a service bureau in Chicago to keypunch 18,500 chargeback and precompliance transactions included in the claim. After all claimed chargeback and precompliance items were keyed, reviewed and analyzed, it appeared that Global could have rejected a significant number of the claimed chargebacks for one of various reasons and could have substantially mitigated its losses.

7. Retention of and Meeting with a Credit Card Expert.

Due to the significant number of potential adjustments to the claim, an expert was retained to assist in interpreting and applying the operating regu-

lations. In summary, the expert agreed that had Global “worked the chargebacks” in accordance with right provided to it by the Operating Regulations, Global could have significantly reduced its losses.

8. Review and Analysis of the Merchant Reserve Accounts and the ISO ‘s Reserve Accounts.

In addition, a review and analysis was performed regarding USA and Home’s merchant reserve accounts and Florida’s general reserve account, as well as other reserve accounts for merchants which Florida brought to Global. The terms and conditions of the agreements governing these reserve accounts were also analyzed. It soon became apparent that Global had not credited the claim for the reserve account balances remaining on deposit. Amounts previously debited by Global to cover other chargebacks which were not included in the claim were also analyzed. It appeared, however, that if Global could have avoided many of the chargebacks which it claimed as losses, it could also have avoided many of the chargebacks for which it had already reimbursed itself from several of the merchant’s reserve accounts.

9. Calculation of the Amount of Loss Which the Insured Would Have Sustained Had the Insured Terminated the Merchants at the Point in Time at Which Global Realized the Merchants Were Engaging in Deceptive Telemarketing Practices and That a Major Problem with Chargebacks and Precompliance Items Existed.

As previously mentioned, the compliance officer discovered after three to four months of processing for the merchants that USA and Home were engaging in deceptive telemarketing practices and that a major problem existed with chargebacks. It appeared that an argument could be made that the insured should have terminated the merchants after Global’s compliance officer learned about these practices. Global’s projected loss had Global terminated the merchants after three to four months was then quantified. Surprisingly, the projection demonstrated that Global would have sustained losses well in excess of the penal sum of the bond even if Global had terminated the merchants after the first three to four months of processing their paper. This was because the merchants had very large volumes of sales in the first three to four months and had very high chargeback ratios on those sales, while at the same time reserve accounts did not have much time to accumulate significant balances.

10. Results of the Detailed Review and Analysis of the Chargebacks and Precompliances Claimed as Losses and All Activity Running through the Merchant Reserve Accounts and the ISO’s Reserve Accounts.

To summarize the findings, a schedule titled “ADJUST” was prepared. The schedule may be found at the end of this article in Tables A, B, and C.

The following discussion addresses the schedule, line item by line item, and at this juncture the reader should review the schedule in order to better understand the discussion. A copy of the schedule was given to Global at the first settlement meeting to explain the basis for the adjustments to the claim and to serve as the basis for the initial settlement offer of \$272,892.

LINE 1. Chargebacks claimed as losses:

USA Sales	\$ 2,290,101
Home Water Purifiers	1,498,275
Total Amount Claimed	<u>\$ 3,788,376</u>

Global claimed that it sustained losses on approximately 18,500 chargebacks and precompliance items totaling approximately \$3.8 million. However, an analysis of the total activity of these two merchants indicated: (1) total sales of \$21,300,000; (2) credits voluntarily issued by the merchants plus total chargebacks of \$11,300,000. This means that approximately 53 percent of the total sales made by USA and Home resulted in credits being issued by them or resulted in chargebacks and/or precompliances.

LINE 2. Adjustments—Before Allocation of Available Reserve Account Balances:

Items 2A through 2N below address the adjustments made to the claim and the basis for each. With few exceptions, the basis for the adjustments was not because Global was negligent (although Global was apparently negligent in not “working the chargebacks”), but was rather on the basis that Global did not properly mitigate its losses, as required by the bond. As explained in Section II, the law governing these types of adjustments varies.

LINE 2A. Chargeback Fees Included in the Amounts Claimed:

Global included in the claim chargeback fees assessed by VISA and MasterCard in the amounts of \$26,120 for USA and \$10,075 for Home, for a total of \$36,250. Adjustments for these fees were on the basis that they were indirect and/or consequential losses expressly excluded by the bond.

LINE 2B. Chargebacks Honored by Global beyond Time Frames Allowed per Visa and Mastercard Regulations:

Global included in the claim chargebacks in the amounts of \$342,469 for USA and \$277,651 for Home, for a total of \$620,120, for which the

chargebacks were presented beyond the time frames allowed for the respective reason codes for those chargebacks per the VISA and MasterCard Operating Regulations.

LINE 2C. 50 Percent of Chargebacks Resulting from “Non Receipt of Requested Item” Reason Code:

Global included in the claim chargebacks in the amounts of \$47,334 for USA and \$23,084 for Home, or a total of \$70,418, on which the chargeback reason code was “Nonreceipt of Requested Item.” This means that \$70,418 in chargebacks were presented because the cardholder requested the merchant to provide a document or other piece of information, usually to identify what was being billed for, who in the household ordered the item, or related information. This happens often when the cardholder does not recognize the name of the merchant appearing on the monthly statement and cannot relate the merchant to the product purchased. This happened more often for USA than Home, because USA was factoring sales for other merchants and the cardholder would not necessarily have ever heard the name “USA” during the telephone sales conversation. An article appearing in *Credit Card Management* (an authoritative trade magazine) indicated that a large portion of chargebacks could be avoided if the merchants and merchant banks would respond to requests for documentation from the cardholders and do so on a timely basis. Based upon this article, 50 percent of these chargebacks (or \$23,667 for USA and \$11,542 for Home, for a total of \$35,209 in total) were adjusted under the assumption that had Global required the merchants to respond to requests for documentation from the cardholders on a timely basis, at least 50 percent of these chargebacks could have been avoided.

LINE 2D. Chargebacks on Which Chargeback Reports Were Missing:

Global included in the claim chargebacks in the amounts of \$102,539 for USA and \$13,588 for Home, for a total of \$116,127, on which Global had no documentation in support of these claimed losses. These chargebacks were adjusted on the basis that it is the insured’s burden to prove *all* of its losses, not just a portion of its losses, and because the results of the detailed review and analysis of that portion of the claim which was supported by documentation demonstrated that had the insured been able to provide the necessary documentation in support of these chargebacks, there was a strong likelihood a large percentage of these chargebacks would have been adjusted for reasons described above or below.

LINE 2E. Chargebacks on Transactions Exceeding Floor Limits:

Global included in the claim chargebacks in the amounts of \$1,692 for USA and \$10,845 for Home, or a total of \$12,537, on which the chargeback reason code was “transactions exceeded the floor limit” and on which the merchant did not get preapproval from VISA or MasterCard for the sale.

These items were adjusted because Global had established a “zero floor limit” for these telemarketers, meaning that *all* transactions had to be approved by VISA or MasterCard before the merchant presented the paper in the first instance. These transactions were not pre-approved by VISA–MasterCard and yet Global funded the nonapproved sales anyway. These chargebacks were adjusted on the basis that Global should not have funded these nonapproved sales in the first instance. Had Global funded only preapproved sales, this chargeback right would not have been available to the cardholders.

LINE 2F. Precompliance Items for Which No Documentation Was Provided:

This is the same type of adjustment as discussed in 2D above, except for two differences. First, this adjustment relates to precompliance items as opposed to chargebacks. Second, the amount of detail provided by Global on precompliance losses exceeded the amount of precompliance items claimed by \$772 for USA and by \$4,450 for Home, for a total of \$5,222. Therefore, to be consistent, the claim was adjusted *upward* for the excess of the precompliance items supported by documentation provided by Global over total precompliance items claimed as losses.

LINE 2G. Chargebacks in Excess of \$700 Each Allowed by Global:

Global included in the claim chargebacks in the amounts of \$1,096 for USA and \$7,493 for Home, for a total of \$8,589, on which the transactions exceeded \$700 each. Global knew that no product sold by USA or Home exceeded \$700. Of the other more than 18,500 chargebacks and precompliance items claimed, none exceeded \$700 each. Knowing this, Global still allowed chargebacks on individual sales transactions that exceeded \$700.

LINE 2H. Chargebacks Having Transaction Dates after USA and Home Were Terminated:

Global included in the claim chargebacks in the amounts of \$13,660 for USA and \$11,432 for Home, for a total of \$25,092, on which the transaction dates of the original sales were after USA & Home were terminated as Merchants by Global. This means that Global allowed these sales to be funded after it terminated USA & Home.

LINE 2J. Duplicate Chargebacks:⁴⁷

Global included in the claim chargebacks in the amounts of \$34,350 for USA and \$21,662 for Home, or a total of \$56,012, which were allowed as chargebacks twice by Global. It is not uncommon for a chargeback to be

47. Omission of “T” was intended to avoid confusion with other numbers and letters.

presented a second (or third) time in situations where the merchant and/or merchant bank rejected the first presentment for cause. However, when a chargeback is initiated a second time, VISA or MasterCard give that chargeback a identification number that is different than that assigned to the first chargeback. The duplicate chargebacks that we adjusted for were identical to each other, clearly meaning that Global allowed the same chargeback to be presented twice, which in effect doubled portions of its loss.

LINE 2K. Duplicate Precompliance Items:

Global included in the claim precompliance items in the amounts of \$14,756 for USA and \$14,457 for Home, for a total of \$29,213, which were allowed as precompliance items twice by Global. This is the same type of adjustment as 2J above, except that they were precompliance items as opposed to chargebacks.

LINE 2L. Duplicate Chargeback/Precompliance Items:

Global included in the claim chargebacks and precompliance items in the amounts of \$42,671 for USA and \$30,031 for Home, for a total of \$72,702, which were allowed first as a chargeback and second as a precompliance item by Global. This is the same type of adjustment as 2J and 2K above, except that in the first instance, the item was allowed as a chargeback and in the second instance the item was allowed as a precompliance item, which in effect doubled portions of its loss.

LINE 2M. Precompliance Items Paid beyond 212 Days after Transaction Date:

Global included in the claim precompliance items in the amounts of \$168,934 for USA and \$43,883 for Home, or a total of \$212,817, which were allowed more than 212 days after the date of the original sales transaction. This is beyond the time frame specified in the VISA or MasterCard Operating Regulations.

LINE 2N. Precompliance Items Having Transaction Dates after the Merchant's Termination Date:

Global included in the claim precompliance items in the amounts of \$11,126 for USA and \$9,199 for Home, or a total of \$20,325, on which the transaction dates of the original sales were after USA & Home were terminated as merchants by Global. This means that Global allowed the funding of these sales after it terminated USA & Home.

LINE 2 TOTAL ADJUSTMENTS – BEFORE ALLOCATION OF RESERVE ACCOUNTS:

The adjustments discussed above in items 2A through 2N totaled \$782,362 for USA and \$457,408 for Home, for a total amount of \$1,239,770.

LINE 1 LESS 2 = ADJUSTED CLAIM – BEFORE ALLOCATION OF AVAILABLE RESERVE ACCOUNT BALANCES:

The total amounts claimed as losses less the total adjustments in items 2A through 2N above are as recapped below. Also presented below are total adjustments 2A through 2N stated as a percentage of the amounts claimed, which will be used later in the analysis of and allocation of the reserve accounts:

<u>Description</u>	<u>USA Sales Corporation</u>	<u>Home Water Purifiers</u>	<u>Totals</u>
Total Amounts Claimed	\$ 2,290,101	\$ 1,498,275	\$ 3,788,376
Less Total Adjustments Items 2A through 2N	782,362	457,408	1,239,770
	<hr/>	<hr/>	<hr/>
Adjusted Claim Before Allocation of Reserve Account Balances (Item 1 Less Item 2)	\$ 1,507,739	\$ 1,040,867	\$ 2,548,606
	<hr/>	<hr/>	<hr/>
Total Adjustments Before the Allocation of Reserve Account Balances- Stated as a Percentage of the Amounts Claimed	34.16%	30.53%	32.73%

LINE 3. Analysis of Existing Reserve Account Balances:

In addition to the above adjustments, further adjustments were made to account for amounts which still remained in several reserve accounts on deposit at Global. Even though the accounts were established for the purpose of protecting Global against the risk of chargebacks, Global had not voluntarily credited the claim for amounts remaining in these reserve accounts. There were four categories of reserve accounts which were established to cover chargebacks on merchants which Florida Marketing brought to Global. The first category consisted of reserve accounts to cover chargebacks which were established in the name of USA and Home. The second category was reserve accounts to cover chargebacks which were established in the name of other merchants which Florida brought to Global, but on which merchants Global did not sustain nor claim losses. The third was a reserve account established to purchase product for USA which was set up as a result of USA's cash flow problems. The fourth and final reserve account was Florida's own reserve account to cover chargebacks on any merchants

which Florida brought to Global. In items 3A through 3E, the claim was adjusted for each of these existing reserve account balances for reasons described below.

LINE 3A. Existing General Reserve Account Balance Collected from USA and Home:

Global had on deposit in demand deposit accounts in its bank reserve accounts in the amount of \$555,575 for USA and \$132,742 for Home, or a total of \$688,317. The purpose of the reserve accounts was to cover future chargebacks for these merchants. Global had not voluntarily credited the claim for amounts remaining in these reserve accounts.

LINE 3B. Existing General Reserve Account Balances Collected from Other Merchants Brought by Florida to Global:

Global had on deposit in demand deposit accounts in its bank reserve accounts totaling \$394,443 which were collected from other merchants brought to Global by Florida on which Global had not sustained nor claimed losses. The purpose of these reserve accounts was to cover future chargebacks not only on these other merchants, but also for chargebacks received in connection with any other of the merchants which Florida brought to Global. Global was astute in requiring all telemarketing merchants to agree to this condition. These reserve accounts were allocated on a pro rata basis to USA and Home's adjusted claim (i.e., Losses Claimed less Adjustments discussed in items 2A through 2N). Of the \$394,443 existing in other merchants' reserve accounts, \$233,350 was allocated to USA and \$161,093 was allocated to Home.

LINE 3C. Total Existing General Reserve Account Balance Collected from All Other Merchants Brought by Florida to Global:

This is simply the total of line items 3A and 3B. The resulting totals are \$788,925 for USA and \$293,835 for Home.

LINE 3D. Florida's Existing Reserve Account Balance:

As mentioned earlier, Florida was required to have a reserve account to cover future chargebacks on any of the merchants which Florida brought to Global. The amount remaining in Florida's reserve account at the time USA and Home were terminated was \$379,927. This reserve account was also allocated between USA and Home on a pro rata basis as to USA and Home's adjusted claim (i.e., Losses Claimed less Adjustments discussed in items 2A through 2N). Of the \$379,927 on deposit in Florida's reserve account, \$224,762 was allocated to USA and \$155,165 was allocated to Home.

LINE 3E. Product Reserves Collected from USA Less Documented Product Purchases:

As mentioned earlier, Global required that a product reserve account be established by USA to insure that USA would have the cash necessary to purchase the product that it was selling. The amount remaining in that reserve account at the time the USA and Home were terminated was \$134,354. This amount was used as an adjustment to the claim on USA's chargebacks because under the terms of the merchant agreement USA agreed to indemnify Global against all chargeback losses.

LINE 3. Full Amount of Existing Reserve Account Balances Plus USA's Product Reserve Account:

This is simply the total of all existing reserve account balances on deposit at Global at the time it terminated USA and Home as merchants as discussed above in items 3A through 3E. In total, the claim was adjusted for existing reserves of \$1,148,042 for USA and \$449,000 for Home.

LINE 4. Amounts Added Back to Home's Reserve Account for Inappropriate Charges to Home's Reserve Account:

In addition to the existing reserve account balances adjusted in items 3A through 3E above, the claim was also adjusted for excessive amounts which Global had previously withdrawn from Home's reserve accounts to cover other chargebacks which were not included in the claim (because Global did not sustain losses on same as a result of withdrawing monies to cover same from Home's reserve account). Based upon the analysis of the chargebacks claimed as losses, it was determined that Global allowed many more chargebacks than it should have, which in turn reduced the amount of reserves which should have been available to cover items which were included in the claim. When Global previously withdrew amounts from Home's reserve account it did so to cover *all* of Home's chargebacks at the time and not just chargebacks which it was required to permit per the VISA and MasterCard Operating Regulations. As an adjustment, 30.53 percent of the amounts previously withdrawn by Global from Home's reserve account, were added back, because the analysis of Home's chargebacks revealed that Global should *not* have allowed 30.53 percent of the chargebacks claimed as losses on Home. It was the surety's position that the previous charges by Global to Home's reserve account was 30.53 percent too large because Global allowed prior excessive chargebacks (not included in the claim on Home) that it should not have allowed. USA's reserve account was not similarly adjusted because there were no prior withdrawals from USA's reserve account.

LINE 5. Amounts Added Back to All Other Merchants' Reserve Accounts for Inappropriate Charges to Those Reserve Accounts:

As with item 4 above, it was the surety's position that if Global allowed excessive chargebacks on USA and Home, Global also allowed excessive chargebacks on the other merchants that Florida brought to Global. It was estimated that excess chargeback to be 32.73 percent, which was the same as the excess chargeback rate allowed on USA and Home collectively. Applying this excess chargeback factor of 32.73 percent to prior withdrawals from the other merchants' reserve accounts resulted in an excess charge to the other merchants' reserve accounts (which Florida brought to Global) of \$512,091. As mentioned earlier, Global required that all merchants which Florida brought to Global agree that their reserve accounts could be used to cover chargebacks from any one or more merchants in that group. The \$512,091 was allocated to USA and Home on a pro rata basis as to their adjusted losses before allocation of reserve accounts. The resulting adjustments were \$302,950 for USA and \$209,141 for Home.

A recap of the items discussed in items 1 through 5, and application of the bond deductible, is as follows:

<u>Line Item</u>	<u>Description</u>	<u>USA Sales</u>	<u>Home Water Purifiers</u>	<u>Totals</u>
1.	Losses Claimed	2,290,101	1,498,275	3,788,376
2.	Less total adjustments excluding reserves	782,362	457,408	1,239,770
	Adjusted claim before reserve accounts (line 1 less line 2)	1,507,739	1,040,867	2,548,606
3.	Less full amount of existing reserve account balances plus USA's product reserve	1,148,042	449,000	1,597,041
	Adjusted claim less full amount of existing reserve accounts & USA's product reserve (line 1 less line 2 + 3)	359,698	591,867	951,565
4.	Less total estimated inappropriate charges to Home's reserve account		116,581	116,581
5.	Less total estimated inappropriate charges to other merchants reserve account	302,950	209,141	512,091
6.	Adjusted claim - after all reserve accounts	<u>56,748</u>	<u>266,145</u>	<u>322,892</u>
7.	Less bond deductible			<u>50,000</u>
8.	Adjusted claim - after all reserve accounts and after bond deductible			<u>\$ 272,892</u>

Note that the adjusted claim after all reserve accounts (but before application of the bond deductible) of \$322,892 (line item number 6 above) consists of an adjusted *loss* of \$56,748 for USA and an adjusted *loss* of \$266,145 for Home. Had either net adjusted amount resulted in a positive number (as opposed to a net loss), this would have resulted in offsetting a net adjusted gain on one merchant against a net adjusted loss on another merchant. As discussed above, the then-controlling case law (pre-*Kinzer*) indicated that offsetting gains against losses was not appropriate. It is for this reason that it was necessary to segregate the adjustments by merchant and to have a reasonable and rational basis for the allocation of reserve accounts between the merchants.

E. The Settlement Process

The initial offer of settlement was put forth in the amount of \$272,892, which was supported by attached Tables 1, 2 and 3, a copy of which was provided to Global at the initial settlement meeting. The initial settlement meeting adjourned without a counteroffer and without threat of litigation. Global asked for time to review the schedule and the computer printouts prepared and provided to Global in support of each adjustment. Global undertook a sample testing of the supporting computer printouts, and asked for excerpts from VISA and MasterCard Operating Regulations upon which several of the adjustments were based. Global also sought out its own expert on credit card chargebacks.

At a second settlement meeting, Global said in general, its expert disagreed with the surety's position and its expert's position. In summary, Global's expert contended that although a strict reading of the VISA and MasterCard Operating Regulations may support the surety's position, in practice, chargebacks are more liberally allowed by merchant banks on a routine basis. Global's expert contended that if one does not allow a chargeback the first time, the chargeback will simply be initiated a second and a third time by the cardholder. The second settlement meeting ended with an agreement to disagree. Global was also informed that there was "some room" for negotiation, but that another offer would not be put forth until Global submitted a counteroffer. Shortly after the second meeting, a counteroffer was submitted by Global. A third settlement meeting was arranged, at which time Global and the surety agreed to a settlement of \$975,000, with rights to salvage being split 50-50.

IV. CONCLUSION

Credit card transactions and operating systems are quite complex, and attempting to understand them can be a daunting task. Hopefully, this case

study will provide a strong foundation to begin an analysis of a chargeback claim. At a minimum, the case study illustrates the value of conducting a thorough investigation. The investigation in the case study revealed that Global's net loss was significantly less than it claimed, and led to the arguable conclusion that it actually suffered no loss (if fees were included). Chargeback losses are not rare. After Dealman was fired, he moved to an adjacent county and did the same thing with another bank.⁴⁸

48. The authors handled that claim as well.

TABLE 1.

LINE ITEM	DESCRIPTION	USA SALES CORPORATION	HOME WATER PURIFIERS	TOTALS
1	SPECIFIC CHARGEBACKS AS CLAIMED	2,290,101	1,498,275	3,788,376
	LESS: ADJUSTMENTS TO ITEMS INCLUDED IN THE CLAIM AS FOLLOWS:			
2 A	CHARGEBACK FEES INCLUDED IN THE AMOUNTS CLAIMED	(26,175)	(10,075)	(36,250)
2 B	CHARGEBACKS HONORED BEYOND TIME FRAME ALLOWED PER VISA & MC REGULATIONS	(342,469)	(277,651)	(620,119)
2 C	50% OF CHARGEBACKS RESULTING FROM "NON RECEIPT OF REQUESTED ITEM" CHARGEBACK REASON CODE	(23,667)	(11,542)	(35,209)
2 D	CHARGEBACKS ON WHICH CHARGEBACK REPORTS ARE MISSING	(102,539)	(13,588)	(116,127)
2 E	CHARGEBACKS ON TRANSACTIONS EXCEEDING FLOOR LIMITS	(1,692)	(10,845)	(12,537)
2 F	PRECOMPLIANCE ITEMS FOR WHICH NO DETAIL HAS BEEN PROVIDED	772	4,450	5,222
2 G	CHARGEBACKS IN EXCESS OF \$ 700.00 EACH	(1,096)	(7,493)	(8,589)
2 H	CHARGEBACKS HAVING TRANSACTION DATES AFTER MERCHANTS TERMINATION DATE	(13,660)	(11,432)	(25,092)
2 J	DUPLICATE CHARGEBACKS	(34,350)	(21,662)	(56,012)
2 K	DUPLICATE PRECOMPLIANCE ITEMS	(14,756)	(14,457)	(29,213)
2 L	DUPLICATE CHARGEBACK/PRECOMPLIANCE ITEMS	(42,671)	(30,031)	(72,702)
2 M	PRECOMPLIANCE ITEMS PAID BEYOND 212 DAYS AFTER TRANSACTION DATE (180 + 30 + 2)	(168,934)	(43,883)	(212,817)
2 N	PRECOMPLIANCE ITEMS HAVING TRANSACTION DATES AFTER MERCHANTS TERMINATION DATE	(11,126)	(9,199)	(20,325)
2	TOTAL ADJUSTMENTS	(782,362)	(457,408)	(1,239,770)
1 LESS 2	ADJUSTED CLAIM - BEFORE ALLOCATION OF AVAILABLE RESERVE ACCOUNT BALANCES	1,507,735	1,040,867	2,548,606
	ADJUSTMENTS AS A PERCENTAGE OF AMOUNTS CLAIMED (USED FOR EXTRAPOLATIONS IN TABLE 2)	34.16%	30.53%	32.73%

LINE ITEM	DESCRIPTION		USA SALES CORPORATION	HOME WATER PURIFIERS	TOTALS
	<i>ANALYSIS OF RESERVE ACCOUNTS</i>				
3	FULL AMOUNT OF EXISTING RESERVE A/C BALANCES ON ALL MERCHANTS & USA'S PRODUCT RESERVE:				
3 A	EXISTING GENERAL RESERVE ACCOUNT BALANCES COLLECTED FROM USA & HOME		(555,575)	(132,742)	(688,317)
3 B	EXISTING GENERAL RESERVE ACCOUNT BALANCES COLLECTED FROM OTHER MERCHANTS (PRORATED BETWEEN USA & HOME AS TO ADJUSTED LOSSES)		(233,350)	(161,093)	(394,443)
3 C	TOTAL EXISTING GENERAL RESERVE ACCOUNT BALANCES COLLECTED FROM ALL MERCHANTS		(788,925)	(293,835)	(1,082,760)
3 D	ISO RESERVE ACCOUNT BALANCE (PRORATED BETWEEN USA & HOME AS TO ADJUSTED LOSSES)		(224,762)	(155,165)	(379,927)
3 E	PRODUCT RESERVES COLLECTED FROM USA LESS DOCUMENTED PRODUCT PURCHASES		(134,354)	0	(134,354)
3	SUBTOTAL – FULL AMOUNT OF EXISTING RESERVE ACCOUNT BALANCES & USA PRODUCT RESERVE		(1,148,804)	(449,000)	(1,597,041)
4	AMOUNTS TO BE ADDED BACK TO HOME'S RESERVE – INAPPROPRIATE CHARGES TO HOME'S RESERVE ACCOUNT:				
	TOTAL OFFSETS AGAINST ALL OTHER MERCHANT'S GENERAL RESERVE ACCOUNTS	381,871			
	HOME'S ADJUSTMENT RATE AS A PERCENTAGE OF DOLLARS CLAIMED (SEE TABLE 1)	30.53%			
	AMOUNTS TO BE ADDED BACK TO HOME'S RESERVE				
4	INAPPROPRIATE CHARGES TO HOME'S RESERVE ACCOUNT:	(116,581)	0	(116,581)	(116,581)
5	AMOUNTS TO BE ADDED BACK TO RESERVES – INAPPROPRIATE CHARGES TO ALL OTHER MERCHANTS' RESERVE ACCOUNTS:				
ACCOUNTS		1,564,802)			
	USA'S & HOME'S AVERAGE ADJUSTMENT RATE AS A PERCENTAGE OF DOLLARS CLAIMED (SEE TABLE 1)	U32.73%			
5	AMOUNTS TO BE ADDED BACK TO RESERVES – INAPPROPRIATE CHARGES TO ALL OTHER MERCHANTS' RESERVE ACCOUNTS:				
	(PRORATED BETWEEN USA & HOME AS TO ADJUSTED LOSSES)	(512,091)	(302,950)	(209,141)	(512,091)

TABLE 2.

TABLE 3.

LINE ITEM	DESCRIPTION	USA SALES CORPORATION	HOME WATER PURIFIERS	TOTALS
1	SPECIFIC CHARGEBACKS AS CLAIMED	2,290,10	1,498,275	3,788,37
2	TOTAL ADJUSTMENTS	(782,362)	(457,408)	(1,239,770)
1 LESS 2	ADJUSTED CLAIM – BEFORE AVAILABLE RESERVE ACCOUNT BALANCES	1,507,739	1,040,86	2,548,60
3	SUBTOTAL – FULL AMOUNT OF EXISTING RESERVE ACCOUNT BALANCES & USA'S PRODUCT RESERVE	(1,148,042)	(449,000)	(1,597,041)
	ADJUSTED CLAIM LESS FULL AMOUNT OF EXISTING RESERVE ACCOUNT BALANCES & USA'S PRODUCT RESERVE	359,698	591,867	951,565
4	SUBTOTAL – ESTIMATED INAPPROPRIATE CHARGES TO HOME'S RESERVE ACCOUNT	0	(116,581)	(116,581)
5	SUBTOTAL – ESTIMATED INAPPROPRIATE CHARGES TO ALL OTHER MERCHANTS' RESERVE ACCOUNTS	(302,950)	(209,141)	(512,091)
6	ADJUSTED CLAIM – AFTER ALLOCATION OF ALL RESERVE ACCOUNTS	56,748	266,145	322,892
		=====	=====	
7	LESS: CURRENT BOND DEDUCTIBLE			(50,000)
8	ADJUSTED CLAIM – AFTER ALL RESERVE ACCOUNTS & BOND DEDUCTIBLE			272,892
				=====

<u>Chargeback Reason</u>	<u>Code</u>	<u>Documentation Required</u>	<u>Time Limit</u>	<u>VISA Manual Page</u>	<u>Section Number</u>
No Authorization of T&E Transaction	20	N	45	41	2.4G.1.
Late Presentation of T&E Transaction	21	N	120	42	2.4G.2.
Expired Card of T&E Transaction	22	Y	120	43	2.4G.3.
Invalid T&E Transaction	23	Y	120	43	2.4G.4.
T&E Merchant Service Error	24	Y	120	45	2.4G.5.
T&E Processing Error	25	Sometimes	120	47	2.4G.6.
T&E Copy Fulfillment	26	N	45	48	2.4G.7.
T&E Document Fulfillment	27	N	120	49	2.4G.8.
Warning Bulletin of T&E Transaction	28	N	45	50	2.4G.9.
Declined Authorization of T&E Transaction	29	N	45	52	2.4G.10.
Services Not Rendered	30	Y	120	33	2.4E.15.(a)
Error in Addition	31	Sometimes	120	23	2.4E.1.
Fraudulent Transaction Prior to Embossed Valid Date	32	Y	120	24	2.4E.2.
Incorrect Account Number	36	N	120	24	2.4E.3.
Cancelled Recurring or Preauthorized Health Care Transaction	41	Y	120	34	2.4E.15.(b)
Unauthorized Transaction Exceeds Floor Limit	47	Y	120	25	2.4E.4.
Credit Posted as a Debit or Debit Posted as a Credit	50	Sometimes	120	25	2.4E.5.
Incorrect Transaction Amount	51	N	120	26	2.4E.6.
Mail/Telephone Order, Recurring Transaction, Preauthorized Health Care Transaction or Magnetic-Stripe-Reading Telephone Transaction on Expired or Never Issued Account Number	52	N	120	26	2.4E.7.
Not as Described	53	Y	120	35	2.4E.15.(c)
Claim or Defense	54	Y	120	36	2.4E.15.(d)
Defective Merchandise	56	Y	120	37	2.4E.15.(e)
Imprinting of Multiple Drafts	57	Y	180	39	2.4F.1.
Negative Account Number Verification	59	N	90	23	2.4D.1.
Requested Item Illegible	60	N	45	21	2.4C.1.
Mail/Telephone Order, Recurring Transaction, Preauthorized Health Care Transaction or Magnetic Stripe-Reading Telephone Transaction of Unauthorized Purchaser	61	Y	120	27	2.4E.8.
Counterfeit Transaction	62	Y	180	40	2.4F.2.

TABLE 4.1

<u>Chargeback Reason</u>	<u>Code</u>	<u>Documentation Required</u>	<u>Time Limit</u>	<u>VISA Manual Page</u>	<u>Section Number</u>
Warning Bulletin	70	N	45	15	2.4B.1.
Declined Authorization	71	N	45	18	2.4B.2.
Transaction Exceeds Floor Limit	72	N	45	18	2.4B.3.
Expired Card	73	N	120	28	2.4E.9.
Late Presentment	74	N	120	29	2.4E.10.
Non-Matching Account Number	77	N	45	20	2.4B.4.
Nonreceipt of Requested Item	79	N	45	22	2.4C.2.
No Imprint	81	Y	120	30	2.4E.11.
Duplicate Processing	82	Sometimes	120	30	2.4E.12.
No Signature	84	Y	120	31	2.4E.13.
Credit Not Processed	85	Y	120	38	2.4E.16.
Altered Amount	86	Y	120	32	2.4E.14.
Noneceipt of Merchandise	90	Y	120	37	2.4E.15.(f)
Questionable Merchant Activity	93	N	45	21	2.4B.6.
Cancelled Hotel Reservation	94	Y	120	53	2.4G.11.
Advance Lodging Deposit	95	Y	120	53	2.4G.12.
Transaction Exceeds Limited Amount	96	N	45	10	2.3B.5.
Second Presentment	Same as Chargeback	Y	45	10	2.3B.3.
Second Chargeback	Same as Chargeback	Y	45	10	2.3B.4.
Third Presentment	Same as Chargeback	Y	45	10	2.3B.5.

TABLE 4.2