

**Common Sense from the Common Law:
Why a Longstanding Legal Doctrine Supports Limiting
Bank Overdraft Fees to a “Reasonable and Proportional”
Standard**

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Over the past decade, overdraft fees and abuses have spiraled out of control, snaring millions of consumers while generating billions in profits for banks. A new [white paper](#) by the National Consumer Law Center explores why overdraft fees should be subject to a “reasonable and proportional” standard, how overdraft fees are currently excessive and unreasonable, and why the ability to charge excessive overdraft fees encourages banks to engage in abusive practices to maximize overdrafts. The white paper also describes how excessive overdraft fees are contrary to a centuries-old legal doctrine that prohibits punitive damage clauses in contracts. It concludes with suggestions for legal avenues that the Consumer Financial Protection Bureau (CFPB) can use to restore the standard of “reasonableness” to overdraft fees.

Key Points:

Overdraft fees cost consumers billions of dollars, mostly paid by those least able to afford it.

Consumers paid \$29.5 billion in overdraft fees in 2011. Overdraft abuses have become widespread, as fees have skyrocketed and the vast majority of banks now use automated overdraft programs that generate more fees. All 10 of the largest banks in the United States, which hold nearly 60% of all deposit volume nationwide, used automated overdraft programs in 2011.

Overdraft practices disproportionately burden low- and moderate-income consumers. An FDIC study reported that the small percentage of consumers who overdraw their accounts 20 or more times per year paid 60% of all overdraft fees. Another study found that the consumers who shouldered the vast majority of overdraft fees were more likely to be lower income, non-white, single, and renters.

Overdraft fees are disproportionate and unreasonable, far exceeding the cost to the bank of the overdrawn transaction.

The median overdraft fee is now \$35, which almost certainly outstrips the cost to the bank to process the overdraft, and generates a substantial profit. In fact, the amount of the overdrawn transaction itself is often less than the fee; the median amount of all overdrawn transactions is \$36, and for debit card overdrafts is \$20 or less, compared to the fee of \$35.

Older data indicates the cost of processing a nonsufficient funds (NSF) transaction, which should be similar to processing costs for overdrafts, is 64 cents to \$3.50. Information from other countries is also enlightening. Banks in Australia recently admitted in litigation that their overdraft fees were not related to the amount of damages they incurred. Data from South Africa indicate the cost of processing an NSF transaction is 54 cents.

Unreasonable and disproportionate overdraft fees are contrary to a centuries-old legal doctrine that prohibits punitive damages for violation of a contract.

For at least three centuries, the common law¹ has prohibited clauses that impose penalty damages for a breach of contract. When damages are difficult to determine, the common law permits the parties to decide in advance on a fixed sum of “liquidated damages” for a breach, but only if that sum is reasonably related to the actual damages likely to be sustained by the party. Contract provisions that impose a penalty above a reasonable estimate of actual damages are prohibited. This doctrine has thrived for centuries and is codified as part of the Uniform Commercial Code, which is a comprehensive model state law governing commercial transactions and has been enacted by all 50 states in some version. This “anti-penalty doctrine” continues to be applied to this date, with the exception of a critical area – consumer financial services.

The anti-penalty doctrine has been blocked by court decisions from applying to overdraft fees and other bank penalty fees.

The anti-penalty doctrine is not applied in the U.S. in the area of bank penalty fees due to a number of court decisions. Decisions from the 1980s ruled that nonsufficient (NSF) funds and overdrawn transactions were not technically a breach of contract, and thus the anti-penalty doctrine did not apply. More recent court decisions held that any state statute statutory or common law limitations on the amount of overdraft and other fees cannot be applied to banks due to federal preemption.

Ironically, consumer financial services is the market in which the anti-penalty doctrine is most needed. Even scholars who have questioned the doctrine have recognized that penalty provisions should not be enforced when there is unequal bargaining power. The relationship between banks and consumers is one in which the bargaining power of the parties is not only unequal, it is grossly disproportionate. In Australia, that country’s highest court recognized the need for the anti-penalty doctrine in consumer financial services, and found that overdraft and other bank-imposed fees could be subject to the doctrine.

Unreasonable and disproportionate overdraft fees have led to other abuses to maximize the number of overdrafts, as predicted by the anti-penalty doctrine.

Penalty fees that are excessive, unreasonable, and disproportionate end up becoming a profit center. Not only is this contrary to a fundamental principle of contract law, it creates an enormous incentive for the party receiving the profit-making fee to engage in tactics that cause more breaches of the contract and maximize fees. This phenomenon was explained in 1978 in an article co-authored by a legal scholar who would later become chairman of the Federal Trade Commission under President Bush.

The failure to apply the anti-penalty doctrine to overdraft fees has directly led to the proliferation of abusive practices designed to maximize the fees such as:

- extending overdrafts to debit and ATM card transactions, where previously transactions had been declined without a fee;

¹ Common law is the body of law that originated from England, and is developed by centuries of court decisions, as opposed to statutory law created by the enactment of legislatures. In addition to Great Britain, many of the countries that were former British colonies, such as the United States, Canada, and Australia, rely on common law.

- pressuring, badgering, and using deceptive statements to persuade consumers to opt in to debit card and ATM overdrafts;
- re-ordering checks and other debits from high-to-low amount in order to maximize the number of overdraft fees that are charged; and
- promoting overdrafts to consumers, and encouraging them to use overdrafts as a source of credit.

Solutions:

The anti-penalty doctrine is the basis of the Credit CARD Act's requirement that credit card penalty fees be "reasonable and proportional," a standard which should be applied to overdraft fees.

The Credit Card Accountability, Responsibility, and Disclosures (CARD) Act of 2009 requires that penalty fees for credit cards be "reasonable and proportional" to the omission or violation for which they are imposed. The genesis of this standard was the anti-penalty doctrine.

The Credit CARD Act could provide a means to restore the concept of "reasonableness" and the anti-penalty doctrine to overdraft fees, at least when imposed for debit card overdrafts. The CFPB now has authority to issue regulations to interpret the Credit CARD Act. The CFPB could apply the reasonable and proportional standard to overdrafts accessed by debit cards by treating them as "credit cards."

The CFPB should require that overdraft fees be reasonable and proportional using its authority to ban unfair, deceptive, and abusive practices.

Another avenue for the CFPB to require that overdraft fees be reasonable and proportional is to use its authority to prevent unfair, deceptive, or abusive practices. Unreasonable and disproportionate overdraft fees are unfair and abusive, and they encourage additional unfair, deceptive, and abusive practices. If an overdraft fee would have been prohibited by the Uniform Commercial Code or the common law anti-penalty doctrine, or would have been voided as unconscionable, but for preemption, then the CFPB should be able to treat the fees as unfair or abusive. There seems no better use of the CFPB's power to ban unfair, deceptive, and abusive acts than to restore a centuries-old doctrine that still protects businesses – the more sophisticated and powerful entities – but not consumers.

Download the full report:

http://www.nclc.org/images/pdf/banking_and_payment_systems/common-law-overdraft-fees.pdf

Since 1969, the nonprofit National Consumer Law Center® (NCLC®) has worked for consumer justice and economic security for low-income and other disadvantaged people, including older adults, in the U.S. through its expertise in policy analysis and advocacy, publications, litigation, expert witness services, and training.

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