

UNITED STATES DISTRICT COURT  
EASTERN DISTRICT OF NEW YORK

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IN RE VISA CHECK/MASTERMONEY  
ANTITRUST LITIGATION

MASTER FILE NO. CV-96-5238  
(Gleeson, J.) (Mann, M.J.)

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**Report of Independent Expert  
on Visa prepayment proposal**

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14 September 2009

## I. Scope of Report and Qualifications

I have been appointed by Judge Gleeson to act as an Independent Expert to advise the Court on whether securitization or prepayment of the remaining payments owed to the Plaintiff Class (the "Class") by MasterCard International Inc. ("MasterCard") and Visa U.S.A. Inc. ("Visa") in this case would benefit the plaintiff Class.

In March 2009, I delivered an initial report to the Court with regard to a securitization of the remaining MasterCard payments (Black MasterCard Securitization Report). In that report, I concluded that, if completed at an appropriate interest rate, a securitization of the remaining MasterCard payments would be advantageous to the Class, compared to the status quo of continuing annual payments. Judge Gleeson subsequently approved the Securitization proposal. In June 2009, MasterCard proposed to prepay its remaining obligations through a single payment of \$335 million on Sept. 30, 2009, which would replace four annual payments of \$100 million each, due on or before December 22 of 2009, 2010, 2011, and 2012. The prepayment amount is 83.75% of the face amount of the annual payments. In July 2009, I delivered to the Court a supplemental report containing my opinion that the MasterCard prepayment would be advantageous to the Class compared to a securitization of the MasterCard payments (Black MasterCard Prepayment Report).

Visa has now approached Lead Counsel (Constantine Cannon) with a proposal to prepay its remaining obligations in the underlying litigation settlement (four payments of \$200 million each, due in four installments on or before December 22 of 2009, 2010, 2011, and 2012). After negotiations, Visa agreed to make a single payment of \$682 million on September 30, 2009 ("Visa Prepayment") subject to court approval. The prepayment amount is 85.25% of the face amount of the remaining annual payments, and thus exceeds the MasterCard prepayment, as a percentage of the face amount of the remaining payments. In this Report, I address whether the Visa Prepayment is advantageous to the Class, compared to the alternatives of both (i) the current stream of annual payments, and (ii) a hypothetical securitization of the Visa payments ("Visa Securitization"). I conclude that the prepayment is strongly preferable to both alternatives.

My qualifications and other background information are stated in the Black MasterCard Securitization Report and only changes need be noted here. I am currently Hayden W. Head Regents Chair for Faculty Excellence, School of Law, and Professor of Finance, Red McCombs School of Business, at the University of Texas at Austin. Effective Sept. 1, 2010, I will move to Northwestern University, where I will be Nicholas D. Chabraja Professor at the School of Law and the Kellogg School of Management. I participated in discussions with Lead Counsel over the negotiations between Lead Counsel and Visa concerning the terms of the proposed prepayment.

## II. Background and Documents Reviewed

In preparing this Supplemental Report, I have reviewed the following sources of information, in addition to those referred to in my prior reports:

- (i) Prepayment Agreement between the Class and Visa;
- (ii) analyses of the discount rate implicit in the prepayment amount, prepared by Cannonade Capital, the financial advisor to Class Counsel, and the effective discount rate, taking into account the expenses that will be avoided through the Visa Prepayment;
- (iii) analyses of the “securitization-equivalent” discount rate (taking into account differences in expenses between the Prepayment proposal and a securitization, prepared by Cannonade Capital;
- (iv) other materials and information provided to me by Lead Counsel and Cannonade Capital.

I have also held discussions with Lead Counsel Robert Begleiter at Constantine Cannon and Joshua Slovik at Cannonade Capital. I asked a number of questions, received all of the documents and other information that I requested, and believe that the information available to me forms a sound basis for the opinions expressed below. Capitalized terms used in this Report but not defined here have the meanings given to them in the Black MasterCard Securitization Report.

I have assumed, and have not separately verified, the accuracy of the information provided to me by Lead Counsel and Cannonade Capital. My comparison of the Visa prepayment to the alternatives of the status quo or a securitization are based on the assumptions set forth below. Additional assumptions with regard to the MasterCard Securitization, many of which would also apply to the Visa Securitization, are set forth in the Black MasterCard Securitization Report.

## III. Assumptions

To compare the Visa Prepayment to the status quo and to a potential Visa Securitization, I need to make a number of assumptions, including assumptions about the timing of payments, the market rate that investors would demand to hold a Visa promise to make its annual payments, the weighted average cost of capital (WACC) for Class members and how that cost of capital varies for different Class members, and the expenses that would be incurred under the status quo of annual payments and the expenses to complete the Visa Securitization. I believe these assumptions to be reasonable. Lead Class Counsel has confirmed that they consider these assumptions to be reasonable.

## A. Timing Assumptions

An important set of assumptions involves the timing of payments to the Class under various scenarios. This timing affects the present value of distributions to the Class, as well as the transaction costs that will be incurred to distribute payments.

*Timing of Visa regular payments.* If the Visa Prepayment is not completed, Visa is obligated to make its regular annual payments on or before December 22, 2009, and again in 2010, 2011, and 2012. In the past, Visa has chosen to make its annual payment early, at the end of September of each year, but it has no legal obligation to do so. I assume that Visa would make timely payments each year, but not early payments.

*Timing of distribution of MasterCard prepayment to Class.* I assume that the MasterCard prepayment will be distributed to the Class promptly after it is received. For simplicity, I will ignore the delay between receipt and payment and assume distribution at the end of September 2009. If the Visa Prepayment is *not* approved, prompt distribution of the MasterCard prepayment would involve mailing an extra set of checks, and hence larger distribution costs, than waiting until a Visa payment (either a regular payment or the proceeds from a securitization) is received. In my opinion, it would be worthwhile to the Class to incur these extra distribution costs, in order to speed distribution of the MasterCard prepayment to the Class. This would maximize the present value to the Class of the combined Visa and Mastercard payments, especially for those Class members who are financially constrained and face a high implicit or explicit cost of capital.

*Timing of distribution of Visa prepayment to Class.* If the Court approves the Visa Prepayment, I assume that it will be distributed together with the MasterCard prepayment. Doing so will reduce distribution costs.

*Timing of Visa Securitization.* I assume that if the Court does *not* approve the Visa prepayment, Class Counsel would seek and receive Court approval for a Visa Securitization. However, it will take some time for Class Counsel to submit a securitization proposal and then revive the securitization effort that was begun for MasterCard. I assume that a Visa securitization could be completed on Dec. 31, 2009, roughly contemporaneously with the next regular Visa payment date, and the proceeds would be promptly distributed to the Class members. The Visa Securitization could perhaps be completed faster than this, but not by enough to affect my conclusion below that the Visa Prepayment strictly dominates the Securitization, because the interest rate that would be needed to make the Securitization preferable to the Prepayment is not achievable.

## B. Visa Discount Rate

The Prepayment will be advantageous to the Class, as compared to the status quo, if it provides a larger present value. For simplicity, I will compute all present values as of Sept. 30, 2009, the date of the Visa Prepayment and the assumed date of distribution of this payment to Class members. The present value of the Visa Prepayment at that date is \$682

million – the amount of the payment. The present value of the current stream of payments is more complex, can only be estimated, and will be different for different merchants.

Under strong “perfect capital markets” assumptions, the present value of the current stream of payments should equal the interest rate that investors would demand to accept Visa’s current, unsecured obligation to make those payments between now and 2012. Unfortunately, there is no simple way to estimate that rate. Visa does not have outstanding publicly traded debt, from which a market rate could be inferred. It does have an A+ credit rating from Moody’s and Standard & Poor’s for its commercial paper program and revolving credit facilities.

There are two potential approaches that could be used to estimate this market interest rate. A direct approach would begin by estimating the market rate on standard, publicly traded unsecured Visa debt with maturity comparable to the remaining maturity of the payments. These payments will be made, relative to a prepayment, in 3, 15, 27, and 39 months, in equal amounts, so the average maturity is 21 months. One would then modify this rate to reflect various factors which would affect the rate that investors would likely demand, of which the most important are likely to be: investor uncertainty about whether and by how much default risk is higher for Visa’s obligation to the class than for straight unsecured Visa debt; limited or zero liquidity for the stream of payments; the need for investors to invest time and effort in understanding Visa’s obligation to make the payments, for which investors would be compensated in equilibrium through a higher interest rate; and a thin market for straight debt with this short a maturity.

An alternative approach would involve using the expected interest rate on the MasterCard securitization notes as a benchmark rate, and then adjust this rate for changes since July 2009 in the market rate of interest, and for differences between the two offerings, including Visa’s higher creditworthiness. An advantage of this approach is that the expected rate on the MasterCard securitization includes many of the same rate-increasing factors, compared to straight unsecured MasterCard debt, as would the discount rate on the current Visa schedule of payments. A weakness of this approach is that the MasterCard securitization process was begun but not completed. Therefore, the market rate on MasterCard debt can only be estimated. I was advised by Cannonade Capital in connection with my report on the MasterCard prepayment that the interest rate on the notes for the MasterCard securitization was likely to be in the range of 9-10%, measured as a bond-equivalent yield.

I considered both of the approaches sketched above, and concluded that the second “start with MasterCard” approach involves less uncertainty, so this is the approach I use below. I consider a range of MasterCard securitization rates from 8.5% to 10.5%.

As I discuss in the Black MasterCard Securitization Report, an assessment of the value of the Visa Prepayment, compared to the current schedule of Visa payments should take into account capital market imperfections. One can understand the Class members as having involuntarily lent money to Visa, and as needing to obtain the funds to do so from their own investors. In perfect capital markets, the marginal rate to obtain those funds should equal the rate investors would require to invest directly in the Visa payments.

However, in practice, almost all merchants will have a weighted average cost of capital (WACC) higher than market discount rate on the Visa payments. Moreover, the Visa payments are a tiny percentage of the revenue, and likely a tiny percentage of the net income, of any single merchant. Thus, it is likely that creditors of these merchants will not fully adjust their assessment of a merchant's overall riskiness to reflect the lower risk associated with the Visa stream of payments than with the remainder of the merchant's business. In many cases, especially for smaller merchants, creditors are likely not to adjust their risk assessment at all. For other merchants, there could be partial adjustment. Some merchants are financially constrained and, at the margin, effectively cannot borrow at all.

For merchants for whom creditors adjust partially or not at all, the relevant cost of capital is the cost to them of obtaining the funds they lent to Visa, rather than the rate that investors would charge Visa directly. It seems reasonable to me to assume that a 1% monthly cost of capital, or 12.30% bond-equivalent yield, is a reasonable average marginal Class cost of capital for the current Visa stream of payments. This is above the marginal cost of capital for some large, well-capitalized merchants, but likely below the marginal cost of capital for many smaller merchants.

### **C. Avoided Annual Expenses**

The Visa Prepayment will involve negligible incremental distribution or other transaction costs, because it can be bundled with the MasterCard prepayment. A single check will be mailed to each merchant, for a larger amount. In contrast, the current schedule of Visa payments involves ongoing distribution expenses, to make annual payments to the Class members in December 2009, 2010, 2011, and 2012. The current payment schedule will also require some ongoing expenses to manage the litigation trust, including the fees of Lead Counsel.

The Class incurred total expenses of approximately \$50 million during the period from inception in June 2003, through April 2009, or a bit less than 6 years, excluding one-time expenses associated with the MasterCard securitization. This is an average of about \$8.3 million per year. The annual run rate for expenses could be lower going forward because this amount includes some startup expenses, but could also be higher due to inflation. I consider it reasonable to assume that going forward, expenses will continue at a similar run rate. To determine the present value of the current stream of payments, I therefore subtract \$8.3 million from each annual Visa payment of \$200 million.

### **D. Visa Securitization Expenses**

Below, I compare the Visa Prepayment both to the status quo of annual payments and to the potential Visa Securitization. To compare the prepayment to the securitization, I need to estimate the expenses that the securitization would entail, that can be avoided through a prepayment. The Visa Securitization will involve at least the following additional costs, compared to the Visa Prepayment:

- A mailing of the bulk of the Securitization proceeds soon after the securitization is completed, and either a partial or full mailing in 2012 consisting of the remaining funds in the reserve and equity accounts that the Securitization will require. I discuss these accounts, and the potential for a less costly partial mailing, in the Black MasterCard Securitization Report. Assuming that only a partial mailing would be required in 2012, these costs can be estimated at \$10 million.
- Investment banker fees would be 1.25% of the offering proceeds, or approximately \$8.6 million.
- Legal fees for issuers and underwriters counsel relating to structuring the securitization and delivering the required legal opinions are estimated at \$1.1 million.
- Expenses for administration of the litigation trust and the separate securitization trust, are estimated at \$1.2 million. I provide more detail on these expenses in the Black MasterCard Securitization Report.

These additional expenses total approximately \$21 million. Most would be incurred at or soon after the date of the Securitization, so their present value is also approximately \$21 million.

#### **E. Redistribution of Uncashed Checks**

It is inevitable that some payments to Class members will not be collected. I am advised that the uncollected amount, for a combined distribution of prepayments by MasterCard and Visa of a bit over \$1 billion, is likely to be several percent of the amount distributed, or on the order of \$30 million. These amounts will need to be redistributed to Class members who can be reached. A similar need to redistribute otherwise uncollected amounts will arise under the alternatives of a Visa Securitization and continuation of annual payments.

This redistribution will involve some additional transaction costs. I recommend, as a means to reduce these costs, that the redistribution be conducted reasonably promptly after the main distribution, perhaps 90 days after the initial distribution, so that fewer redistribution checks will remain uncashed. I also recommend that Class Counsel make a judgment, subject to court approval, that checks in nominal amounts, say under \$10-20, should not be sent because the transaction costs of sending them are too high relative to the check amount.

There are minor differences between the Visa Prepayment, a Visa Securitization, and continuation of annual payments in the likely level of transaction costs for a final redistribution, as well as loss of present value due to a decision to bundle redistribution payments with the next payment that would otherwise be made. On the whole, I believe the Visa Prepayment offers the best strategy for minimizing the sum of transaction costs and time value of money costs. However, the savings relative to the other payment strategies is small compared to other differences between the three strategies. I therefore do not attempt to quantify the relative costs.

## IV. Prepayment versus Present Value of the Current Stream of Payments

### A. Prepayment IRR

The raw internal rate of return (IRR) to Visa from the Prepayment is 0.79% per month, or 9.66% per year (expressed as a bond-equivalent yield). However, the relevant calculation for the Class involves comparing the amount the Class would receive, net of annual expenses, to the prepayment amount. If one subtracts estimated annual expenses of \$8.3 million from the amounts to be paid by Visa, the effective IRR to the Class for the Visa prepayment, net of these expenses (“Class Prepayment IRR”), will be 7.11% (bond-equivalent yield). In this report, I state interest rates as bond-equivalent yields unless otherwise specified. This is how corporate and government bond yields are commonly reported.<sup>1</sup>

The 7.11% Class Prepayment IRR can be understood as the effective interest rate that the Class members would receive, by retaining the status quo of annual payments instead of accepting the Prepayment. Assuming perfect capital markets, the Prepayment will be advantageous to the Class if this IRR is lower than the market interest rate that investors would charge to accept the current Visa stream of payments. If one allows for imperfect capital markets, the Prepayment will be advantageous to the Class if this IRR is lower than the effective marginal cost of capital to Class members.

This estimate of the Class Prepayment IRR is sensitive to the level of future expenses, and is therefore rough. However, it seems reasonable to believe that the actual realized Class Prepayment IRR would be likely to be in a range from 6.75%-7.5%.

### B. Market Interest Rate for Current Visa Payments

I initially assume perfect capital markets. The Prepayment will be advantageous to the Class if the Class Prepayment IRR is lower than the market interest rate on the current Visa payments. That market rate can usefully be decomposed into a number of components:

Market interest rate on Treasury securities of comparable maturity (about two years): currently around 1%

Estimated spread above Treasury securities to issue the MasterCard securitization notes: 7.5-9.5% (reflects MasterCard default risk, additional risk associated with the litigation payments compared to ordinary public debt; limited liquidity of the securitization notes; information costs; and unusual, short maturity of the notes)

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<sup>1</sup> One can readily convert from bond-equivalent yield to a true annual yield, as follows. Suppose that a bond is quoted as paying an 8% yield (implicitly, a bond-equivalent yield). This means that the bond pays 4% interest, twice a year. Including the implicit semi-annual compounding, since the first interest payment can be reinvested when received for the rest of the year, the economic yield will be  $y_{\text{annual}} = (1 + y_{\text{bond-equiv}}/2)^2 - 1$ , or 8.16%.

Reduction in spread due to improvement in market conditions from July to September 2009: -1.0%.

Reduction in spread due to greater creditworthiness of Visa (A+ rating, versus BBB+ for MasterCard) and existence of two ratings for Visa, versus one rating for MasterCard: -0.4% to -0.6%.

Increase in spread because securitization notes will have some liquidity, albeit limited, , while the direct obligation of Visa to make the litigation payments has, effectively, no liquidity.

The magnitude of the last item is uncertain, but it could roughly offset the reduction in spread from Visa's greater creditworthiness. Thus, if the estimated range of rates for a MasterCard securitization is 8.5-10.5%, the estimated range of rates for Visa's direct payment obligation is 7.5-9.5%.

It is apparent that the estimated Class Prepayment IRR (point estimate of 7.11%; range of 6.75%-7.5%) is at or below the bottom of the range of estimated market interest rates for the current Visa payments. I therefore conclude that the Visa Prepayment is advantageous to the Class, compared to the status quo, even under the strong assumption of perfect capital markets. This conclusion only becomes stronger once one allows for imperfect markets, where many Class members are financially constrained and must, in effect, fund their involuntary loan to Visa at substantially higher rates than this.

### **C. Comparison to Visa Securitization**

I next compare the Visa Prepayment to a Visa Securitization. To do so, one must first estimate the market rate that investors will demand to invest in Visa Securitization notes. This requires two adjustments to the 7.5%-9.5% interest rate range estimated above. First, in contrast to the current stream of Visa payments, Visa Securitization notes will have some liquidity (comparable to MasterCard securitization notes), so the higher spread, included above due to no liquidity of the current Visa payments, will drop out of the estimate. On the other hand, the investment bankers who were engaged for the MasterCard Securitization have advised Cannonade Capital that the offering size would be large compared to other securitization transactions that are being completed under current market conditions, which might affect the feasibility of the Visa Securitization or the interest rate at which it could be completed, especially given the unusual nature of this securitization, including its short maturity. At a minimum, they advised that this large size will require a higher interest rate, to attract more buyers. One can crudely estimate that these two factors would roughly offset each other, so that the estimated range of rates for Visa Securitization notes would also be 7.5%-9.5%.

The next step is to estimate what interest rate the Visa Securitization notes would need to carry, for the Securitization to convey value to the Class equal to the Prepayment. I estimate above that the Securitization will involve additional expenses, relative to the Visa Prepayment, of roughly \$21 million. I also estimate that the Visa Securitization could be completed at year-end 2009, or 3 months slower than the Prepayment.

The expected structure for the Securitization would require some reserve and equity accounts to be created, with distribution of these amounts to the Class deferred until after the final payment is made in 2012. The Class would receive two distributions. There would be an initial large distribution, on the order of \$650 million, depending on the interest rate in the Securitization, soon after the Securitization closes. There will also be a second smaller distribution, expected to be about \$37 million, of funds left in the Class account after all payments are received from Visa and all expenses have been provided for. I assume this payment will be made at December 31, 2012. The second, deferred payment arises from the need, in the Securitization, to create and hold reserves (\$21 million) and an equity account (another \$16 million). These funds would be held in interest-bearing accounts, but short term market interest rates are currently close to zero and are far below the Class members' cost of capital. Thus, the present value of the deferred payment to the Class is less than the principal amount.

The Prepayment will not require this partial deferral, so the full amount of the Prepayment can be paid promptly to the Class. This increases the present value of the payment. Put differently, the effective interest rate paid by the Class on the Securitization Notes, taking into account the delayed payment of the funds in the reserve and equity accounts, is higher than the rate received by the Note purchasers. I estimate this difference below.

There is a small risk that the securitization might fail to attract sufficient demand to be completed at all, and a larger risk that weak demand might result in a higher interest rate on the Securitization notes than is currently expected.<sup>2</sup>

All three factors discussed above work against the value of a Visa Securitization, compared to the Visa Prepayment. Expenses to the Class would be higher, the initial payment would be made at December 31, 2009 instead of Sept. 30, and there will be an additional deferral of payout of the reserve and equity amounts until the end of 2012. Taking these factors into account, for the Securitization to provide the same \$682 million present value as the Prepayment, it would have to be completed at a "breakeven" interest rate of 5.80%.

The interest rate on the Visa Securitization notes, at which the Visa Securitization would have the same present value as the Visa Prepayment, depends on the discount rate one uses to discount the payments to the Class in the Visa Securitization from the dates they would actually be made back to present value at Sept. 30, 2009, in order to compare them to the payments under the Visa Prepayment. The 5.80% estimate above assumes that one uses a discount rate of 1% per month -- my estimate above of an overall marginal Class cost of capital -- as the discount rate for payments to the Class under the Visa Securitization -- both the large initial payment at December 31, 2009, and the residual payment at December 31,

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<sup>2</sup> I view the risk of outright failure of the Visa Securitization to be small. Regardless of demand from other investors, if Visa finds it attractive to prepay the entire amount it owes, for a single payment of \$682 million, it would likely also be interested in buying the Notes, potentially all of them, at an effective price lower than this. This would be a form of self-help prepayment, but without the advantages to the Class of an actual prepayment.

2012. If one instead uses the midpoint of my estimate above of market rates on Visa debt of 8.5%, the breakeven rate would be 6.79%

The Securitization would be preferred to the Prepayment only for Note interest rates lower than the breakeven rate. Even a 6.79% rate is well below the range of interest rates which are likely to be achievable at this time for the Visa Securitization. Therefore, in my opinion, the Prepayment dominates the Securitization. This conclusion would only be strengthened if one takes into account the other advantages of the Prepayment, including the risk of non-completion of the Securitization and the risk that additional expenses might deplete the reserve accounts.

### Conclusion

The Visa Prepayment is advantageous to the Class, compared to the alternative of the Visa Securitization and the alternative of the status quo of annual payments. The degree of advantage increases as the size of a merchant decreases. For a typical merchant, the effective Class Prepayment IRR, which I estimate above at 6.75%-7.5%, is likely to be substantially lower than the merchant's marginal cost of capital.

Respectfully submitted,



Bernard S. Black  
Sept. 14, 2009