Updates
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COVID-19: Reserve Issues in Credit Card Processing Agreements

COVID-19's effect on the economy does not discriminate. Business activity has slowed down significantly for many companies, and even more drastically in certain sectors. Some of the industries that have been hit the hardest during this pandemic include retail (brick-and-mortar retail stores and e-commerce retailers, particularly those that sell non-essential products), travel (airlines, hotels, and other travel services providers), and entertainment (movie theaters, sports and entertainment venues, and restaurants).

Virtually all of these businesses accept credit cards from their customers as a method of payment. The acceptance and processing of these credit card transactions is governed by agreements the businesses have in place with payment processors and acquiring banks. Among the key aspects of these agreements are provisions that require the business to post reserves, to protect processors against certain financial risks. In short, reserve provisions set aside funds of the business as a security deposit for the processor, in the event the business is unable to meet its financial obligations under the agreement or to cover excessive chargeback costs.

Depending on the specific arrangement, the required reserves may take the form of cash deposits, and discretion may be reserved to the processor as to the amount and timing of the reserve. At a time when cashflow for many businesses is severely constrained, these types of reserve requirements can have severe financial consequences and be prohibitive for businesses. Notwithstanding the financial challenges caused by reserve funding, these agreements are critical to businesses—without which the business cannot take most payments from customers.

The following update discusses the circumstances under which reserve requirements can be triggered in processing agreements and proposes certain proactive steps processors and businesses can take to anticipate such triggers. It also suggests ways these parties may attempt to come to a mutually acceptable resolution where the business does not have cash on hand to post as a reserve, as a result of the economic slowdown from COVID-19 pandemic.

Payment Processor Reserve Triggers

Payment processors often require businesses (merchants) to maintain a stipulated minimum balance in a reserve account, to protect themselves against payments-related risks. These reserve requirements are sometimes stipulated up front for low-volume merchants but more commonly are put in place (or increased) as a result of the occurrence of certain triggering events.

Common triggering events seen in typical processing agreements include the following, with varying degrees of processor discretion:

- Excessive chargebacks (i.e., charges returned to a merchant by a card network), disputes, or refunds
- Material deterioration in the financial condition or credit of the merchant
- Merchant default under the agreement
- Merchant entering into a card monitoring program (like the MATCH List)

- Merchant violations of the card network rules, such as those of Visa or MasterCard
- An increase in the time between taking payment and fulfilling orders
- Compliance violations
- Grounds for insecurity or risk as determined by the processor

Upon the occurrence of a triggering event, such as those listed above, the processor usually has the right to fund the reserve account in a handful of ways, including: (1) demanding payment by the merchant, (2) demanding a letter of credit, (3) debiting from a merchant-designated bank account, and/or (4) deducting from settlement amounts the processor owes to the merchant from card transactions the merchant has submitted for processing. The agreement may contain language giving processors discretion over whether to require that the merchant quickly fund the reserve account (either within a certain number of days, or through a right to directly debit a merchant's bank account) or to unilaterally set off payments from merchant transactions that take place under the processing agreement.

Depending also on the specific provisions in the agreement, the reserve provisions may contain limitations on the reserve requirements. For example, the agreement may include language that limits the reserve amount to a multiplier tied to chargebacks and returns (for example, a figure equal to three times average monthly chargebacks in the past 12 months). The demand for the reserve may also be subject to standards of reasonableness, as well as provisions calling for the processor to illustrate that the reserve is tailored to address the specific risk that gave rise to the reserve. And lastly, the merchant may have the ability to request that the processor reassess the reasons for requiring the reserve, and to evaluate whether it is still needed and to what extent.

Managing Reserve Triggers

While reserve requirements in processing agreements are typical, a reserve trigger typically complicates the relationship between a merchant and a processor, especially during an economic downturn. From the merchant's standpoint, a reserve trigger negatively affects the merchant's cash flow and can be difficult to comply with during a recession, but maintaining the agreement in good standing is critical for the merchant to be able to continue accepting credit card payments from customers. On the other hand, from the processor's standpoint, reserve requirements are necessary to protect the processor against financial risk, but it is also in the best interest of the processor to offer a reserve solution that is feasible for the merchant, in order to maintain a good long-term relationship with the merchant (the processor's ultimate customer).

If a reserve triggering event occurs, the following are some steps processors and merchants can take to reach a reserve solution that addresses each party's interests:

Review the Processing Agreement

The first step is for each party to review the terms of the processing agreement, to understand exactly what rights and obligations each party has with respect to reserves. The processing agreement will state the terms associated with the reserve account, as well as any processes the parties must go through before the reserve-funding deadline, such as requirements related to notice periods, meetings between the parties, thresholds for reserve funding amounts, and standards of reasonableness.

Merchants Should Develop Proper Documentation for Chargebacks

If the reserve trigger results from excessive chargebacks, a merchant should develop documentation that will enable it to show the processor that it has a grasp of the merchant's economic condition as well as the reasons for and conditions of the current spate of chargebacks.

A merchant will likely have documentation of its sales and returns averaged year-over-year, but it should also consider how it presents other aspects of its economic health, such as account balances, current sales numbers, and other economic projections.

A merchant also may be able to analyze and present data about changes in sales, returns, and chargeback activities by showing information about customer reasons for chargebacks and information that ties chargeback rates to certain business lines or geographies. Isolating risk factors can help the merchant provide the processor with an understanding of the risks to the merchant's business, such as limiting sales weaknesses or chargeback spikes to only certain business lines. This information could help the processor better understand a merchant's risk and could influence the amount of reserve that the processor requests.

Because chargeback procedures heavily favor the consumer, the merchant and processor should also work together to best position themselves to rebut unnecessary or incorrect chargebacks and to ensure that the issuer is submitting chargebacks appropriately (which, in turn, can reduce the reserve requirement). Under certain circumstances, a merchant will be able to provide evidence and documentation in response to a chargeback. The merchant and processor should work together to collect, maintain, review, and submit evidence that shows that the consumer received the purchased goods, services, or event, or that the proper remedy for the consumer is through working directly with the merchant rather than a chargeback. If cancellations of events or other services were caused by government order or regulation, the merchant should maintain those records as well, as card networks are directing issuers to have consumers work with merchants directly to resolve cancellations, rather than through the chargeback process.

Merchants Should Develop Proper Documentation for Overall Financial Condition

Similar to the chargeback information above, if the reserve trigger results from the merchant's deteriorating financial condition, a merchant should develop documentation that will enable it to provide the processor comfort as to its overall financial condition, despite any short-term financial issues. Such information, if effectively presented to the processor, may increase the processor's confidence in the overall financial condition of the merchant, and in turn cause the processor to be comfortable with a lower reserve amount.

Processors Should Consider Reserve Alternatives Despite Agreement

If a reserve provision is triggered, processors should be open to alternative reserve structures, even if the reserve structure is different from the reserve provisions in the agreement, so long as the structure adequately addresses the processor's risk. For example, many processing agreements have broad and open-ended provisions around reserve triggers, and they leave much discretion to the processor as to the amount and timing of the reserve. A processor may have the right to demand a substantial sum under the reserve provision but, in reality, the sum may be excessive compared to the actual risk the processor is attempting to protect against. In such a scenario, despite what the reserve provisions may provide, a processor should consider lower or alternative reserve amounts, particularly when they will assist its merchant client with cash flow issues, so long as the processor is adequately protected. High reserve amounts affect merchant cash flow issues at a particularly challenging time during this pandemic, and merchant cash flow and survival inures to the benefit of both the merchant and the processor.

Keep an Open Line of Communication

Merchants and processors should ensure that they have a direct line of communication with one another. As with many aspects of running a business, relationships are key. A close relationship with the counterparty's account representative will help the parties better understand each other's thought process and help the parties communicate important information to one another. Both parties' business depend on the success of the other's, and any communication that can help the parties understand each other's concerns, challenges, and risks could help smooth ongoing discussions and the ultimate resolutions.

Individuals with questions or concerns about reserve provisions in their processing agreements should seek advice from trusted counsel. The Perkins Coie Electronic Financial Services attorneys are available to guide clients as they navigate these issues in their processing agreements.

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