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NSF Fees

JAMES J. WHITE*

Overdraft fees now make up more than half of banks' earnings on consumer checking accounts. In the past century, overdrafts have gone from the banker's scourge to the banker's profit center as bankers have learned that there is much to be made on these short term loans at breathtaking interest rates. I note that the federal agencies have been complicit in the growth of this form of lending. I propose that the banks and the agencies recognize the reality and attempt to mitigate these rates by encouraging the development of a competitive market.

I. INTRODUCTION

By hypothesis, drawing checks against insufficient funds has happened as long as there have been checking accounts. In the early days, giving someone a bad check was so morally reprehensible that it sometimes landed one in jail.¹ A bounced check might even have drawn a reproach from the banker on whose bank the check was drawn for fear that the checks from that bank would get a bad name. A “rubber check” has always provoked an angry response and perhaps an aggressive collection effort from the payee. But in many cases, a banker who was sensitive to the needs of his customers would pay an overdrawn check with the expectation that his depositor had made an error and would soon cover the overdraft.

In the last half of the twentieth century, this story changed. In 2000, an estimated 251 million checks were returned by drawee banks for insufficient funds² and a large number—unknown to me but in the tens or hundreds of millions—were paid even though there were not sufficient funds in the account on which they were drawn. In nearly every case, whether the check was returned³ or was paid despite insufficient funds,⁴ the bank charged a fee.

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¹ Even today, several jurisdictions impose jail sentences for writing bad checks. *See, e.g., LOS ANGELES CO. DIST. ATT'Y, LOS ANGELES COUNTY DISTRICT ATTORNEY BAD CHECK RESTITUTION PROGRAM 2 (2001)* (quoting Steve Cooley, District Attorney: “Upon conviction, bad check writers may face up to a year in county jail or a longer sentence in state prison . . .”), available at <http://da.co.la.ca.us/pdf/badcheck.pdf>.

² *See* Geoffrey R. Gerdes & Jack K. Walton II, *The Use of Checks and Other Noncash Payment Instruments in the United States*, 88 FED. RES. BULL. 360, 365 (2002), available at http://www.federalreserve.gov/pubs/bulletin/2002/0802_2nd.pdf.

³ Banks typically charge a bounced check fee in this situation.

⁴ Banks typically charge an overdraft fee in this situation.

Today, the average fee for an NSF check, paid or not,⁵ is in the neighborhood of \$25⁶ and some New York banks charge as much as \$33.⁷ By one estimate, banks earned more than \$33 billion on NSF and overdraft fees in 2003.⁸ These fees make up to half of banks' earnings on consumer checking accounts.⁹ Today, the banker can hardly claim to be the surrogate of the injured payee, nor can he claim to fear that his bank's checks will be devalued by the frequent dishonor of other checks from his bank. The banker's tacit encouragement of overdrafts and routine return of bad checks belies the first claim and the huge volume of returned checks belies the second.

What was formerly reprehensible to the banker is now understood to be a bubbling source of revenue; in the words of the market, bad checks have become a "profit center."¹⁰ While the injury to and anger of the payee is not less than it was, the banks on whom these checks are drawn appear to have embraced bad checks. As we will see, thousands of banks have adopted slick, automated programs to decide which checks to return and which to pay. The evidence suggests that banks make more money by paying a large share of the overdrawn checks than by sending them back.¹¹ This is in part because semi-formal legitimation of overdrafts by a bank encourages customers who

⁵ When I refer to "NSF fees," in general I mean to include fees charged for any check drawn against insufficient funds whether the check is paid or returned.

⁶ Greg McBride, *Checking Study: Online v. Traditional Banks*, BANKRATE.COM, May 11, 2005, <http://www.bankrate.com/brm/news/chk/20050511d1.asp?prodtype=bank>.

⁷ See Dilyara Bareeva & Katherine Wyatt, *NSF and Overdraft Fees in New York State: The Impact of Bank Characteristics and Changes in Retail Payments*, N.Y. ST. BANKING DEP'T, Feb. 2005, at 3, available at <https://www.banking.state.ny.us/rp0502.pdf>.

⁸ See Lee Conrad, *As Industry Collects Billions, Consumers Cry Foul*, U.S. BANKER, May 2005, at 50, available at <http://www.us-banker.com/article.html?id=20050502M67VUQZG> (citing a study by Mike Moebs, chairman of Moebs Services, an economic research firm).

⁹ See Bill Stoneman, *Sizing NSF-Related Fees*, BANKING STRATEGIES, Jan.–Feb. 2005, at 17, 18, available at http://www.bai.org/bankingstrategies/2005-jan-feb/sizing/?WT.mc_id=PayPort_sizing_HP.

¹⁰ See, e.g., Sheshunoff Management Services, *Platinum Overdraft*SM, http://www.aba.com/cab/cab_pod.htm (last visited Nov. 27, 2006) ("Platinum OverdraftSM . . . allows financial institutions to streamline, standardize and simplify the process of overdraft decision-making This highly integrated deposit account overdraft coverage solution dramatically improves customer service and increases non-interest income.").

¹¹ See *infra* notes 12–15 and accompanying text.

would not otherwise overdraw to do so.¹² The courts have generally given banks a free hand, and the federal agencies' behavior has ranged from full-throated support for the banks' actions to soft-spoken approval.

So what is the problem? The problem is that the overdraft fees that the banks earn are extraordinary¹³ when measured against the banks' cost (a dollar or less to return a check)¹⁴ and risk (none when the check is returned and slight when it is not). And, of course, the banks are feeding off the weakest and poorest of their customers;¹⁵ the poorer, not the richer, draw bad checks. Banks can get away with such high fees in part because the light of the market barely shines in the dark corner of NSF practices. To date, few banks have shown any interest in advertising their low overdraft rates and few consumers choose their bank on the belief that they will frequently overdraw.¹⁶ If the market could somehow be made to work here, it would solve the problem, but I am doubtful.

¹² See National Credit Union Administration Letter to Credit Unions, No. 05-CU-03, at 6 (Feb. 2005), available at <http://www.ncua.gov/letters/2005/CU/05-CU-03.pdf> [hereinafter NCUA Letter].

¹³ The table below shows that the finance charge for the short-term cash advance of overdraft protection translates to triple-digit interest rates. For example, a \$20 penalty fee imposed on a \$100 overdraft when repaid in fourteen days amounts to an effective annual percentage rate (APR) of 521%.

<i>Effective APR For Various Repayment Period (In Days)</i>							
Fee	Overdraft Amt.	Period Rate	3	7	14	30	45
\$20	\$100	20%	2433%	1043%	521%	243%	162%
\$25	\$100	25%	3042%	1304%	652%	304%	203%
\$35	\$100	35%	4258%	1825%	913%	426%	284%
\$35	\$500	7%	852%	365%	183%	85%	57%
\$25	\$900	3%	338%	145%	72%	34%	23%

¹⁴ The cost to the bank is even less when an overdraft fee is charged. See, e.g., *Perdue v. Crocker Nat'l Bank*, 702 P.2d 503, 508 (Cal. 1985) ("At the time of filing the suit, the charge was \$6 for each NSF check, whether the check was honored or returned unpaid, even though 'the actual cost incurred by the defendants in processing the NSF check is approximately \$0.30.'").

¹⁵ See, e.g., Nikitra S. Bailey, *Predatory Lending: The New Face of Economic Injustice*, HUM. RTS. MAG., Summer 2005, at 14, available at <http://www.abanet.org/irr/hr/summer05/predator.html>.

¹⁶ *But see*, advertisement by Washington Mutual, offering one free Overdraft/NSF fee for WaMu Free Checking customer, http://www.wamu.com/personal/accountchoices/checking/default_MI.htm (last visited Dec. 5, 2006).

II. THE FIRST CASES

The two most prominent cases dealing with banks' rights to charge NSF fees are *Perdue v. Crocker National Bank*, a 1985 decision of the California Supreme Court,¹⁷ and *Best v. United States National Bank of Oregon*, a 1987 decision of the Oregon Supreme Court.¹⁸ Both were class actions. In *Perdue*, the California Supreme Court reversed the trial court's grant of a demurrer¹⁹ and allowed several causes of action to go ahead (whether the charges were set in good faith,²⁰ whether the charges were unconscionable,²¹ and whether the bank engaged in deceptive practices²²). In *Best*, the Oregon Supreme Court reversed the trial court's grant of summary judgment for defendant on the issue of whether the defendant had set its NSF fees in good faith.²³ After the supreme court decisions, both cases were settled without further published opinions.²⁴

Despite the absence of a final and conclusive statement of the parties' rights, each class of plaintiffs must have thought it held a comfortable lead going into the fourth quarter. In Oregon, there was a statement that if the plaintiffs could prove what they claimed, they would show absence of good faith by the defendant.²⁵ In California, the court invited a hearing at the trial court that was unlikely to save the bank from a finding of unconscionability: "[P]laintiff's charge that the bank's NSF fee is exorbitant, yielding a profit far in excess of cost, cannot be dismissed on demurrer. . . . [T]he parties should be afforded a reasonable opportunity to present evidence as to the commercial setting, purpose, and effect. . . ."²⁶

Each of the cases dealt with several issues that recur in different forms in later cases. In *Perdue*, the plaintiffs' first argument was that the signature card was not a contract at all, that it was merely a way to show a depositor's signature.²⁷ That argument flopped.²⁸

¹⁷ *Perdue v. Crocker Nat'l Bank*, 702 P.2d 503, 525 (Cal. 1985).

¹⁸ *Best v. U.S. Nat'l Bank of Or.*, 739 P.2d 554, 563 (Or. 1987).

¹⁹ *Perdue*, 702 P.2d at 525.

²⁰ *Id.* at 510.

²¹ *Id.* at 514.

²² *Id.* at 515-16.

²³ *Best*, 739 P.2d at 559.

²⁴ Dwight Golann, *Developments in Consumer Financial Services Litigation*, 43 BUS. LAW. 1081, 1082 (1988) (discussing settlement of *Perdue*); Philip Emerson, *Oregon Class Actions: The Need for Reform*, 27 WILLAMETTE L. REV. 757, 769-70 (1991) (discussing settlement of *Best*).

²⁵ *Best*, 739 P.2d at 559.

²⁶ *Perdue*, 702 P.2d at 514.

²⁷ *Id.* at 509-10.

Second, the plaintiffs claimed that the contract was not enforceable because it gave too much discretion to the bank and so lacked consideration for the want of duty on the bank.²⁹ Citing the California Commercial Code section 2305 by analogy and other California cases, the court made short work of that argument too.³⁰

Next, the *Perdue* court gave several pages to consideration of the unconscionability claim.³¹ The court first elaborated on the consequence of finding that the contract is a contract of adhesion.³² That discussion brings to memory the California court's later and more prominent unconscionability opinion in *Armendariz v. Foundation Health Psychcare Services, Inc.*³³ Quoting from its earlier finding of unconscionability of an arbitration clause³⁴ and relying on its notorious *A&M Produce* case,³⁵ the court summarized the plaintiff's rights:

Generally speaking . . . there are two judicially imposed limitations on the enforcement of adhesion contracts or provisions thereof. The first is that such a contract or provision which does not fall within the reasonable expectations of the weaker or 'adhering' party will not be enforced against him. The second—a principle of equity applicable to all contracts generally—is that a contract or provision, even if consistent with the reasonable expectations of the parties, will be denied enforcement if, considered in its context, it is unduly oppressive or "unconscionable."³⁶

The court stated that the 2000% difference between the NSF charge of \$6 and the claimed cost of \$0.30 did not prove plaintiffs' case, particularly since the \$0.30 cost was contested.³⁷ However, with apparent approval, it cited several cases that found a price to be unconscionable, and it explicitly rejected the defendant's best argument—that a price equal to the market price cannot be unconscionable.³⁸ The court concluded by drawing attention to the

²⁸ *Id.* at 510.

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.* at 510–14.

³² *Perdue*, 702 P.2d at 511.

³³ *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669 (Cal. 2000).

³⁴ *See Perdue*, 702 P.2d at 511 (discussing *Graham v. Scissor-Tail, Inc.*, 623 P.2d 165, 180 (Cal. 1981)).

³⁵ *See id.* (discussing *A&M Produce Co. v. FMC Corp.*, 135 Cal. App. 3d 473, 497 (Cal. Ct. App. 1982)).

³⁶ *Id.* (quoting *Graham*, 623 P.2d at 172–73).

³⁷ *Id.* at 513.

³⁸ *Id.* at 512.

small print of the deposit agreement and to the fact that under the agreement, the “bank has all the rights and the depositor all the duties.”³⁹

The court concluded its unconscionability discussion with the obligatory direction that the trial court allow the defendant to show the “commercial setting, purpose” and the like.⁴⁰ Of course, as Professor Leff pointed out years ago, this opportunity is hardly what the defendant wants or needs.⁴¹ As Professor Leff noted then, the intention and effect of many clauses that are claimed to be unconscionable is to squeeze the stuffing out of the plaintiff.⁴² Making that clear will not help the defendant.

Finally, the *Perdue* court dealt with the argument that the six dollar NSF fee is an invalid penalty—i.e., that it is a failed liquidated damage clause.⁴³ In a holding that has been followed in all the later decisions,⁴⁴ the court noted that there is no promise by the depositor not to draw checks on insufficient funds.⁴⁵ And if there is no promise to be broken, then the fee cannot be a penalty for breaking the contract.

In Oregon, the plaintiffs did almost as well as they did in California. The court dismissed the penalty argument for the same reason as was given in California—no agreement broken, no penalty possible.⁴⁶

Disagreeing with the California Supreme Court at every turn, the Oregon court rejected plaintiffs’ claim of unconscionability.⁴⁷ The court noted that the plaintiffs had agreed to charges “existing at any time.”⁴⁸ It noted that the costs were relatively small (five dollar NSF fee)⁴⁹ and were similar to those charged by others (so moving toward the rejected market defense?).⁵⁰ The plaintiffs could close their accounts at any time and apparently had at least “ordinary intelligence and experience.”⁵¹ So unconscionability might be okay for the funny people in California, but not for Oregonians.

³⁹ *Id.* at 513.

⁴⁰ *Perdue*, 702 P.2d at 514.

⁴¹ See Arthur A. Leff, *Unconscionability and the Code—The Emperor’s New Clause*, 115 U. PA. L. REV. 485, 544–46 (1967).

⁴² See *id.* at 544.

⁴³ *Perdue*, 702 P.2d at 515–16.

⁴⁴ See, e.g., *Howard v. Babcock*, 863 P.2d 150, 160 (Cal. 1993).

⁴⁵ *Perdue*, 702 P.2d at 516.

⁴⁶ *Best v. U.S. Nat’l Bank of Or.*, 739 P.2d 554, 556 (Or. 1987).

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.* at 556.

⁵⁰ *Id.*

⁵¹ *Id.*

The *Best* court did find that the defendant had to use good faith in setting the NSF fees.⁵² It cited Restatement (Second) of Contracts section 205 and particularly comment d on good faith performance:

Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further; bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.⁵³

The court continued: "It is . . . not necessarily sufficient, as the Bank contends, that the Bank acted honestly in setting its NSF fees or that its fees were similar to those of other banks."⁵⁴ The court concluded that there was "a genuine issue of material fact whether the Bank set its NSF fees in accordance with the reasonable expectations of the parties," and if the fees were not in accordance with those expectations, they would be in bad faith.⁵⁵

The *Best* court suggested that the fact that the fees were called "service charges," and that they were not prominently mentioned in the contract, could lead to the inference that the bank would fix them to give the same return of cost and profit as other fees:

This inference could reasonably lead to the further inference that the depositors reasonably expected that the Bank's NSF fees would be priced similarly to those checking account fees of which the depositors were aware—the Bank's monthly checking account service fees and per check fees, if any. By "priced similarly," we mean priced to cover the Bank's NSF check processing costs plus an allowance for overhead costs plus the Bank's ordinary profit margin on checking account services.⁵⁶

The court concluded by noting that there was evidence that the fees were not in good faith if the test was "costs" plus "ordinary profit margin."⁵⁷

Even though the plaintiffs had lost an NSF case in front of the New York Court of Appeals,⁵⁸ the plaintiffs' offense looked unstoppable in the summer

⁵² *Best*, 739 P.2d at 562.

⁵³ *Id.* at 557–58 (quoting RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1981)).

⁵⁴ *Id.* at 558.

⁵⁵ *Id.* at 559.

⁵⁶ *Id.* at 559.

⁵⁷ *Id.* at 559.

of 1987. One does not have to be clairvoyant to know what the banks' appellate lawyers told their clients about the meaning of these cases: I suspect that the banks' lawyers in both *Perdue* and *Best* said that it was time to make a deal with the plaintiffs. And the plaintiffs' lawyers might have been justified to dream of easy paydays from cases in Chicago, Miami, Dallas, and Atlanta.

It was not to be. *Perdue* and *Best* were the high-water mark. As far as I can tell, no plaintiff ever won again. At least there are no reported opinions to document any plaintiff victories after 1987.⁵⁹

III. THE LATER CASES

In *Tolbert v. First National Bank of Oregon*, the Oregon Supreme Court cut the legs out from under *Best*.⁶⁰ In *Tolbert*, the bank argued that a bank could act in bad faith only if it set the NSF fees in a way that conflicted with the "reasonable contractual expectations" of the plaintiffs.⁶¹ Noting that its employees and its documents made clear the initial fees, that the agreement plainly gave the bank "discretion" to set new fees, and that new fees were announced to the customers by mail at or near the time they were instituted, the bank argued that, as a matter of law, the customers could not challenge the fees as set in bad faith because every customer had agreed to the fees under First National's scheme. The court found that the plaintiffs' "reasonable expectations" were irrelevant where the plaintiffs had agreed to the fees charged by the bank.⁶² Alternatively, the court held that the forms of notice, the terms, and the kinds of agreement proved that the plaintiffs' reasonable expectations had been met.⁶³

After *Tolbert*, little is left of *Best*. If a bank is careful to make written disclosures of its current charges, to state how it uses broad discretion to set new charges, and to send notice of changes, the bank cannot be attacked for having failed to use good faith in setting its NSF fees. Any bank that pays the least attention to its agreements and disclosures can meet the *Tolbert* test.

⁵⁸ See *Jacobs v. Citibank, N.A.*, 459 N.Y.S.2d 781, 783 (N.Y. App. Div. 1983).

⁵⁹ In a recent unpublished case from the Ninth Circuit, however, the plaintiffs are hanging on by their fingernails. See *In re Wash. Mut. Overdraft Prot. Litig.*, No. 04-55885, 2006 U.S. App. LEXIS 22863, at *3 (9th Cir. Sept. 7, 2006).

⁶⁰ *Tolbert v. First Nat'l Bank of Or.*, 823 P.2d 965, 969, 971 (Or. 1991), accord *Wallace v. Nat'l Bank of Commerce*, 938 S.W.2d 684, 686 (Tenn. 1997).

⁶¹ *Tolbert*, 823 P.2d at 967.

⁶² *Id.* at 969.

⁶³ *Id.* at 971.

Except in *Perdue*, the argument that high NSF fees are unconscionable has failed. Of course, that argument was rejected in *Best*⁶⁴ contemporaneously with *Perdue*. In *Saunders v. Michigan Avenue National Bank*, the Illinois intermediate appellate court affirmed the trial court's dismissal of plaintiff's claim that the NSF policy was unconscionable.⁶⁵ The court emphasized that the plaintiff was "not intimidated or coerced into accepting the terms" but was "free to select from a multitude of other Banks with a variety of services and fees."⁶⁶ To the plaintiff's claim that the \$220 of fees that she incurred were so excessive that the amount alone was evidence of unconscionability, the court responded that the plaintiff herself exaggerated the fees by waiting two months to pay off the overdraft.

The Alabama Supreme Court rejected the unconscionability argument not on its merits but because unconscionability gives a plaintiff no "affirmative relief."⁶⁷ Of course, the court's argument is hardly conclusive; if the term that authorized the fees was invalid as unconscionable, the plaintiff should be able to recover the improperly collected fees in restitution because there would be no contractual basis for the bank to claim them.

By 1998, the plaintiffs had turned to a more sophisticated, but no more successful argument—that NSF or overdraft fees were essentially interest. If the fees were interest charges, they might be subject to the disclosure requirements of the Truth in Lending Act⁶⁸ and in many cases (since the overdraft was small, the period outstanding was short, and the \$20 or \$30 fee was high by comparison) would be usurious under applicable state law.⁶⁹ The courts found that the contested charges were not interest and therefore not usurious.⁷⁰

When the drawee bank dishonors a check drawn on insufficient funds, this interest charge argument fails because, by dishonoring, the bank has declined to make a loan. If there was never a loan to the customer, there can be no interest charge. When the bank pays the overdraft and so charges an "overdraft" fee, not an "NSF" fee, the plaintiffs' argument is more plausible. But the fact that the fee is flat, not related to the time the loan is outstanding

⁶⁴ *Best v. U.S. Nat'l Bank of Or.*, 739 P.2d 554, 556 (Or. 1987) (holding that "[t]he unconscionability doctrine is inapplicable to the amount of the fee").

⁶⁵ *Saunders v. Mich. Ave. Nat'l Bank*, 662 N.E.2d 602, 611 (Ill. App. Ct. 1996). *Saunders* also had a good faith and an illegal penalty cause of action. These too were dismissed without trial.

⁶⁶ *Id.*

⁶⁷ *Sanders v. Colonial Bank of Ala.*, 551 So. 2d 1045, 1045 (Ala. 1989).

⁶⁸ *Taylor v. Union Planters Bank*, 964 F. Supp. 1120, 1122 (S.D. Miss. 1997).

⁶⁹ *Video Trax v. NationsBank*, 33 F. Supp. 2d 1041, 1044 (S.D. Fla. 1998); *Nicolas v. Deposit Guar. Nat'l Bank*, 182 F.R.D. 226, 231–32 (S.D. Miss. 1998).

⁷⁰ *Nicolas*, 182 F.R.D. at 231–32; *Video Trax*, 33 F. Supp. 2d at 1044; *Taylor*, 964 F. Supp. at 1124.

or to the principal balance of the loan, makes this fee different from a conventional interest charge whose amount is dependant on principal balance and term.

Some plaintiffs have argued that banks consciously arrange the order of payment of checks to maximize the number and amount of NSF fees.⁷¹ Assume a depositor has \$2,000 in her account and five checks totaling \$2,350 (one check of \$1,950, and four checks of \$100). If the bank returned the large check and paid the other four, there would be one NSF fee, but if it paid the large check first, it would collect four fees. Depositors claimed that banks who used their discretion to pay the larger first, did so to maximize their fees.⁷² Banks responded that they believed their customers would want to have the largest—and presumably most important—creditor paid even if a larger number of small creditors were disappointed.⁷³

The banks have prevailed. In *Hill v. St. Paul Federal Bank for Savings*, plaintiffs claimed that the practice of paying large checks first was a violation of the banks' duty of good faith and that the practice violated the Illinois Consumer Fraud Act.⁷⁴ The court of appeals affirmed the trial court's dismissal.⁷⁵ First, it noted that the deposit agreements gave the banks discretion to pay or return NSF checks.⁷⁶ It found that Article 4 of the Uniform Commercial Code gave drawee banks discretion about the order in which they wished to pay checks that were presented for payment on the same day.⁷⁷ That discretion rested in section 4-303 even before the 1990 amendments to Article 4 when the statute provided that payment may be made "in any order convenient to the bank."⁷⁸ After the 1990 amendments, the rule rests on a more elaborate statement in Comment 7 to section 4-303.⁷⁹

⁷¹ *Hill v. St. Paul Fed. Bank for Sav.*, 768 N.E.2d 322, 324 (Ill. 2002).

⁷² *Id.* at 326.

⁷³ Brief of Defendant-Appellee at 9, *Hill v. St. Paul Fed. Bank for Sav.*, 768 N.E.2d 322 (Ill. 2002) (No. 1-00-2226), 2001 WL 34315791.

⁷⁴ *Hill*, 768 N.E.2d at 324.

⁷⁵ *Id.* at 323.

⁷⁶ *Id.* at 324.

⁷⁷ *Id.* at 325 ("[I]tems may be accepted, paid, certified, or charged to the indicated account of its customer in any order." (quoting U.C.C. § 4-303(b) (1957)).

⁷⁸ *Id.*

⁷⁹ Comment 7 reads in part:

As between one item and another no priority rule is stated. This is justified because of the impossibility of stating a rule that would be fair in all cases, having in mind the almost infinite number of combinations of large and small checks in relation to the available balance on hand in the drawer's account; the possible methods of receipt; and other variables. Further, the drawer has drawn all the checks, the drawer should have funds available to meet all of them and has no basis for urging one should be paid before another

After nearly twenty years of repeated and varied attacks by many teams of plaintiffs' lawyers, the banks have lost only two reported cases. Unconscionability, the winning theory in California, has succeeded nowhere else. The argument that charging high NSF fees is a violation of drawee banks' duty to perform their contracts in good faith has won only in Oregon, and, even there, a later case has undermined that victory. If the plaintiffs have a future, it is not in the courts.

IV. EARLY REGULATION

From the beginning, the Comptroller of the Currency has played a role in the dispute between depositors and their banks. In the last year, all of the federal financial agencies have proposed practices concerning overdraft fees.

Since 1971, the Comptroller has had a regulation that urges banks to set their fees "on a competitive basis and not on the basis of any agreement."⁸⁰ The function of the 1971 version seems to be only to warn banks away from anti-trust violations.

In 1983, the Comptroller issued a revision that was plainly aimed at NSF fees, among others.⁸¹ As the California Supreme Court notes in its *Perdue* opinion, this revision was published while *Perdue* was before the California courts.⁸² The court rejected plaintiffs' argument that the regulation was an inappropriate attempt to influence pending litigation.⁸³ The revision was more elaborate than its predecessor.⁸⁴ Subsection (c) of the revision asserted

Id. (quoting U.C.C. § 4-303 cmt. 7 (1957) (amended 1990)).

⁸⁰ 12 C.F.R. § 7.8000 (1972) ("All charges to customers should be arrived at by each bank on a competitive basis and not on the basis of any agreement, arrangement, undertaking, understanding or even discussion among banks or their officers.").

⁸¹ See 12 C.F.R. § 7.8000 (1984).

⁸² *Perdue v. Crocker Nat'l Bank*, 702 P.2d 503, 518 (Cal. 1985).

⁸³ *Id.* at 518 n.22.

⁸⁴ 12 C.F.R. § 7.8000 (1984).

(a) All charges to customers should be arrived at by each bank on a competitive basis and not on the basis of any agreement, arrangement, undertaking, understanding or discussion with other banks or their officers.

(b) Establishment of deposit account service charges, and the amounts thereof, is a business decision made by each bank and the Office will not substitute its judgment. In establishing deposit account service charges, the bank may consider, but is not limited to considering:

- (1) Costs incurred by the bank, plus a profit margin, in providing the service;
- (2) The deterrence of misuse by customers of banking services;
- (3) The enhancement of the competitive position of the bank in accord with the bank's marketing strategy;

federal preemption in the setting of fees: State laws setting or restricting fees “impair the efficiency of national banks and conflict with the regulatory scheme governing the national banking system and are preempted by federal law.”⁸⁵ The banks argued that federal law had preempted the plaintiffs’ state (unconscionability) claims.⁸⁶ The banks lost, and the argument has not played an important role in the cases since.

I do find some irony here. Remember that the Comptroller is a federal official whose duty is to seek the common good, not merely to help banks skin their customers. Under subsection (b)(1) the bank should consider its costs and a proper “profit margin” in setting its fees.⁸⁷ Here is a case where the banks’ fees are trivial and the profit margin is grandly in excess of that earned on any other loan in the bank. How does subsection (b)(1) justify a fee of \$25 or \$30?

The second subsection endorses banks’ deterrence of misuse;⁸⁸ presumably this means keeping depositors from overdrawing their accounts; but drawing an NSF check is a “misuse” only if one regards an NSF check from the perspective of the payee. As I suggest above, NSF fees are a profit center for the drawee, a valued use, not a misuse.⁸⁹

The third and fourth subsections of (b) concern only banks’ wealth, its “competitive position,” and its “safety and soundness.”⁹⁰ Stated as baldly as

(4) Maintenance of the safety and soundness of the institution.

(c) A national bank may establish any deposit account service charge pursuant to paragraphs (a) and (b) of this section notwithstanding any state laws which prohibit the charge assessed or limit or restrict the amount of that charge. Those laws impair the efficiency of national banks and conflict with the regulatory scheme governing the national banking system and are preempted by federal law.

(d) This interpretive ruling does not apply to (1) charges imposed by a national bank in its capacity as a fiduciary, which are governed by 12 CFR 9; and (2) service charges on dormant accounts which are governed by 12 CFR 7.7515.

Id.

⁸⁵ *Id.* § 7.8000(c). In *Perdue* the court noted that Article 4 of the UCC governs many aspects of the relation between the depositor and his bank. 702 P.2d at 521. In general, no state statutes limit banks’ NSF fees, so the preemption issue has not been pushed by the banks. But the issue arose in 1999 when two California municipalities (Santa Monica and San Francisco) set limits on ATM fees. See generally Blair S. Walker, *States, Cities Tussle With Banks Over ATM Surcharges*, STATELINE.ORG, Nov. 19, 1999, <http://www.stateline.org/live/ViewPage.action?siteNodeId=136&languageId=1&contentId=13856>.

⁸⁶ See, e.g., *Perdue*, 702 P.2d at 520–21.

⁸⁷ 12 C.F.R. § 7.8000(b)(1) (1984).

⁸⁸ 12 C.F.R. § 7.8000(b)(2) (1984).

⁸⁹ See *supra* notes 3–12 and accompanying text.

⁹⁰ 12 C.F.R. § 7.8000 (b)(3)–(4) (1984).

they are, these justifications seem remarkable to me. "Do what you need to do to make money, even if you take advantage of your most stupid and weak customers." Is that what the Comptroller is urging? It seems so.

The Comptroller has issued revisions in 1984, 1988, 1996, and 2001.⁹¹ All of the revisions maintain the four rules with little change. The preemption rule has been softened,⁹² and the language of the regulation has been modified to make clear the Comptroller's opinion that NSF fees are not interest charges.⁹³

The Comptroller appeared as an amicus in the *Perdue* case⁹⁴ and he appears to have been a steadfast advocate of the banks' position ever since. There is no hint in his position in court or in the body or accompanying commentary that he regards banks' NSF policies, which must be well known to him, to be problematic because they are so large in comparison to the banks' costs. That this might be a case where the market has failed seems never to have occurred to the Comptroller.

V. NEW FEDERAL RULES

In February of 2005, the four federal agencies that govern financial institutions⁹⁵ issued a document called "Joint Guidance on Overdraft Protection Programs" (Guidance).⁹⁶ The Guidance does not deal with fees for checks that are returned; it deals with the growing alternative of paying and charging for overdrafts. While this document went through a commentary process of the kind that might be used for a formal regulation of one of the

⁹¹ 49 Fed. Reg. 28,237, 28,238 (July 11, 1984) (codified at 12 C.F.R. § 7.8000 (1984)); 53 Fed. Reg. 51,535, 51,535 (Dec. 22, 1988) (codified at 12 C.F.R. § 7.8000 (1988)); 61 Fed. Reg. 4,849, 4,869-70 (Feb. 9, 1996) (codified at 12 C.F.R. § 7.4002 (1996)); 66 Fed. Reg. 34,784, 34,787-88 (July 2, 2001) (codified at 12 C.F.R. § 7.4002 (2001)). This change is doubtless a response to cases like *First Bank v. Tony's Tortilla Factory*, 877 S.W.2d 285, 288 (Tex. 1994) (holding that NSF fees are not interest), and *Bank One v. Mazaika (In re Citibank Credit Card Litig.)*, 680 A.2d 845, 847 (Pa. 1996) (holding that NSF fees are interest).

⁹² Compare 49 Fed. Reg. 28,237, 28,237 (July 11, 1984) (codified at 12 C.F.R. § 7.8000 (1984)) with 66 Fed. Reg. 34,784, 34,788 (July 2, 2001) (codified at 12 C.F.R. § 7.4002 (2001)).

⁹³ 66 Fed. Reg. 34,784, 34,786 (July 2, 2001) (codified at 12 C.F.R. § 7.4001 (2001)).

⁹⁴ See *Perdue v. Crocker Nat'l Bank*, 702 P.2d 503, 507 (Cal. 1985).

⁹⁵ The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and National Credit Union Administration (NCUA).

⁹⁶ See Joint Guidance on Overdraft Protection Programs, 70 Fed. Reg. 8428 (Feb. 18, 2005), available at <http://www.ots.treas.gov/docs/7/73252.pdf> [hereinafter Guidance].

agencies, the document itself does not purport to be a regulation of any of those agencies.⁹⁷ Nevertheless the Guidance cannot be ignored by any of the governed financial institutions even if a bank's violation of the Guidance might not give an injured depositor a civil cause of action against the bank for violating the Guidance.

The Guidance shows the federal agencies either to be in denial about banks' practices or to be engaging in a splendid hypocrisy. On the one hand, the Guidance seems to deny that overdraft fees are loans.⁹⁸ On the other hand, the Guidance urges the banks not to market these plans as loans.⁹⁹ The Guidance shows an even deeper hypocrisy by insisting that these transactions be treated as loans in banks' reports to the federal agencies but in directing that they be made in such a way that they will not be regarded as loans for the Truth in Lending Act, thus insuring that no APR needs to be revealed to the depositor/debtor.¹⁰⁰

As I suggest above, most banks have now realized that there is money to be made in charging NSF fees on returned checks and even more money to be made by paying most of those checks (so encouraging more overdrafts) and charging an overdraft fee for each.¹⁰¹ Except in name, the banks have abandoned the idea that paying overdrafts is a "courtesy" or that overdrafts are to be discouraged. They are steaming full speed ahead with sophisticated, software-controlled overdraft plans while the federal agencies are still pretending that allowing overdrafts is a courtesy, not a loan.

The Guidance makes the obligatory warnings that banks must be careful not to advance credit to those who are not creditworthy and to be careful to follow the applicable law on disclosures and the like.¹⁰² It also encourages certain disclosures about fees and notification of changes in fees.¹⁰³ These exhortations are unremarkable but salutary.

The last section of the Guidance on "Best Practices" warns that institutions "should not market the program in a manner that encourages routine or intentional overdrafts."¹⁰⁴ If I am even half right about the banks' current practices, their incentives, and their plans, that warning is hypocritical, for it urges the banks not to "market" a plan that most banks have implemented or soon will implement.¹⁰⁵ Other parts of the "Best

⁹⁷ *Id.* at 8428.

⁹⁸ *See id.* at 8429.

⁹⁹ *Id.* at 8430.

¹⁰⁰ *See id.* at 8429–31.

¹⁰¹ *See* Conrad, *supra* note 8, at 50.

¹⁰² Guidance, *supra* note 96, at 8430.

¹⁰³ *Id.* at 8431.

¹⁰⁴ *Id.* at 8430.

¹⁰⁵ *Id.*

Practices” section tell the banks to disclose all of the features of their plans to their depositors.¹⁰⁶ Won’t that “disclosure” inevitably “encourage[] routine or intentional overdrafts”?¹⁰⁷

In its instructions on characterizing a permissible overdraft, the Guidance’s hypocrisy becomes more evident. The “Best Practices” section tells the banks to emphasize the discretionary nature of the program even while The National Credit Union Administration admits that when a bank pays an NSF check, “credit is extended,”¹⁰⁸ and also notes that “[o]verdraft balances should be reported on regulatory reports as loans.”¹⁰⁹ Of course, most of these programs are, or will be, discretionary in name only. The Guidance admits that the “accommodation” formerly granted to customers has “become automated,”¹¹⁰ that is, the bank’s computer has been programmed to pay overdrafts for customers who meet certain criteria without the concurrent exercise of any human discretion.

Understand the legal significance of the banks’ discretion: if the bank has not agreed in writing to make the advance, the fee is not treated as interest for the purpose of the Truth in Lending Act.¹¹¹ So, on the one hand, the Guidance recognizes and encourages behavior that makes the transaction appear to be something other than a loan for the purposes of consumer credit disclosures, and, on the other hand, it insists that the transaction be treated as a loan for reporting to the agency and for the banks’ own underwriting. Put more harshly, the Guidance condones misrepresentation to the depositor.

In my opinion, the regulatory agencies wish neither to see, hear, nor speak of these loans. By pretending that the former practices still prevail—that paying an overdraft is merely an occasional act of generosity by the banker—the agencies spare themselves the task of confronting the real issues in a burgeoning area of lending. One remedy for the excessive fees that are charged for overdrafts and NSF checks is to encourage a market to develop around this service. If banks competed to provide overdraft loans, the fees would drop and the depositors would be served by lower costs. But the Guidance explicitly discourages the growth of such a market by warning against “marketing” a service for intentional overdrafts. And the agencies’

¹⁰⁶ *Id.* at 8430–31.

¹⁰⁷ *Id.* at 8430.

¹⁰⁸ NCUA Letter, *supra* note 12, at 7.

¹⁰⁹ *Id.* at 9.

¹¹⁰ Guidance, *supra* note 96, at 8429.

¹¹¹ See Regulation Z, 12 C.F.R. § 226.4(c)(3) (2006). That section excludes the following from the definition of finance charge: “Charges imposed by a financial institution for paying items that overdraw an account, unless the payment of such items and the imposition of the charge were previously agreed upon in writing.” *Id.*

conscious disregard of the true nature of this market allows them to ignore the fact that these are loans at extremely high rates.

VI. CONCLUSION

It is hard to know what to do about the market for NSF loans. Twenty years have shown that the courts do not have the answer. In any case the courts' tools, unconscionability and bad faith, are blunt instruments that are unlikely to produce an efficient solution.

If the regulatory agencies are to deal with the problem, a first step would be to treat overdraft advances as loans and so subject to the Truth in Lending Act and to whatever usury laws might apply. That at least would require the disclosure of an APR, and it would make some depositors look elsewhere for loans. How many depositors would be scared off by the high APR? That's the question, and I am not sanguine that an APR disclosure would change much.

Perhaps the market could be made to work here. In a competitive market there is doubtless an equilibrium at a rate that might be high but still well below the rate that prevails now. A first step toward a market is to do the opposite of the Guidance, to encourage "marketing" of the program and disclosure of APR's. Would a market flourish here? It might; despite the adverse selection problem, some banks might find it in their interest to attract overdrawers, even at rates substantially below those now prevailing.¹¹²

Last and least, in my opinion, should be a prohibition of overdraft loans or a regulatory mandate of NSF or overdraft fees. It is clear that many depositors wish to borrow by overdrawing their accounts. In my opinion, denying them this privilege is more reprehensible than letting them make foolish loans. And I have no reason to think that a federal agency could find the right price if it were given the power to set the rate.

¹¹² See, e.g., UNIV. OF MICH. CREDIT UNION, *Overdraft Protection Options*, <http://www.umcu.org/checking/overdraft.html> (last visited Nov. 30, 2006) (charging "\$24 per day for all NSF transactions occurring on that day up to \$500"); see also COUNTRYWIDE BANK, *Overdraft Line of Credit*, <https://bank.countrywide.com/scontent.aspx?cmtag=Content-overdraft> (last visited Nov. 30, 2006) ("Because overdraft line of credit is a short-term loan, you will be responsible for paying the current accrued interest plus 5% of the outstanding balance on this loan on a monthly basis.").