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Restoring the Wisdom of the Common Law: Applying the Historical Rule Against Contractual Penalty Damages to Bank Overdraft Fees

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By

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I. Introduction

For three centuries or more, the common law has prohibited contract provisions that impose a penalty greater than the amount of damages caused by a breach of the contract. When those damages are difficult to determine, the common law permits "liquidated damages" provisions that are reasonably related to the actual damages sustained by the party. However, provisions that impose a penalty above a reasonable estimate of those damages are prohibited.

This doctrine has thrived for centuries and is codified as part of the Uniform Commercial Code. The anti-penalty rule continues to be applied to this date, with the exception of a critical area – consumer financial services.

Ironically, consumer financial services is the market in which the anti-penalty doctrine is most needed. Even critics of the anti-penalty doctrine have recognized that penalty provisions should not be enforced when there is the presence of unequal bargaining power or unconscionability. Yet consumer financial services is a market in which the bargaining power of the parties is not only unequal, it is grossly disproportionate.

This article explores the relationship of the anti-penalty provision with one particularly controversial damages provision in consumer financial services – the overdraft fee. The article provides background on both overdraft fee practices and the anti-penalty doctrine. It discusses how it came to be that the anti-penalty doctrine is not applied to overdraft fees. This article shows how the failure to apply the anti-penalty doctrine has led banks to turn overdraft fees into a profit center, and to engage in many unfair, deceptive, and abusive tactics to induce more overdrafts in order to generate more fees. It documents how the doctrine was partially revived in the context of credit card penalty fees with the establishment of a "reasonable and proportional" standard in the Credit CARD Act. The article discusses how this same standard could be applied to regulate overdraft fees, so that they once again meet the anti-penalty doctrine's standard of a reasonable relationship to actual damages. Finally, it discussed another alternative that can be used to require that overdraft fees be reasonable and proportional, by treating fees that do not meet this standard as "unfair" or "abusive" under the Dodd-Frank Act.

II. Background on Overdraft Programs and Fees

When a consumer has insufficient funds to pay a check, electronic Automated Clearing House (ACH), debit card, ATM, or other account transaction, the bank can either deny payment or cover the amount. In both of these situations, the bank generally assesses a fee. When the bank pays the transaction, it is called an overdraft, and the fee is an overdraft fee. When the bank denies payment on the transaction, except for debit card and ATM transactions, it will impose a "not sufficient funds" or NSF fee.

Traditionally, banks usually denied transactions when the consumer's account contained insufficient funds. They permitted overdrafts usually only for their best customers as an occasional courtesy.

However, with the advent of computer software programs, and the arrival of third-party vendors that sold services to help banks maximize fee income, banks realized they could generate large profits by permitting and even inducing overdrafts. For consumers who have regular income coming into the account, especially if the income is direct deposited, the bank is guaranteed a payment that will repay the overdraft and the accompanying fees in a matter of days.[1] Thus, the last ten to fifteen years have seen the rise of automated overdraft programs that impose enormous costs on consumers and generate large profits for banks.[2]

It was the third-party vendors that initially catalyzed current overdraft practices by selling programs that would automate overdrafts, as well as creating tactics to maximize them.[3] In the early 2000s, these vendors promoted these programs to banks by claiming they would allow banks to significantly increase their overdraft fee income. For example, the website of one consultant (Pinnacle) promised banks that its services would raise overdraft fee income by "100%, 200%, 300% or more!"[4] A pioneer in this field, John M. Floyd Associates, claimed that financial institutions participating in its program would increase overdraft income anywhere from 50 to 300%.[5]

Banks thus embarked on a series of escalating measures to cause their customers to engage in more overdrawn transactions and pay more fees:

- Automatically paying all overdrawn transactions within a set limit, rather than as an occasional courtesy.
- Increasing the amount of overdraft fees significantly, and charging them for each transaction, even if there are several or many transactions in a day.[6]

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[1] Most overdrafts are repaid an average of only three days later. ERIC HALPERIN, LISA JAMES, & PETER SMITH, CENTER FOR RESPONSIBLE LENDING, DEBIT CARD DANGER: BANKS OFFER LITTLE WARNING AND FEW CHOICES AS CUSTOMERS PAY A HIGH PRICE FOR DEBIT CARD OVERDRAFTS 8 (Jan. 25, 2007), *available at* www.responsiblelending.org/overdraft-loans/research-analysis/Debit-Card-Danger-report.pdf.

[2] Automated overdraft programs should be distinguished from overdraft lines of credit, which are explicitly treated as credit products and require an application and approval process. They also should be distinguished from overdraft programs that involve a transfer from a credit card or savings account.

[3] For one of the first reports on automated overdraft programs, *see* CONSUMER FED'N OF AM. & NATIONAL CONSUMER LAW CENTER, BOUNCE PROTECTION: HOW BANKS TURN RUBBER INTO GOLD BY ENTICING CONSUMERS TO WRITE BAD CHECKS (Jan. 27, 2003), *available at* www.nclc.org/images/pdf/overdraft_loans/bounce-protection-appendix-2003.pdf.

[4] *Id.* at 7.

[5] *Id.*

[6] After many years of criticisms, some banks did limit the number of overdraft fees that they charge in a single day, capping the number at somewhere between three to as many as ten. Ten overdraft fees can still total hundreds of dollars per day. See CONSUMER FED'N OF AM., 2012 CFA SURVEY OF BIG BANK OVERDRAFT LOAN FEES AND TERMS 2 (June 27, 2012), *available at*

- Charging additional fees if the account remains overdrawn for some number of days; these fees are often referred to as "sustained" or "continuous" overdraft fees.[7]
- Extending overdrafts to debit and ATM card transactions, where previously transactions had been declined without a fee if there were not sufficient funds in an account.[8] In many cases, overdraft programs result in consumers incurring fees for transactions they would rather have denied.[9]
- Recovering both the amount of the overdraft and the associated fees, by setting off that amount against the consumer's next deposit, even if the the amount is income protected from garnishment, such as Social Security benefits.[10] Thus, the bank puts itself first in line ahead of all the consumer's other bills, including the consumer's rent or mortgage, grocery bills, or utilities.
- Reordering transactions in high-to-low order, *i.e.*, clearing transactions to an account not in the order in which they are received, but from highest to lowest in amount. As shown in detail in Section IV.B, *infra*, this practice of re-ordering transactions results in more overdrafts, and the imposition of more fees, than a chronological or other neutral method of clearing transactions.
- Promoting overdrafts to consumers, encouraging them with statements such as "Access your Paycheck Before you have it! Sound too good to be true? Well it isn't, you can now start writing checks before you get paid without the worry of returned checks."[11]
- Including overdraft limits in the available balance disclosed to consumers, thus deceiving them into believing they had more funds than they actually did, which would result in more overdrafts.

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www.consumerfed.org/pdfs/Studies.CFAOverdraftSurveyUpdateJune2012.pdf [hereinafter CONSUMER FED'N OF AM., 2012 CFA SURVEY].

[7] *Id*. at 2.

[8] *The Overdraft Protection Act of 2009, Hearing before the House Comm. on Fin. Serv.*, 111th Congr. 46 (2009) (statement of Eric Halperin, Director of the D.C. Office, Center for Responsible Lending).

[9] PEW CENTER ON THE STATES, OVERDRAFT AMERICA: CONFUSION AND CONCERNS ABOUT BANK PRACTICES 5 (May 2012) (75% of people who overdrafted in the last year preferred to have their transactions declined if there was not enough money in their account, rather than pay a $35 overdraft fee)[hereinafter PEW CENTER ON THE STATES, OVERDRAFT AMERICA]; LESLIE PARRISH, CENTER FOR RESPONSIBLE LENDING, RESEARCH REPORT: CONSUMERS WANT INFORMED CHOICE ON OVERDRAFT FEES AND BANKING OPTIONS 4 (Apr. 16, 2008), *available at* www.responsiblelending.org/overdraft-loans/research-analysis/final-caravan-survey-4-16-08.pdf [hereinafter PARRISH, INFORMED CHOICE] (73-80% of consumers surveyed would rather have their debit card transaction denied than have it covered in exchange for an overdraft fee).

[10] *See* LEAH PLUNKETT & MARGOT F. SAUNDERS, NATIONAL CONSUMER LAW CENTER, RUNAWAY BANDWAGON: HOW THE GOVERNMENT'S PUSH FOR DIRECT DEPOSIT OF SOCIAL SECURITY EXPOSES SENIORS TO PREDATORY BANK LOANS (July 2010), *available a*t www.nclc.org/images/pdf/pr-reports/runaway-bandwagon.pdf.

[11] *See* CONSUMER FED'N OF AM. & NATIONAL CONSUMER LAW CENTER, BOUNCE PROTECTION, supra note 3, at 4.

In response to these practices, federal regulators took limited measures to protect consumers. They imposed additional disclosure requirements for overdraft fees under the Truth in Savings Act[12] and prohibited the inclusion of permissible overdraft amounts in the available balance amounts provided by automated systems.[13] They required banks to obtain the consumer's opt-in consent to permit overdrafts on ATM and one-time debit card transactions.[14]

Unfortunately, these measures proved inadequate to protect consumers. For example, a number of banks repeatedly badgered or used deceptive statements to pressure consumers into opting in to debit card and ATM overdrafts.[15] Major banks threatened that "Your Debit Card May Not Work the Same Way Anymore Even If You Just Made a Deposit" and "We Need to Hear From You . . . To keep your account operating smoothly . . . To avoid any interruptions in how we service your account, we need to hear from you."[16] The disclosure required by TISA proved to be ineffective in slowing down the growth of overdraft abuses.

Thus, the number of overdrafts, and the amount of overdraft fees paid by consumers, have continued to spiral upward. Consumers paid $29.5 billion in overdraft fees in 2011, versus $10.3 billion in 2004.[17] Overdraft abuses have become widespread, as the vast majority of banks now use automated overdraft programs that impose these high fees. A study by Pew Charitable Trusts found that all ten of the largest banks in the United States, which hold nearly 60% of all deposit volume nationwide, impose these programs.[18] (However, a few banks limit their

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[12] Reg. DD, 12 C.F.R. § 1030.11.

[13] Reg. DD, 12 C.F.R. § 1030.11(c).

[14] Reg. E, 12 C.F.R. § 1005.17(b)(1).

[15] *See* LESLIE PARRISH, CENTER FOR RESPONSIBLE LENDING, BANKS TARGET, MISLEAD CONSUMERS AS OVERDRAFT DEADLINE NEARS (Aug. 5, 2010), *available at* www.responsiblelending.org/overdraft-loans/research-analysis/Banks-Target-And-Mislead-Consumers-As-Overdraft-Dateline-Nears.pdf [hereinafter PARRISH, BANKS TARGET, MISLEAD CONSUMERS]; CENTER FOR RESPONSIBLE LENDING RESEARCH BRIEF, BANKS COLLECT OPT-INS THROUGH MISLEADING MARKETING (Apr. 2011) , *available at* www.responsiblelending.org/overdraft-loans/policy-legislation/regulators/banks-misleading-marketing.html.

[16] *Id.*

[17] PEW CHARITABLE TRUSTS, STILL RISKY: AN UPDATE ON THE SAFETY AND TRANSPARENCY OF CHECKING ACCOUNTS 22 (June 2012), *available at* www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Safe_Checking_in_the_Electronic_Age/Pew_Safe_Checking_Still_Risky.pdf [hereinafter PEW CHARITABLE TRUSTS, STILL RISKY].

[18] PEW HEALTH GROUP, HIDDEN RISKS: THE CASE FOR SAFE AND TRANSPARENT CHECKING ACCOUNTS 5 (Apr. 2011), *available at* www.pewtrusts.org/uploadedFiles/wwwpewtrustsorg/Reports/Safe_Checking_in_the_Electronic_Age/Pew_Report_HiddenRisks.pdf [hereinafter PEW HEALTH GROUP, HIDDEN RISKS]. An earlier study conducted by the FDIC found that three-fourths of FDIC-supervised banks surveyed automatically paid overdrafts for a fee. *See* FEDERAL DEPOSIT INS. CORP., FDIC STUDY OF BANK OVERDRAFT PROGRAMS iii (Nov. 2008), *available at* www.fdic.gov/bank/analytical/overdraft/FDIC138_Report_Final_v508.pdf [hereinafter FDIC STUDY OF BANK OVERDRAFT PROGRAMS]

overdraft programs to only check and ACH transactions, and do not permit them on debit or ATM card transactions.)[19]

Overdraft fees disproportionately burden low- and moderate-income consumers. A Center for Responsible Lending study found that 71% of overdraft fees were shouldered by only 16% of the respondents who incurred overdrafts, and those consumers were more likely to be lower income, non-white, single, and renters when compared to the general population.[20] Respondents reporting the most overdraft incidents were those earning below $50,000.[21] A 2008 FDIC study reported that the small percentage of consumers who overdrew their accounts twenty or more times per year paid 60% of all overdraft fees.[22]

These automated overdraft programs have the effect of turning overdrafts into a form of high-cost credit for consumers, offering short-term credit at triple- or quadruple- digit annual percentage rates. The Consumer Federation of America calculated that, for a $100 overdraft repaid in two weeks, the APR for an equivalent closed-end loan would be over 2,000% at some banks.[23]

The median overdraft fee is now $35.[24] These fees almost certainly exceed the cost to the bank to process the overdraft, and serve to generate a substantial profit for the bank. Indeed, the amount of the overdrawn transaction itself is often not much greater than the fee charged for it. In 2008, the FDIC found that the median amount for overdrawn transactions is $36[25] -- yet the median overdraft fee is $35. For debit card transactions, the amount of the transaction is actually much less than the amount of the fee. The FDIC found that the average debit card transaction triggering an overdraft was $20;[26] the Center for Responsible Lending found the average transaction amount triggered by a debit card overdraft was $17.[27]

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[19] Andrew Martin, *Bank of America to End Debit Overdraft Fees*, N. Y. TIMES, Mar. 9, 2010.

[20] PARRISH, INFORMED CHOICE, *supra* note 9, at 2-3.

[21] *Id*.

[22] FDIC STUDY OF BANK OVERDRAFT PROGRAMS, *supra* note 18, at v.

[23] This report explained that:

> The cost of a $100 overdraft repaid in two weeks, adding up initial and sustained overdraft fees that would accrue in that time period, was computed as if this were a closed-end payday loan. The highest equivalent APRs are charged by Fifth Third Bank (3,250%), RBS Citizens (2,779%), PNC Bank (2,574%), and U.S. Bank (2,158%).

CONSUMER FED'N OF AM., 2012 CFA SURVEY, *supra* note 6, at 2.

[24] PEW CHARITABLE TRUSTS, STILL RISKY, *supra* note 17, at 3.

[25] FDIC STUDY OF BANK OVERDRAFT PROGRAMS, *supra* note 18, at v.

[26] *Id*.

[27] HALPERIN, *supra* note 1, at 25. This report and the FDIC Overdraft Study, *supra* note 18, use five- to six-year-old data which pre-dates the changes to Regulation E requiring opt-in to debit card overdrafts in 2009.

There is no information readily and publicly available about the current cost to the typical bank in the U.S. of an overdrawn transaction. However, banks in Australia recently admitted in litigation that their overdraft fees were not related to the amount of damages they incurred.[28]

Older information sheds light on the cost of NSF transactions. In 1985, the plaintiffs alleged in *Perdue v. Crocker National Bank*,[29] that the cost of an NSF transaction was 30 cents – or about 64 cents adjusted for inflation in 2013. A law review article indicates that the cost of an NSF transaction was 75 cents in 1974 – or $3.50 adjusted for inflation in 2013.[30] A report from South Africa seems to indicate that the current cost of processing an NSF transaction is below 5 Rand per item, or 54 cents.[31]

One would assume that the transaction costs for overdrafts would be similar. The most significant difference between an NSF versus an overdrawn transaction would be any losses from unpaid overdrafts. However, such losses are miniscule when compared to the profits from overdraft fees. Furthermore, there is precedent for the argument that such losses should not be included in the calculation of the costs of the overdraft. In the context of credit cards, federal regulators have decided that lenders should not include losses from accounts associated with late payments or over-the-limit transactions in the calculation of the cost of those violations.[32] Finally, losses are likely to be low, given that banks ensure that they are repaid by taking the overdrawn amount and associated fee from the consumer's next deposit, and many consumers have their wages or benefits automatically direct deposited to their bank accounts.

III. The Liquidated Damages Anti-Penalty Doctrine

The common law of contracts has for centuries prohibited penalty damages for the breach of a contract. In many cases, a contract will contain what is called a "liquidated damages" clause, which is an amount that the parties agree will be paid if one party breaches the contract. The common law has long held that a court will not enforce a liquidated damages provision if it

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[28] Andrews v. Australia & New Zealand (ANZ) Banking Group Ltd. [2012] HCA 30, ¶ 26 (Austl.) (noting a "concession by the ANZ [bank] that it did not determine the quantum of these fees by reference to a sum which would have constituted a genuine pre-estimate of the damage the ANZ might suffer as a consequence of permitting the overdrawing of an account").

[29] Perdue v. Crocker Nat'l Bank, 702 P.2d 503 (Cal. 1985).

[30] Howard M. Klepper, *Bank Charges for Insufficient Funds Checks*, 69 Cal. L. Rev. 599, 604 (1981).

[31] SOUTH AFRICA COMPETITION COMMISSION, BANKING ENQUIRY REPORT TO THE COMPETITION COMMISSIONER 142 (Mar. 2008), *available at* www.compcom.co.za/assets/Banking/Nonconreport/4-Penalty-Fees.pdf.

[32] 12 C.F.R. pt. 1026, supp. I, § 1026.52(b)(1)(i) cmt. 2 (hereinafter Official Interpretations of Reg. Z). The United Kingdom's Office of Fair Trading reached a similar conclusion. *See* UNITED KINGDOM OFFICE OF FAIR TRADING, CALCULATING FAIR DEFAULT CHARGES IN CREDIT CARD CONTRACTS 1, 19–22, 25 (Apr. 2006), *available at* www.oft.gov.uk/shared_oft/reports/financial_products/oft842.pdf.
One difference is that with credit cards, the periodic interest is supposed to compensate the lender for credit losses.

goes beyond a reasonable attempt to compensate for the costs as a breach and instead acts as a penalty.[33] This "anti-penalty" doctrine is well-established both in the traditional common law and in state statutes.

A standard formulation of the test for this anti-penalty doctrine is that, in order for a liquidated damages clause to be enforceable: (1) the estimate of the damages must be reasonable (*i.e.*, roughly equal to the damages that the non-breaching party would sustain upon breach); (2) the damages must be difficult to ascertain; and (3) the parties must have intended that the clause represent liquidated damages rather than act as a penalty.[34] In some cases, only the first two criteria are used.[35]

The Uniform Commercial Code (U.C.C.), which is a comprehensive model state law governing most commercial transactions, includes this anti-penalty doctrine as part of its provisions governing contracts for sales. All 50 states have adopted the U.C.C. in some version.[36] The U.C.C.'s formulation of the doctrine is slightly different than the common law formulation, stating:

> (1) Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.[37]

This anti-penalty doctrine has deep historical roots. Commentators date its origins from the Seventeenth Century[38] or the Fifteenth Century.[39] It originated in England, and is a feature in the law of other Commonwealth countries, such as Australia.[40] The doctrine originated in the courts of equity in medieval England, at a time when the use of penal bonds in contracts would commonly result in double recovery for breaches.[41] The equity courts assumed jurisdiction to

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[33] *See generally* Kenneth W. Clarkson, Roger LeRoy Miller, & Timothy J. Muris, *Liquidated Damages v. Penalties: Sense or Nonsense*, 1978 WIS. L. REV. 351 (1978); Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 554 (May 1977).

[34] Taken from Clarkson, Miller, & Muris, *supra* note 33, at 353.

[35] *Id.*

[36] Robert K. Rasmussen, *The Uneasy Case Against the Uniform Commercial Code*, 62 LA. L. REV. 1097 (2002).

[37] U.C.C. § 2-718. Since Article 2 of the U.C.C. applies only to contracts for sales, this section would not directly apply to bank accounts. However, it shows that the anti-penalty doctrine is widely accepted and adopted.

[38] Clarkson, Miller, & Muris, *supra* note 33, at 351, n.2.

[39] Goetz & Scott, *supra* note 33, at 554.

[40] *See* Andrews v. ANZ Banking Group Ltd [2012] HCA 30 (Austl.) (applying doctrine to overdraft fees; discussing history of doctrine in Great Britain).

[41] Goetz & Scott, *supra* note 33, at 554-55. *See also* Andrews v. ANZ Banking Group Ltd. [2012] HCA 30, ¶¶ 33-45 (Austl.).

limit recovery on these bonds to prevent oppression.[42] The courts of law subsequently adopted this anti-penalty doctrine. [43]

The anti-penalty doctrine derives from a fundamental principle of contract law, which traditionally has provided that the remedy for a breach is compensation to the non-breaching party for the loss resulting from breach, and does not include punitive damages.[44] As one commentator noted, the anti-penalty doctrine is "founded upon the principle that one party should not be allowed to profit by the default of the other, and that compensation, and not forfeiture, is the equitable rule; the injured party is not allowed to recover more than a just compensation or obtain a collateral advantage."[45]

Thus, courts have refused to enforce provisions that attempted to secure performance through *in terrorem* penalties, because it would overcompensate the non-breaching party.[46] Overcompensation and punitive damages can also be viewed as economically inefficient, as the discussion of the Clarkson, Miller, and Muris article below explains.

Despite its ancient and venerable history, the anti-penalty doctrine is not without its critics. A number of scholars have argued that the doctrine should be abolished on grounds of freedom of contract, economic efficiency, and even using behavioral economic decision theory.[47] One famous critic is Judge Richard Posner, who questioned the doctrine in *Lake River Corp. v. Carborundum Co.*[48] Even then, the Seventh Circuit ultimately upheld the doctrine, believing that it was in the hands of the Illinois state courts as to whether to abolish the doctrine.

Other scholars have supported the anti-penalty doctrine on various bases. One scholar has argued that liquidated damages clauses are more likely than other contract terms to be the result of flaws and limits in human cognition.[49] This scholar postulated that the doctrine serves as a protection against parties' unrealistically optimistic projections, caused by these cognitive limits, of their ability to perform an obligation. Several scholars have argued that the doctrine

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[42] Andrews v. Australia ANZ Banking Group Ltd. [2012] HCA 30, ¶ 41 (Austl.), *citing* SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS §42:15 (4th ed. 2000).

[43] Goetz & Scott, *supra* note 33, at 555.

[44] RESTATEMENT (SECOND) OF CONTRACTS, Ch. 16, Introductory Note (1981). *See also* Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145 (1970) ("courts in this country, as in most of the rest of the world, expressly reject the notion that remedies for breach of contract have punishment as a goal, and with rare exceptions, refuse to grant 'punitive damages' for breach of contract").

[45] David Brizzee, *Liquidated Damages and the Penalty Rule: A Reassessment*, 1991 B.Y.U. L. REV. 1613, 1628 (1991), *quoting* 22 AM. JUR. 2D DAMAGES § 727 (1988).

[46] *Id. See also* Clarkson, Miller, & Muris, *supra* note 33, at 358-59.

[47] Goetz & Scott, *supra* note 33; Brizzee, *supra* note 45; Larry A. DiMatteo, *Penalties as Rational Response to Bargaining Irrationality*, 2006 MICH. ST. L. REV. 883; Debora L. Threedy, *Liquidated and Limited Damages and the Revision of Article 2: An Opportunity to Rethink the U.C.C.'s Treatment of Agreed Remedies*, 27 IDAHO L. REV. 427, 460 (1990).

[48] 769 F.2d 1284 (7th Cir. 1985).

[49] Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211 (1995).

serves the purpose of economic efficiency, for example by preventing enforcement of penalty clauses that would otherwise deter breaches of contract that would actually promote economic efficiency.[50]

One of the most notable articles supporting the anti-penalty doctrine was co-authored by Professor Timothy Muris, a former chairman of the Federal Trade Commission appointed by President George W. Bush.[51] This article postulated that the anti-penalty doctrine served to promote economic efficiency, because penalty clauses that overcompensate a non-breaching party create incentives for that party to engage in tactics that induce a breach. Such breach-inducting tactics were seen as inefficient. The article argued that the doctrine should be reformulated to focus on the reasonableness of the liquidated damages amount, abandoning the other two criteria of intent and difficulty of ascertaining damages, and adding the criterion of whether the non-breaching party has the opportunity or incentive to engage in breach-inducing activities.[52]

Thus, despite challenges from academics, the anti-penalty doctrine continues to flourish, most notably in the business-to-business and employment contexts. For example, local and state bar journals discuss the need to avoid running afoul of the doctrine when drafting a liquidated damages provision in a business contract.[53] A Westlaw search of the terms "liquidated damages" and "penalty" in the same sentence reveals 238 cases from 2012 and 2013, indicating the doctrine is alive and well, since it is still being raised by parties in litigation to this day.

An example of a 21st century application of the doctrine in the employment context is the 2006 decision *Willard v. Javier*,[54] where a liquidated damages provision was invalidated because of the weaker bargaining position of one party. The Maryland Court of Special Appeals held that "a non-breaching party cannot simply survive the legal test of reasonableness, regardless of the assignment of the burden of proof, where, as in the case sub judice, the court is not dealing with a freely negotiated damages provision made between two parties of equal sophistication."[55]

Indeed, even scholars who have urged the abolition of the anti-penalty doctrine have recognized that some legal doctrine must replace it in situations where the bargaining power between the parties is unequal. These scholars have postulated that, in such cases, a penalty

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[50] Clarkson, Miller, & Muris, *supra* note 33; Mark P. Gergen, *A Defense of Judicial Reconstruction of Contracts*, 71 IND. L.J. 45 (1995); Samuel A. Rea, Jr., *Efficiency Implications of Penalties and Liquidated Damages*, 13 J. LEGAL STUD. 147 (1984).

[51] Clarkson, Miller, & Muris, *supra* note 33. Mr. Muris is currently a professor at George Mason University and also a scholar at the conservative American Enterprise Institute.

[52] Clarkson, Miller, & Muris, *supra* note 33, at 352.

[53] *See, e.g.,* George Bundy Smith & Thomas J. Hall, *Determining the Validity of Liquidated Damages Provisions*, 247 N.Y.L.J., Feb. 17, 2012, at 1; Bob Kenagy, *Using a Liquidated Damages Clause in Major Agreements for the Sale of Goods*, MICH. BAR J., Nov. 20, 2010, at 26.

[54] 899 A.2d 940 (Md. Ct. App. 2006).

[55] *Id*. at 952-953.

clause should be invalidated using the theory of unconscionability. For example, one of the earlier leading articles to urge abolition of the anti-penalty doctrine noted, "[t]he modern development of unconscionability as a unifying fairness principle presents a less costly alternative to the sweeping invalidation powers exercised under the penalty rule."[56] Another commentator put forward the notion that "[t]he key factors in the enforcement of supra-compensatory liquidated damage clauses should be those of negotiation and relative bargaining power."[57] And a third scholar argued specifically for that standard focusing on the adhesive nature of the contract, stating:

> In the context of a negotiated contract between parties of relatively equal bargaining power, such a provision should be presumptively enforceable. Courts have little need to second guess the allocation of risks represented by liquidated and limited damages in such cases. Conversely, a liquidated or limited damage provision in an adhesion context should be subjected to rigorous judicial examination against fairly strict standards.[58]

Setting aside the issue of whether these critics have adequately refuted the arguments that contractual penalties cause economic inefficiencies and exploit optimism bias that even businesspersons can suffer from, it is important to note that critics of the anti-penalty doctrine recognize the need for protections in situations where there are contracts of adhesion or unequal bargaining power.

IV. Application of the Anti-Penalty Doctrine in Consumer Financial Services

A. Limited Application of Doctrine in Financial Services

While the anti-penalty doctrine is alive and healthy in the business-to-business and employment context, one area in which the anti-penalty doctrine has not been applied with as much vigor is the context of consumer contracts, particularly consumer financial services. Its application has been limited, at best, and has been most used to void late fees. It has not been successfully applied to challenge overdraft or NSF fees.

In cases involving a variety of different types of contracts, a number of courts have struck down late fees because they acted as a penalty.[59] In particular, a late fee calculated as a percentage of

[56] Goetz & Scott, *supra* note 33, at 594.
[57] DiMatteo, *supra* note 47, at 903.
[58] Threedy, *supra* note 47, at 431.
[59] *See, e.g.*, N. Bloom & Son (Antiques), Ltd. v. Skelly, 673 F. Supp. 1260 (S.D.N.Y. 1987) (sales invoices called for interest at 2% per month on balances unpaid for more than thirty days; given amounts involved this was an impermissible penalty and thus void); *In re* Hein, 60 B.R. 769 (Bankr. S.D. Cal. 1986) ($500/day late fee was unenforceable penalty); Garrett v. Coast & So. Fed. Sav. & Loan Ass'n, 511 P.2d 1197 (Cal.

the outstanding loan balance, rather than as a percentage of the delinquent amount, may be void as a penalty.[60] (Note that the older cases involving late fees imposed by banks are probably no longer valid due to federal preemption, discussed further at the end of this section).

In contrast, litigants have not been successful in urging courts to invalidate overdraft or NSF fee provisions using the anti-penalty doctrine. Several cases from the 1980s that attempted to apply the doctrine to NSF fees were unsuccessful because the courts held that the contract did not prohibit NSF transactions, and thus they did not constitute not a breach.[61] These courts cited as determinative the fact that the bank account agreement did not explicitly prohibit a consumer from engaging in a transaction without sufficient funds. More recently, as discussed at the end of this section, challenges to NSF and overdraft fees have failed on grounds that they were preempted by federal banking laws and regulations.

The claim that NSF or overdraft transactions do not constitute a breach, and thus these fees are not penalties, is questionable. The banking industry has repeatedly asserted that the purpose of overdraft fees is to penalize consumers so that they are deterred from overdrawing their accounts. For example, in 2008, the then-President and CEO of the American Bankers Association, a trade group for the banking industry, stated that "Overdraft fees are meant as a deterrent. … Just as a parking ticket discourages a driver from parking in a handicapped spot, overdraft fees are meant to discourage customers from overdrawing their accounts."[62]

Similarly, a spokeswoman for the same group stated that:

1973) (liquidated damages analysis; late fee was unrelated to actual damages incurred); Beasley v. Wells Fargo Bank, N.A., 1 Cal. Rptr. 2d 446 (Cal. Ct. App. 1991) (late charge calculated to include indirect costs and collection agency expenses did not constitute good faith effort to compensate for damage caused by a specific default). *See also* Begelfer v. Najarian, 409 N.E.2d 167, 186 (Mass. 1980) (finding late charge usurious on other grounds; it would also be unenforceable as an unreasonable, unconscionable, and oppressive penalty); Funding Group, Inc. v. Water Chef, Inc., 852 N.Y.S.2d 736 (N.Y. Sup. Ct. 2008) (late fee provision awarding the equivalent of 120% per year penalty unreasonable and "confiscatory" in light of public policy of the criminal usury statute; business case).

[60] *See* Garrett v. Coast & So. Fed. Sav. & Loan Ass'n, 511 P.2d 1197 (Cal. 1973). *See also In re* Jordan, 91 B.R. 673 (Bankr. E.D. Pa. 1988) (1.5% monthly late fee calculated on full amount of delinquency impermissible for a variety of reasons, *inter alia* late charges excessive in relation to creditor's damage an unenforceable penalty); Johnnycake Mountain Assocs. v. Ochs, 2006 WL 538109 (Conn. Super. Ct. Jan. 18, 2006) (calculating late fee as percentage of balloon payment was so disproportionate as to be a penalty and was thus unenforceable), *aff'd in part, rev'd in part on other grounds*, 932 A.2d 472 (Conn. Ct. App. 2007); Velenchik v. First Union Nat'l Bank, 2003 WL 21152967 (Conn. Super. Ct. May 7, 2003) (calculating late fee on balloon payment was penalty and thus unenforceable).

[61] *See* Perdue v. Crocker Nat'l Bank, 702 P.2d 503 (Cal. 1985); Jacobs v. Citibank, N.A., 462 N.E.2d 1182 (N.Y. 1984); Best v. U.S. Nat'l Bank of Or., 739 P.2d 554, 563 (Or. 1987). *See generally* James J. White, *NSF Fees*, 68 OHIO ST. L.J. 185 (2007) (collecting cases).

[62] Edward Yingling, *Fees Are A Deterrent: Banks Offer Several Ways To Keep Consumers From Overdrawing*, USATODAY, June 23, 2008, at 11A.

> While institutions have historically paid overdrafts for good customers as an accommodation, and it may be appropriate to do so, the amount of the fee is intended to encourage customers to manage and monitor their accounts and maintain a positive balance. *A positive balance is the desired goal of both the institution and the customer*. Because the fee is intended as a deterrent, rationally and intuitively, we expect that the amount of a fine does impact behavior, much as parking tickets discourage illegal parking. If parking illegally in rush hour were $10, we would expect many would find commuting times much longer. [63]

Thus, representatives of the banking industry have affirmatively claimed that overdraft and NSF fees are intended to deter unwanted behavior. An overdraft or NSF transaction, if not formalistically a breach, is an activity that banks claim they are trying to prevent consumers from engaging in. Furthermore, if the banks were to ever claim that an overdraft fee is not a deterrent, but a price for a service they are offering, then that service would be credit. This is because the service is the use of the bank's funds, not the consumer's funds, to pay for a transaction, which is quintessentially credit.

Courts in other countries have recognized that they should go beyond the formal categorization of an act as a breach to determine whether to apply the anti-penalty doctrine in consumer financial services. Most significantly, the High Court of Australia issued a decision in September 2012 in *Andrews v. ANZ Banking Group*, holding that the anti-penalty doctrine should be applied, whether or not there is a formal breach, to any fee that is intended to secure the fulfillment or non-fulfillment of a condition.[64] The *Andrews v. ANZ Banking Group* decision involved both overdraft fees (called an "honour fee" in Australia) and NSF fees (called a "dishonour" fee), as well as credit card over-the-limit fees, and held all of them could be subject to the anti-penalty doctrine even if they were not formal breaches. In its decision, the High Court relied heavily on the development of the anti-penalty doctrine in both the English and American case law, dating back to the Seventeenth Century, noting its roots in equity as well as the common law.

The High Court of Australia did make a distinction between a fee that is paid to secure the occurrence or non-occurrence of some condition, and a fee that is paid as the price for the exercise of a right or option to obtain a benefit. The High Court remanded the case back to the lower court to determine whether overdraft, NSF and over-the-limit fees were indeed security for the performance by consumers of their obligations to the bank, and thus should be subject to the anti-penalty doctrine, or whether they were the price of a benefit or option provided to the

[63] Nessa Feddis, Vice President and Senior Counsel, *Comments from the American Bankers Association Re: OTS-2010-0008: Proposed Supplemental Guidance on Overdraft Protection Programs* 33 (June 28, 2010) (emphasis added).
[64] Andrews v. ANZ Banking Group Ltd. [2012] HCA 30 (Austl.).

consumer.[65] Thus, at least in Australia, the fact that an overdraft or NSF fees is not technically a breach of contract will not stop the application of the anti-penalty doctrine.

More recently in the United States, courts have used preemption to avoid applying the anti-penalty doctrine to overdraft or NSF fees. These cases have held that any state regulation of fees imposed by federally-chartered banks, including overdraft fees, NSF fees, or credit card penalty fees, are preempted by federal banking regulation. In general, federally-chartered banks have a benefit afforded to few other industries in that federal banking law allows them to ignore certain state laws.[66] In the case of fees such as overdraft or late fees, this includes both state statutes as well as common law doctrines and the U.C.C. For example, in *In re Late and Over-Limit Fee Litigation*,[67] a federal district held that "any claims that the defendants' [credit card late and over-the-limit] fees violated the contractual doctrines of liquidated damages or the like are pre-empted" by Section 85 of the National Bank Act.[68] With respect to overdraft fees, the Ninth Circuit has held that "federal law preempts state regulation of the posting order" of transactions, including posting orders that maximize overdraft fees.[69] These state laws included California's Unfair Competition Law and the U.C.C.[70]

The doctrine of preemption does not change the importance of preventing excessive and unreasonable penalties, especially when they create incentives to engage in unfair, deceptive or abusive practices to induce overdrafts. Even if common law anti-penalty doctrine is preempted in the context of overdraft and NSF fees, that only means that the onus is on federal regulators, and not state common laws, to prevent excessive and unreasonable penalties that put banks at odds with their customers.

B. The Anti-Penalty Doctrine Is Most Needed in Consumer Financial Services

The limited application of the anti-penalty doctrine in the consumer financial context is ironic, since one of the rationales to preserve the doctrine is that penalty clauses may be the result of unequal bargaining power and unconscionability. It is harder to imagine a situation with more

[65] And, as discussed above, if the court considers the overdraft fee to the price of the exercise of a benefit, then it should recognize that the benefit is actually credit.
[66] *See generally* NATIONAL CONSUMER LAW CENTER, CONSUMER CREDIT REGULATION Ch. 3 (2012).
[67] 528 F. Supp. 2d 953 (N.D. Cal. 2007).
[68] *Id.* at 960, *citing* Smiley v. Citibank (S.D.), N.A., 517 U.S. 735, 744, 116 S. Ct. 1730, 135 L. Ed. 2d 25 (1996).
[69] Gutierrez v. Wells Fargo Bank, 704 F.3d 712, 716 (9th Cir. 2012).
[70] *Id.* The Ninth Circuit's decision specifically concluded that OCC Interpretive Letters preempted any restrictions on posting practices imposed by the California Unfair Competition Law. However, the District Court's decision had also relied in part on a non-uniform Legislative Comment to the California version of Section 4-303(b) of the U.C.C., which presumably the Ninth Circuit also believed preempted. Gutierrez v. Wells Fargo Bank, 730 F. Supp. 2d 1080, 1120-21 (N.D. Cal. 2010), *aff'd in part, rev'd in part*, 704 F.3d 712, 716 (9th Cir. 2012).

unequal bargaining power, and more fraught with the potential of unconscionability, than consumer financial services.

On one hand are the banks and lenders that draft the agreements, which are often multi-million or billion dollar corporations that have sophisticated lawyers to develop provisions most favorable to these corporations. On the other hand are the individual consumers who are faced with take-it-or-leave it contracts of adhesion that they cannot negotiate.

Indeed, bank account agreements are particularly vulnerable to abuse. Not only are they contracts of adhesion, many consumers do not even sign the actual account agreement. Instead, the document that these consumers sign is a signature card, which incorporates the terms of the account agreement by reference.[71] The actual agreement they might later receive is an extremely long, dense document, often full of technical language that the average consumer would find difficult to understand. At one point, a study by the Pew Charitable Trusts found that the median length of an account agreement plus other disclosures was 69 pages.[72] Federal law currently does not mandate any sort of standardized easy-to-read disclosure, such as exists with credit cards, for bank accounts.

Furthermore, provisions that benefit banks or creditors at the expense of consumers in these contracts of adhesion are almost universal. The only option for consumers to avoid a contract provision with which they disagree is to purchase the services from a competitor. Yet for consumer financial services, market share is often concentrated in the hands of a few players that all use the same onerous provisions. As discussed above, the Pew Charitable Trusts found that all ten of the largest banks in the United States, which hold nearly 60% of all deposit volume nationwide, engage in the practice of automatically covering check and ACH overdrafts and charging a hefty penalty fee.[73] Not only that, 10 out of the top 12 credit unions – financial institutions supposedly formed for the benefit of their customers/shareholders - also use automated overdraft programs (although their median overdraft fee is somewhat lower at $25).[74]

The widespread nature of complicated practices designed to increase overdraft fees also shows why it is important that the anti-penalty doctrine be applied to prevent the non-breaching party from making a profit from a breach. Not only are super-compensatory damages contrary to a fundamental principle of contract law, they have practical consequences because they create incentives to induce the party to breach. Thus, the failure to apply the anti-penalty doctrine to

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[71] *See* Perdue v. Crocker Nat'l Bank, 702 P.2d 503 (Cal. 1985) (signature card is a contract and, through it, bank may set NSF charges, collecting cases). *See also* Bank of America, Frequently Asked Questions, at www.bankofamerica.com/deposits/manage/faq-applying-for-accounts.go (visited Mar. 27, 2013); JPMorgan Chase, Opening Bank Accounts, at www.chase.com/cm/shared/crb/page/aOpeningAccount.html (visited April 17, 2013).

[72] PEW CHARITABLE TRUSTS, STILL RISKY, *supra* note 17, at 7.

[73] PEW HEALTH GROUP, HIDDEN RISKS, *supra* note 18, at 5.

[74] PEW CHARITABLE TRUSTS, STILL RISKY, *supra* note 17, at 20.

consumer financial services has directly led to the proliferation of abusive practices designed to maximize overdraft fees.

The Clarkson, Miller, and Muris article includes an example of how super-compensatory damages create an incentive for one party (in that case, the purchaser of a product) to induce or force a breach of the contract by the other party (in that case, the producer of the product).

Table 1: Table from Clarkson, Miller, and Muris Article[75]

Situation	Stipulated Damages Clause	Actual Damages	Stipulated Damages Paid to Purchaser	Change in Parties' Incentives
1	$500/day	None, project is completed on time	None	No incentive to induce breach if clause reflects actual damages.
2	$500/day	Ten days late with purchaser's actual damages $5,000	$5,000 (clause enforced).	No incentive to induce breach since amount of clause equals actual damages.
3(a)	$500/day	Ten days late with purchaser's damages zero, known to both parties prior to original completion date.	None (clause declared a penalty).	Purchaser does not alter behavior since there is no incentive to induce breach when clause is not enforced.
(b)	$500/day	Same as 3(a).	$5,000 (clause enforced).	Purchaser has incentive to engage in breach-inducing activities since purchaser who faces no harm from delay can obtain $500 additional revenue for each day's delay

[75] Clarkson, Miller, & Muris, *supra* note33, at 369.

Applying this example to overdraft fees, one can see exactly why banks have been so aggressive and eager to utilize tactics to induce overdrafts.

Situation	Overdraft Fee Clause	Actual Damages	Overdraft Fee Paid to Bank	Change in Parties' Incentives
1	$35.00/occurrence	None, no overdrafts	None	None
2	$35.00/occurrence	Overdraft; bank's actual cost is $35.00	$35.00 (clause enforced).	No incentive to induce breach since amount of clause equals actual damages.
3(a)	$35.00/occurrence	Overdraft; bank's actual cost is $3.50.[76]	None (clause declared a penalty).	Bank does not alter behavior since there is no incentive to induce breach when clause is not enforced.
(b)	$35.00/occurrence	Same as 3(a).	$35.00 (clause enforced).	Bank has incentive to induce breach through tactics discussed below, since bank that faces low damages of only $3.50 from overdraft can obtain $31.50 additional revenue for each overdraft.

Situation 3(b) is exactly what occurs currently with respect to overdraft fees. The failure to apply the anti-penalty doctrine to gives banks a tremendous incentive to engage in practices that induce more overdrafts, both enriching the bank's bottom line and harming vulnerable consumers.[77] These breach-inducing activities include those tactics described in Section II, *supra*, such as:

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

[76] Using the assumption from Section II, *supra*, that overdraft fees cost $3.50 per transaction.

[77] Clarkson, Miller, & Muris do postulate that penalty clauses in lending should be upheld because they believed there is no way a lender could induce a breach in that context. Unfortunately, this assumption has proven to be entirely untrue. Banks have developed many "tricks and traps" to induce breach. In addition to high-to-low posting order in the overdraft context, in the credit card context, lenders used hair trigger tactics in order to treat payments as late. One example was setting payment cutoff times early in the morning, so that a payment received on the due date could be treated as late. *See* NATIONAL CONSUMER LAW CENTER, CONSUMER CREDIT REGULATION § 8.6.1. (2012). The tactics used in the credit card context to induce breach were so abusive, Congress felt the need to specifically address them in the Credit CARD Act.

TABLE 2: **From *Gutierrez v. Wells Fargo*: The Effect of High-to-Low Posting Order**

High-to-Low Posting: How the bank ordered transactions

DATE	TRANSACTION DESCRIPTION	$ +/–	BALANCE
10/5	**Starting Balance**		**$316.90**
10/5 – 5	Return of Autozone purchase	$17.23	
			$334.13
10/10 – 1	Online transfer of funds to another account	–$80.00	
			$254.13
10/6 – 3	ATM withdrawal at a Non-Wells Fargo ATM	–$22.00	
			$232.13
10/6 – 4	Non-Wells Fargo ATM fee	–$2.00	
			$230.13
10/7 – 1	Debit card purchase at Albertsons Supermarket	–$74.39	
			$155.74
10/10 – 2	Check #1103	–$65.00	
			$91.74
10/5 – 2	Debit card purchase at Autozone	–$47.99	
			$42.75
10/6 – 1	Debit card purchase at IHOP Restaurant	–$26.51	
			$16.24
10/5 – 3	Debit card purchase at Autozone	–$17.23	
			-$0.99
	Overdraft Penalty Fee	–$22.00	
			–$22.99
10/5 – 1	Debit card purchase at Subway Restaurant	–$11.27	
			–$34.26
	Overdraft Penalty Fee	–$22.00	
			–$56.26
10/6 – 2	Debit card purchase at Farmer Boys Restaurant	–$8.10	
			–$64.36
	Overdraft Penalty Fee	–$22.00	
			–$86.36
10/5 – 4	Debit card purchase at Autozone	–$3.23	
			–$89.59
	Overdraft Penalty Fee	–$22.00	
10/10	***Final Balance***		***–$111.59***
	Total Cost of Overdraft Fees		**–$88.00**

Chronological Posting: How the transactions actually occurred

DATE	TRANSACTION DESCRIPTION	$ +/–	BALANCE
10/5	**Starting Balance**		**$316.90**
10/5 – 1	Debit card purchase at Subway Restaurant	–$11.27	
			$305.63
10/5 – 2	Debit card purchase at Autozone	–$47.99	
			$257.64
10/5 – 3	Debit card purchase at Autozone	–$17.23	
			$240.41
10/5 – 4	Debit card purchase at Autozone	–$3.23	
			$237.18
10/5 – 5	Return of Autozone purchase	$17.23	
			$254.41
10/6 – 1	Debit card purchase at IHOP Restaurant	–$26.51	
			$227.90
10/6 – 2	Debit card purchase at Farmer Boys Restaurant	–$8.10	
			$219.80
10/6 – 3	ATM withdrawal at a Non-Wells Fargo ATM	–$22.00	
			$197.80
10/6 – 4	Non-Wells Fargo ATM fee	–$2.00	
			$195.80
10/7 – 1	Debit card purchase at Albertsons Supermarket	–$74.39	
			$121.41
10/10 – 1	Online transfer of funds to another account	–$80.00	
			$41.41
10/10 – 2	Check #1103	–$65.00	
			–$23.59
	Overdraft Penalty Fee	–$22.00	
10/10	***Final Balance***		***–$45.59***
	Total Cost of Overdraft Fees		**–$22.00**

Note: Data in this chart were taken directly from the opinion in *Gutierrez v. Wells Fargo Bank*. The left column illustrates how Wells Fargo was able to charge Ms. Gutierrez four overdraft penalty fees (a total of $88) through manipulating the posting order to deplete her balance more quickly. The right column shows what the balance would have been had the transactions been posted chronologically. In the second scenario, Ms. Gutierrez would have been charged only a single $22 overdraft penalty fee.[70]

- promoting overdrafts to consumers, and encouraging them to use overdrafts as a source of credit;
- including overdraft limits in the available balance disclosed to consumers; into opting in to debit card and ATM overdrafts; and
- re-ordering checks and other debits in high-to-low order in order to maximize the number of overdraft fees that are charged.

The most pernicious and ruthlessly effective of the breach-inducing tactics is the last one. The chart on the preceding page, taken from a Pew Charitable Trusts study, shows how the practice of re-ordering transactions results in significantly more overdrafts, and the imposition of more fees, than a neutral chronological posting of transactions.[78]

Indeed, one commentator had presciently predicted in 1981 the advent of high-to-low transaction re-ordering because of the financial incentive of a fee (then NSF fees) that is much greater than the actual costs of the transgression.[79] And the federal judge in the *Gutierrez v. Wells Fargo* case had harsh words for this practice, characterizing it as:

> a trap - a trap that would escalate a single overdraft into as many as ten through the gimmick of processing in descending order. It then exploited that trap with a vengeance, racking up hundreds of millions off the backs of the working poor, students, and others without the luxury of ample account balances.[80]

It is precisely the failure to apply the anti-penalty doctrine to overdraft fees that has led to these breach inducing traps. Indeed, the decision in the *Gutierrez* case discusses Wells Fargo's internal bank memos that document how the bank deliberately engineered its practices to maximize overdrafts, *i.e.*, induce breaches:

> Internal bank memos and emails leave no doubt that, overdraft revenue being a big profit center, the bank's dominant, indeed sole, motive was to maximize the number of overdrafts and squeeze as much as possible out of what it called its "ODRI customers" (overdraft/returned item) and particularly out of the four percent of ODRI customers it recognized supplied a whopping 40 percent of its total overdraft and returned-item revenue. This internal history-which is laid bare in the bank's internal memos-is so at odds with the bank's theme of "open and honest" communication and that "overdrafts must be discouraged" that the details will be spread herein. … Internal bank memos were presented at trial pertaining to a bank-wide strategic plan called "Balance Sheet Engineering"-or "BSE" for short (see, e.g., TX 36, 61). The documents and testimony surrounding the BSE plan provided clear evidence that the challenged practices were

[78] This table is reproduced from PEW HEALTH GROUP, HIDDEN RISKS, *supra* note 18, at 16.
[79] Klepper, *supra* note 30, at 606.
[80] Gutierrez v. Wells Fargo Bank, 730 F. Supp. 2d 1080, 1119 (N.D. Cal. 2010), *aff'd in part, rev'd in part*, 704 F.3d 712, 716 (9th Cir. 2012).

implemented for no other purpose than to increase overdrafts and overdraft fee revenue.[81]

V. Revival of the Anti-Penalty Doctrine

The anti-penalty doctrine has been partially revived in the context of credit cards through the Credit Card Accountability, Responsibility, and Disclosures (CARD) Act of 2009. That Act provides a model for applying the doctrine to overdraft fees as well.

The Credit CARD Act requires that penalty fees for credit cards be "reasonable and proportional" to the omission or violation to which they related.[82] The genesis of this standard was the anti-penalty doctrine as derived from the common law, which was specifically cited when consumer advocates suggested this language to congressional drafters.[83]

The Credit CARD Act required the Federal Reserve Board to issue regulations establishing standards for assessing whether the amount of a penalty fee is reasonable and proportional.[84] In writing these regulation, the Act required the Federal Reserve to consider:

(1) the cost incurred by the creditor from the omission or violation;
(2) the deterrence of the omission or violation;
(3) the conduct of the cardholder; and
(4) any other factors as the Federal Reserve may deem necessary or appropriate.

The Federal Reserve issued regulations limiting the dollar amount of penalty fees to either: (1) a reasonable proportion of the credit card company's total costs as a result of that type of violation or (2) an amount within the safe harbors that are established by regulation.[85] The Federal Reserve set the safe harbors at $25 for the first violation and $35 for each violation thereafter of the same type during the next six months.[86] Deterrence and consumer conduct are not separate factors that a creditor may consider, but they are implicitly built into the safe harbor.[87]

Credit card penalty fees are also subject to certain bright-line limits or prohibitions. They cannot exceed the dollar amount associated with the violation or omission, *e.g.*, a lender cannot charge a $25 late fee for an amount due of $15.[88] No penalty fee may be charged if there is no dollar

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[81] *Id.* at 1097.
[82] 15 U.S.C. § 1665d(a).
[83] Personal recollection of author.
[84] 15 U.S.C. § 1665d(b).
[85] Reg. Z § 1026.52(b)(1).
[86] Reg. Z § 1026.52(b)(1)(ii)(A).
[87] 75 Fed. Reg. 37,526, 37,532 - 34 (June 29, 2010).
[88] Reg. Z, 12 C.F.R. § 1026.52(b)(2)(i)(A).

amount associated with the violation; thus, fees are prohibited for declined transactions, account inactivity, and account closure.[89]

The Credit CARD Act's requirement for reasonable and proportional penalty fees could be one avenue to restore the concept of "reasonableness" and the anti-penalty doctrine to overdraft fees, at least when applied to overdrafts accessed by debit card. The Credit CARD Act is part of the Truth in Lending Act (TILA). As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Consumer Financial Protection Bureau (CFPB) now has authority to issue regulations to interpret TILA's provisions.[90]

The CFPB could apply the reasonable and proportional standard to overdrafts accessed by debit cards by treating them as "credit cards" under the Credit CARD Act. This is possible because TILA, which includes the Credit CARD Act, has a broad definition of credit card as "any card, plate, coupon book or other credit device existing for the purpose of obtaining money, property, labor or services on credit."[91] Overdrafts do serve as a form of credit, in that TILA defines credit as "the right granted by a creditor to a debtor to defer payment of a debt or to incur debt and defer its payment."[92] Thus, a debit card that access overdraft credit can be considered a type of "credit card."

The requirement for reasonable and proportional penalty fees applies to a subset of credit cards, for which the Credit CARD Act uses the phrase "credit cards under an open-end (not home-secured) consumer credit plan."[93] This phrase is undefined in the Act. Currently, Regulation Z defines this phrase to exclude cards that access overdraft credit.[94] But this exclusion is not in the statute.

Under the broader, more general definition of "credit card" under Regulation Z, debit cards that access overdraft lines of credit can be considered to be "credit cards."[95] Regulation Z could be similarly amended to broaden the phrase "credit cards under an open-end (not home-secured) consumer credit plan" to include debit cards that access any form of overdraft. This would subject fees for all overdrafts accessed by debit card to the reasonable and proportional standard.

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[89] Reg. Z, 12 C.F.R. § 1026.52(b)(2)(i)(B).
[90] Pub. L. No. 111-203, § 1100A(2), 124 Stat 1376 (July 21, 2010).
[91] 15 U.S.C. § 1602(k).
[92] 15 U.S.C. § 1602(e). With overdrafts, the bank permits the consumer to incur a debt by using the bank's funds to pay a transaction, and permits deferral of the payment until the consumer's next deposit. *See generally* NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING § 2.5.8 (8th ed. 2012).
[93] 15 U.S.C. § 1665d.
[94] 12 C.F.R. § 1026.2(a)(15)(ii).
[95] Official Interpretations of Reg. Z, 12 C.F.R. § 1026.2(a)(15)-2 ("Examples of credit cards include: A. A card that guarantees checks or similar instruments, if the asset account is also tied to an overdraft line").

Applying the reasonable and proportional standard to overdraft fees would restore the key element of the anti-penalty doctrine to consumer bank accounts. Note that applying this standard should not necessarily result in the same safe harbor amounts of $25 and $35 that the Federal Reserve established for credit card penalty fees. For one thing, banks currently impose a far greater number of overdraft fees on each individual consumer than credit card lenders impose. With credit cards, lenders almost always impose only one fee of each type per month (billing cycle), because they cannot impose more than one fee for a single violation[96] and almost all violations (late payment, returned payment) occur only once per month. The exception is over-the-limit transactions, but the Credit CARD Act prohibits imposing more than one over-the-limit fee per month (billing cycle).[97] In contrast, consumers often incur several overdraft fees, not just in the same month, but in the same day. Thus the costs of running an overdraft program would be spread out over more individual fees, resulting in lower costs per overdrawn transaction. Alternatively, the CFPB could set a safe harbor for overdraft penalty fees of $25 or $35, but limit them to one per month by treating them as a type of over-the-limit fee.

VI. Overdraft Practices Are Unfair, Deceptive, and Abusive Under the Dodd-Frank Act

Another avenue for the CFPB to require that overdraft fees be reasonable and proportional is to use the Bureau's authority to prevent unfair, deceptive, or abusive practices.[98] The Dodd-Frank Act endows the CFPB with this new authority, permitting the agency to issue regulations to prohibit or prevent unfair, deceptive, or abusive practices.[99] As discussed below, unreasonable, disproportionate overdraft fees meet the definition of "unfairness" and "abusiveness," and they give rise to deceptive practices.

A. Unfairness

The Act defines what is "unfair" by incorporating the definition found in the Federal Trade Commission Act (FTC Act),[100] which is:

> (A) the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers; and
> (B) such substantial injury is not outweighed by countervailing benefits to consumers or to competition.[101]

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[96] Reg. Z § 1026.52(b)(2)(ii).
[97] 15 U.S.C. § 1637(k)(7).
[98] 12 U.S.C. § 5531.
[99] *Id.* at § 5531(b).
[100] 15 U.S.C. § 45(n).
[101] 12 U.S.C. § 5531(c)(1).

In applying the "substantial injury" factor, it is important to note that the definition refers to a practice that causes "or is *likely*" to cause injury, so both actual harm and risk of harm should be considered. Consumer injury may be "substantial" if a relatively small harm is inflicted on a large number of consumers or if a greater harm is inflicted on a relatively small number of consumers.[102] Given the sheer magnitude of overdraft fees - $29.5 billion in 2011 – there can be no question that they amount to a substantial injury. Even when the harm is examined per consumer rather than in the aggregate, it is substantial, given that overdraft fees cost from $215 to $1,600 per year on average for the small percentage of consumers that pay the vast bulk of overdraft fees.[103]

Excessive and unreasonable overdraft fees are also not reasonably avoidable. The analysis of whether an injury is reasonably avoidable by consumers should be based on the reasonable consumer, not the perfect consumer. Accordingly, the analysis should take into consumers' likely knowledge gaps and their optimism bias, which has been shown by behavioral economics research.[104] The information differential between banks and consumers is stark. As discussed in Sections II and III.B, *supra*, banks use sophisticated systems to keep track of consumers' transactions and maximize overdrafts. In contrast, behavioral economics research shows that consumers are over-optimistic and tend to discount the likelihood of negative events.[105] Nor do they have the capacity to quickly and accurately assess the risks associated with such contingencies.[106] This gives banks the opportunity to attract consumers with, for example, a promise of "free checking," while at the same time charging high fees for overdrafts and engaging practices to maximize them that will far outstrip any savings from lack of a monthly maintenance fee. As a result, overdraft and their associated fees may not be reasonably avoidable by consumers—especially the lower-income consumers who bear the brunt of these fees.

Excessive overdraft fees promise such enormous profits for banks that they distort market forces. They create pressure across the banking industry to adopt high overdraft fees on a standardized, homogeneous basis, and to push consumers into incurring these fees. Indeed, the mere fact that consumers paid $29.5 billion in overdraft fees in 2011, in some cases for

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[102] *See* NATIONAL CONSUMER LAW CENTER, UNFAIR AND DECEPTIVE ACTS AND PRACTICES § 4.3.2.2 (8th ed. 2012).

[103] FDIC STUDY OF BANK OVERDRAFT PROGRAMS, *supra* note 18, at iv (finding that customers with 5 or more overdrawn transactions paid 93.4% of total overdraft fees for 12-month period; customers with 5 to 9 overdrawn transactions were charged $215 per year in fees on average; customers with 10 to 19 overdrawn transactions were charged $451 per year in fees on average; and customers with 20 or more overdrawn transactions were charged $1,610 per year in fees on average).

[104] *See* NATIONAL CONSUMER LAW CENTER, UNFAIR AND DECEPTIVE ACTS AND PRACTICES § 4.3.2.3.2 (8th ed. 2012).

[105] *See, e.g.*, RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 31-33 (Yale Univ. Press 2008). *See also* Debra Pogrund Stark & Jessica M. Choplin, *A License to Deceive: Enforcing Contractual Myths Despite Consumer Psychological Realities*, 5 N.Y.U. J.L. & BUS. 617, 659-660 (2009).

[106] Stark & Choplin, *supra* note 105, at 667.

transactions that they would have preferred be declined without a fee,[107] is strong evidence of the difficulty consumers have in avoiding these fees.

The distortion of market forces caused by excessive and unreasonable overdraft fees also make them not reasonably avoidable by consumers. The very nature of breach-inducing activity is designed to result in more overdrafts without the consumer's active participation. The harm caused by high-to-low posting is particularly problematic. It is out of consumers' control, and the entire practice is invisible to them.

Unreasonable, disproportionate overdraft fees are not outweighed by benefits to consumers or to competition. To the contrary, they harm competition by giving banks the incentive to engage in economically harmful breach-inducing actions, transforming what should be a banking system that serves consumers into a system of "gotchas."

B. Deception

The Dodd-Frank Act does not define what constitutes a "deceptive" practice, but the FTC's definition of deception is broad. The FTC will find deception "if there is a representation, omission *or* practice that is *likely to mislead* the consumer acting reasonably in the circumstances, to the consumer's detriment."[108] The representation, omission, or practice must also be material.[109] If the representation or practice affects or is directed primarily to a particular group, the FTC examines reasonableness from the perspective of that group.[110]

Because they incentivize banks to induce breaches, disproportionately high overdraft fees have given rise to a number of practices that are deceptive. As discussed above, banks used misleading solicitations and pressuring tactics to induce consumers into opting in to one-time debit card and ATM overdrafts. A survey conducted by the Pew Center on the States found that 54% of consumers who had overdrawn their accounts in 2011 with an ATM or one-time debit card transaction did not think they had opted in.[111] A Center for Responsible Lending study found that 60% of consumers who opted in did so because they believe it would avoid a fee if their debit card was declined.[112] In fact, a declined debit card transaction costs consumers nothing, while opting-in will result in imposition of high overdraft fees if a debit card overdraft occurs. The banks created the misleading impression that opting-in would save consumers

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[107] PEW CENTER ON THE STATES, OVERDRAFT AMERICA, *supra* note 9, at 5 (75 percent of people who had overdrafted in the last year would prefer to have their transaction declined rather than pay a $35 overdraft fee); PARRISH, INFORMED CHOICE, *supra* note 9, at 4 (73-80% of consumers surveyed would rather have their debit card transaction denied than have it covered in exchange for an overdraft fee).
[108] *In re* Cliffdale Assoc., 103 F.T.C. 110 (1984) (analyzing meaning of "deception" in detail in an appendix).
[109] *Id.*
[110] *Id.*
[111] PEW CENTER ON THE STATES, OVERDRAFT AMERICA, *supra* note 9, at 4.
[112] PARRISH, BANKS TARGET, MISLEAD CONSUMERS, *supra* note 9, at 2.

money, when in fact it it was the opposite – declining to opt-in would result in no fees, while opting-in put consumers at risk of high fees.

Banks also engage in deceptive practices with the the practice of re-ordering transactions to maximize overdraft fees. The court in the *Gutierrez v. Wells Fargo* case specifically noted:

> the bank went to lengths to hide [high-to-low posting] practices while promulgating a facade of phony disclosure. The bank's own marketing materials were deceptive in leading customers to expect purchases to be debited in the order made (rather than to be resequenced in high-to-low order). [113]

The court went on to describe how the disclosure regarding posting order in the bank's account agreement created "the the misleading impression that Wells Fargo had not yet chosen to post in the order of the highest dollar amount to the lowest dollar amount or that it would exercise discretion on a case-by-case basis" and that "the 'disclosure' on posting order was buried within a sea of single-spaced text stretching over 60 pages in tiny ten-point font."[114]

Finally, viewing overdrafts as credit, the banks' practices are deceptive in that overdrafts are not directly offered as credit or subject to credit disclosures. Consumers are not told how much overdraft credit they will be given or even whether overdrawn items will be covered. Indeed, in order to induce consumers to opt in to overdraft coverage for debit and ATM cards and yet stay within loopholes in the Truth in Lending Act, banks imply that they will cover overdrafts while actually stating that they retain discretion not to do so.

All of these deceptive practices are the result of a simple fact – that disproportionate and unreasonably high overdraft fees create incentives for banks to use any measures possible – including deceptive ones - to maximize overdrafts. Thus, a rule that limits overdraft fees to a reasonable and proportional amount will prevent these and other deceptive practices.

C. Abusive

The Dodd-Frank Act defines a practice as "abusive" if the CFPB finds that it:[115]

> (1) Materially interferes with a consumer's ability to understand a term or condition of a consumer financial product or service; or
> (2) Takes unreasonable advantage of—
>> (A) A consumer's lack of understanding of the material risks, costs, or conditions of the product or service;

[113] Gutierrez v. Wells Fargo Bank, 730 F. Supp. 2d at 1112-13 (N.D. Cal. 2010), *aff'd in part, rev'd in part*, 704 F.3d 712, 716 (9th Cir. 2012).
[114] *Id*. at 1113.
[115] *12* U.S.C. § 5531(c)(2)

(B) A consumer's inability to protect his or her own interests when selecting or using a product or service; or
(C) The consumer's reliance on a covered person.

This standard has no pre-existing counterpart in the FTC Act. It includes some of the elements of unconscionability under the common law[116] and state UDAP statutes,[117] but is significantly less demanding. For example, many UDAP statutes define unconscionable practices to include taking advantage of a consumer's inability to protect his or her interests, but only where the inability arises from specified causes such as physical infirmity, ignorance, or illiteracy.[118] The Dodd-Frank standard allows a finding of abusiveness without these factors. The standard is also broader than the definition of unconscionability in many state UDAP statutes in that it does not require a showing that the financial services provider acted knowingly when it took advantage of the consumer.

In addition, the Dodd-Frank standard is broader than the definition of unconscionability that courts have used when applying the U.C.C. and common law. Those courts have often required a showing of both procedural unconscionability, *i.e.* oppression or unfair surprise in the process of forming the contract, and substantive unconscionability, *i.e.* terms that are unreasonably, unacceptably, or unfairly harsh. A common test for substantive unconscionability is whether the contract terms "shock the conscience."[119] The Dodd-Frank definition does not require any showing of procedural unconscionability beyond materially interfering with a consumer's ability to understand a term or condition, or taking unreasonable advantage of the consumer. It does not require any showing of substantive unconscionability, much less a showing as strong as "shocking to the conscience."

As discussed in Section III, *supra*, commentators have argued that provisions that provide for punitive liquidated damages in contracts of adhesion should not be enforced because they are unconscionable. If such provisions would be unconscionable under the common law and prohibited by the U.C.C., they should be considered abusive as well. Disproportionately high overdraft fees also take unreasonable advantage of consumers' lack of understanding of the costs and conditions of bank accounts, and the risks that overdraft fees pose to consumers' finances. Since consumers do not expect to overdraw their accounts, these overdraft fees exploit the inability of consumers to protect their own interests when choosing a bank and type of account. Consumers simply do not shop on the basis of overdraft fees and practices. Most critically, disproportionate overdraft fees exploit the tendency of many consumers to rely on their banks, and trust that the bank will not engage in practices that harm their customers in order to make outsized profits.

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[116] *See* NATIONAL CONSUMER LAW CENTER, UNFAIR AND DECEPTIVE ACTS AND PRACTICES § 4.4.9 (8th ed. 2012).
[117] *Id.* § 4.4.
[118] *Id.*
[119] *Id.* § 4.4.9; NATIONAL CONSUMER LAW CENTER, CONSUMER WARRANTY LAW § 11.2.4.4 (4th ed. 2010 and Supp.).

Practices to induce overdrafts that result from the incentives created by disproportionately high overdraft fees also appear to meet the Dodd-Frank definition of "abusive." High-to-low reordering of transactions is a technique, invisible to the consumer, that causes overdraft fees to balloon far beyond a reasonable consumer's expectations. Thus, it materially interferes with a consumer's ability to understand the terms and conditions of the overdraft program. The banks' deceptive promotions to urge consumers to opt-in to debit card overdrafts also interferes with consumers' ability to understand the highly disadvantageous nature of debit card overdrafts, and the magnitude of the fees they risk incurring.

Looking at the second part of the definition of "abusive" in the Dodd-Frank Act, practices such as automatic payment of check and ACH overdrafts, deceptive statements to induce opt-in to debit card overdrafts, and high-to-low reordering appear to take unreasonable advantage of consumers' inability to protect themselves from overdraft transactions and the corresponding excessive fees. The widespread misunderstanding among consumers who thought that opting in would prevent overdraft fees,[120] not permit them, shows that banks are taking unreasonable advantage of that misunderstanding.

When choosing a bank or type of account, consumers cannot be expected to be able to know or compare how banks process transactions or what steps the bank will do to induce overdrafts. The way in which transactions are processed by a bank is a complicated matter that consumers cannot reasonably understand. Again, banks take advantage of the consumer's reliance that the bank will not engage in activities to deliberately trip them into incurring overdrafts and being charged overdraft fees.

D. The Congruence of the Anti-Penalty Standard and Prevention of Unfair, Deception, and Abusive Practices

The core purposes of the anti-penalty doctrine align well with measures to prevent unfair, deceptive, and abusive practices. The doctrine was created many years ago to prevent overreaching by one party to a contract, to prevent excessive harm to the breaching party, and to prevent one party from actually inducing breaches. Thus, a rule that prohibits penalty fees that exceed the anticipated cost of a violation will prevent unfair, deceptive, or abusive practices. There seems no better use of the power to prevent such practices than to restore a centuries-old doctrine that still protects businesses – the more sophisticated and powerful entities – but not consumers.

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[120] PEW CENTER ON THE STATES, OVERDRAFT AMERICA, *supra* note 9, at 4; PARRISH, BANKS TARGET, MISLEAD CONSUMERS, *supra* note 9, at 2.

VII. Conclusion

The wisdom of the common law developed the anti-penalty doctrine over the years to protect parties from overreaching in contracts in response to breaches. Where the doctrine has been entirely absent, such as with overdraft and NSF fees, abuses by the more powerful parties to the contract have spun out of control, costing billions of dollars collectively paid by the weaker parties.

It is time to restore the underpinnings of the anti-penalty doctrine to consumer financial services, particularly overdraft fees, by requiring such fees to be reasonable and proportional to the actual costs incurred by the bank. It appears that this may become the rule in Australia. It could happen here, and the CFPB has the authority to make it happen.

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