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Closing Pandora's Box: Putting an End to Credit Card Companies' Windfall Profits from Penalty Fees

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Introduction

Debra and Michael Johnson live with their two young children in a small two-bedroom house in the suburbs. Debra teaches first grade at the elementary school, and, until recently, Michael worked fifty hours a week as an electrician. They are of modest means and live a modest lifestyle. They had been getting by living paycheck-to-paycheck until Michael lost his job when his company downsized. Michael applied for job after job, but to no avail. The economy was tough and no one was hiring.

With Debra now the family's sole wage earner, the Johnsons are no longer able to pay their bills. They charged the gas and electric bills to their credit card just to keep their heat and electricity on. Next it was the groceries. That was the last charge they made to their credit card. Although they had always paid their bills on time in the past, they had to skip their \$50 minimum payment on the credit card this month. They were getting close to their \$2,500.00 credit limit.

The next month when they received the credit card bill, the new balance due included fifty dollars¹ for the minimum due from the month before, fifty dollars for this month's minimum payment, and a forty dollar late charge. Again, the Johnsons could not afford to pay the credit card bill. The next bill came with another forty dollar late fee. Only this time, the new late fee put the Johnsons over their credit limit, and there was a forty dollar over-limit fee in addition to the other fees. Their new

¹ Most credit card companies require a minimum payment each month of two percent of the total balance. \$50 would be the minimum due on a \$2,500.00 balance.

balance due was \$270.

Finally, after eight weeks and two missed credit card payments, Michael found a new job. The Johnsons did their best to catch up on all their bills by paying what they could. This month, the Johnsons paid \$70 on their credit card—the most they could afford—bringing the balance due down to \$200. However, due to the late and over-limit fees that had been assessed, the Johnsons were still above their credit limit. The credit card company also sent the Johnsons a letter saying that since the family had been late on two consecutive credit card payments, their interest rates were being raised from 7 percent to the “Default Rate” of 30 percent, which would apply not only to new purchases, but to purchases the Johnsons had already made.

The next month, they received another forty dollar late fee and another forty dollar over-limit fee, in addition to their minimum monthly payment of fifty dollars. Now their balance due was \$330. The Johnsons continued to pay as much as they could each month, but did not get caught up on the payments for another three months. By the time the Johnsons got caught up on their minimum payments, they had paid over \$440 in fees to the credit card company, in addition to the 30 percent interest rate.

According to Robert Hammer, chairman of industry consultant R.K. Hammer, “Issuers will reap a record \$20.5 billion in penalty fees in 2009.”² These fees are essentially contract penalties and not compensatory in nature; this results in a windfall to credit card companies.³ As contract penalties have long been held violative of public policy, credit card late and over-limit fees should be abolished. Current legislation is impotent at protecting consumer rights.

This article begins by discussing usury laws and the historic disdain for contract penalties. Part II of this article explains and contrasts liquidated damages and contract penalties. Part III explains why credit card late and over-limit fees are penalties rather than

² Kathy Chu, U.S.A. Today, Bank Credit Card Fees Keep Going Up, March 15, 2009, available at: http://www.usatoday.com/money/perfi/credit/2009-03-15-bank-credit-card-fees_N.htm?csp=34.

³ Kathleen Day and Caroline E. Mayer, Credit Card Penalties, Fees Bury Debtors; Senate Nears Action On Bankruptcy Curbs, Washington Post, March 6, 2005, at A01.

liquidated damages. Finally, Part IV discusses remedial measures that must be taken to prevent credit card companies from reaping windfall profits through penalty fees. I argue that credit card late and over-limit fees are not liquidated damages, but contracted-for penalties that result in unjustified windfall profits to credit card companies which are obtained through contracts of adhesion and should not be enforced because they are illegal under common law and against public policy.

I. History

American jurisprudence's disdain for contract penalties can be traced back to penal bonds in England, which emerged in the late thirteenth century. In order to secure performance under a contract, a promisee would exact from the promisor a sealed instrument which promised to pay a certain sum, on the condition that the obligation to pay would be void upon the promisor's satisfactory completion of performance.⁴ The stipulated penalty for non-performance could be any amount agreed upon by the parties, even if it exceeded the value of the act or forbearance stipulated.⁵ For centuries, English common law courts "enforced such bonds literally and, if the promisor had not strictly performed as required by the contract, would give judgment against the promisor for the sum fixed in the bond, regardless of the amount of loss caused by the promisee by the breach."⁶ Although some courts were sympathetic to the debtor, the prevailing attitude was that one must be held to the letter of his contracts.⁷

Penal bonds originally became popular in England as an alternative to charging interest on loans, which was considered usury, and therefore unlawful for Christians.⁸ In such transactions, the debtor's bond would state that he would pay the creditor ten dollars (or whatever currency was in use at the time) on a certain day, or eighteen dollars if he were to pay after that day.⁹ Since usury was illegal, and could be used by debtors as a defense to the obligation, courts attempted to distinguish

4 E. Allan Farnsworth, *Farnsworth on Contracts* §12.18 at 812 (4th ed. 2004);

5 William H. Loyd, *Penalties and Forfeitures*, 29 *Harv. L. Rev.* 117 (1915).

6 Farnsworth, *supra* note 4 at 812.

7 Loyd, *supra* note 5 at 118, 120.

8 *Id.* at 117, 119.

9 *Id.* at 120.

between “agreements where the penalty was truly conditional, where the borrower could wholly discharge himself by repayment within a given time, and where the written condition was but a subterfuge, and the real intent of the parties was that the loan should not be repaid without the added sum. . . .”¹⁰ The former agreements, where the bond was merely collateral, were generally legal, whereas the latter were considered unlawful usury.¹¹

It was not until the seventeenth century that courts began to chip away at the stronghold of contract penalties by relieving penalties incurred through the “minor negligence” of an obligor.¹² Still, progress was slow.

Although plaintiffs were no longer able to recover in excess of actual damages, defendants still had to suffer judgment in the courts of chancery before they could get their relief at equity.¹³ This inconvenience was later remedied with statutes having the effect of consolidating the actions.¹⁴ The modern law, adopted by the United States, prohibits recovery in excess of actual damages (including interest) for both penal bonds and contracts in general.¹⁵

II. Liquidated Damages vs. Penalties

It has become commonplace for sophisticated parties to include terms in their contracts providing that if the promisor fails to perform as agreed under the contract, he must pay a predetermined sum to the promisee.¹⁶ Since no damages have yet occurred at the time of contract formation, these stipulated sums are often speculative at best. Such provisions are only valid if the sum payable upon breach is meant to approximate the actual damages the promisee would suffer. Courts will not enforce stipulated damage provisions that function as penalties, even

¹⁰ Id. at 121.

¹¹ Id.

¹² Id. at 125

¹³ 4 and 5 Anne, c. 16 §§ 12, 13.

¹⁴ 8 and 9 William III, c. 11 § 8.

¹⁵ Sun Ridge Investors, Ltd. v. Parker, 956 P.2d 876 (Okla. 1998); Flores v. Millenium Interests, Ltd., 185 S.W.3d 427 (Tex. 2005); Raffel v. Medallion Kitchens of Minn., Inc., 1996 WL 675787 (N.D. Ill. 1996); see also James P. George, Reimposable Discounts and Medieval Contract Penalties, 20 Loy. Consumer L. Rev. 50, 61 (2007).

¹⁶ Memorial Gardens, Inc. v. Olympian Sales & Management Consultants, Inc., 690 P.2d 207 (Colo. 1984).

if the parties have both willingly agreed to such a term.¹⁷ “While freedom to contract lies at the core of contract law, freedom of contract does not embrace the freedom to punish, even by contract.”¹⁸ Thus, public policy demands that the stipulated damages be compensatory in nature, rather than punitive.¹⁹

The purpose of contract remedies is to compensate the non-breaching party for any loss she incurs as a direct result of the breach, and to put her in the place she would have been had the breach not occurred.²⁰ Contract remedies are not designed to punish a party who fails to perform under a contract.²¹ Professor Allan Farnsworth explains, “[It] is a fundamental tenet of the law of contract remedies that an injured party should not be put in a better position than had the contract been performed.”²² Thus, well-established common law dictates that contracted-for penalties are unenforceable because they are against public policy.²³

This judicially-imposed safeguard prevents parties with superior bargaining power from contracting for their own unjust enrichment. It is unlikely that a person in an arm’s length negotiation with a party of roughly equal bargaining power would consent to a penalty against himself. By refusing to enforce terms that no reasonable person would intentionally bargain for, the courts help protect consumers from abusive contract terms imposed on them by parties with grossly disproportionate bargaining power.²⁴

17 Canadian Mining Co. v. Creekmore, 295 S.W.2d 357 (1956).

18 DAR & Associates, Inc. v. Uniforce Services, Inc. 37 F.Supp.2d 192, 200 (E.D.N.Y., 1999).

19 Monsanto Co. v. McFarling 363 F.3d 1336, 1345 (C.A. Fed. (Mo.),2004)

20 Restatement Second of Contracts § 356, comment (a).

21 Farnsworth, supra note 4 at 760.

22 Id.

23 Graves v. Cupic, 272 P.2d 1020 (Idaho 1954), Phillips v. Phillips, 820 S.W.2d 785 (Tex. 1991), Norwalk Door Closer Co. v. Eagle Lock & Screw Co. 220 A.2d 263, 266-67 (Conn. 1966.), Lake Ridge Academy v. Carney, 613 N.E.2d 183, 188 (Ohio 1993), Milton Const. Co., Inc. v. State Highway Dept., 568 So.2d 784, 789 (Ala. 1990), Guiliano v. Cleo, Inc., 995 S.W.2d 88, 101 (Tenn. 1999), Leonard v. Northwest Airlines, Inc., 605 N.W.2d 425, 431 (Minn. App. 2000).

24 Courts often take into consideration the relative bargaining power of the parties when determining whether a clause is for a penalty or liquidated damages. See Pacificorp Capital, Inc. v. Tano, Inc., 877 F.Supp. 180, 184 (S.D.N.Y.1995) (“parties bargaining power is a factor when determining if one side is exacting an unconscionable penalty”(quoting Rattigan v. Commodore Intern. Ltd., 739 F.Supp. 167, 172 (S.D.N.Y.1990))).

Contract penalties are also offensive to public policy because they are meant to coerce the promisor into performance through an *terrorem* effect.²⁵ When the amount to be paid by the breaching party is clearly in excess of any actual damages the promisee would suffer, the purpose of the clause is to secure performance by compulsion, not compensate the injured party.²⁶ Judge Jasen of the New York Court of Appeals – illuminating the effects of penalty clauses – explains, “A promisor would be compelled, out of fear of economic devastation, to continue performance and his promisee, in the event of default, would reap a windfall well above actual harm sustained.”²⁷

Although courts generally do not allow promisees to recover windfall damages through penalty clauses, courts do enforce liquidated damages clauses which are structured to estimate a party’s actual loss in the event of a breach.²⁸ To be considered a liquidated damages clause rather than a penalty, the clause must meet three conditions:

- 1) the amount stipulated must be a reasonable one, that is to say, not greatly disproportionate to the presumed loss or injury;
- 2) the damages to be anticipated as resulting from the breach must be uncertain in amount or difficult to prove; and
- 3) there must have been an intent on the part of the parties to liquidate them in advance.²⁹

To be valid, the liquidated damages clause must be a reasonable estimate of forecasted damages when the contract is made, and does not necessarily have to equal actual damages at the time of breach.³⁰ When distinguishing between liquidated damages and penalties, Judge Posner stated, “If damages would be easy to determine [at the time of contracting], or if the estimate greatly exceeds a reasonable upper

25 *Pacheco v. Scoblionko*, 532 A.2d 1036, 1038 (Me. 1987), S.L. Rowland Const. Co. v. Beall Pipe & Tank Corp., 540 P.2d 912, 921 (Wash.App. 1975), *Truck Rent-A-Center v. Puritan Farms 2nd*, 361 N.E.2d 1015, 1018 (N.Y. 1977).

26 *Truck Rent-A-Center*, 361 N.E.2d at 1018.

27 *Id.*

28 *Days Inn Worldwide v. Mandir, Inc.*, 393 F.Supp.2d 1240, 49 (W.D. Okla. 2005), *Manufacturers Cas. Ins. Co. v. Show-Me Power*, 157 F.Supp. 681, 83 (D.C. Mo. 1957).

29 *Stamford v. Banta*, 92 A. 665, 667 (Conn. 1914).

30 *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1289-90 (C.A.7 (Ill.),1985).

estimate of what the damages are likely to be, it is a penalty.”³¹

Since most sophisticated contracts are drafted by intelligent lawyers who know that only liquidated damages are enforceable, the label put on the sum to be paid is often irrelevant.³² One must usually look to the specific facts of the agreement to determine whether the clause is meant to approximate actual damages or as a punitive fee designed to unjustly enrich the promisee.³³ When a liquidated damages clause “is intended to operate as a means to compel performance, it will be deemed a penalty and will not be enforced.”³⁴

If a damages provision is designed to put the non-breaching party in the place he would have been had the contract terms been fulfilled, the parties must anticipate actual damages in the event of a breach.³⁵ To be enforceable, the agreed amount must bear a reasonable relationship to the forecasted damages.³⁶ If the non-breaching party would not suffer any actual damages under a breach, then any stipulated sum to be paid by the breaching party would not be compensatory; if there is no loss, there is nothing to be compensated for. If the damages provision is non-compensatory, it is a punitive damages provision that is unenforceable under the common law on public policy grounds.³⁷

31 Id.

32 Richard A. Lord, *Williston on Contracts* § 65:11 (2008).

33 Contracted for liquidated damages “may be and often are held to provide for a penalty.” *Graves v. Cupic*, 272 P.2d 1020 (Idaho 1954) (Supreme Court of Idaho found the stipulated damages to be unconscionable, exorbitant, arbitrary, and lacking of any “reasonable relation to the damages which the parties could have anticipated from the breach” where a tavern owner attempted to retain \$14,500 in partial payments – toward the \$50,000 purchase price – as liquidated damages when the buyer could not complete the transaction); *Philips v. Philips*, 820 S.W.2d 785, 787 (Tex. 1991) (Supreme Court of Texas rejected the provision of a partnership agreement setting liquidated damages as ten times the actual damages incurred by a breach of trust.); *Lake Ridge Academy v. Carney*, 613 N.E.2d 183, 188-191 (Ohio 1993) (Supreme Court of Ohio permitted liquidated damages provision in a private school reservation agreement providing that repudiation by a child’s parent after an August 1 deadline would result in liability for the full year’s tuition amount because 1) the school would be “unable to calculate and prove the precise damages caused by the loss of one student’s tuition,” 2) the contract, taken as a whole, was not “so manifestly unconscionable, unreasonable, and disproportionate in amount as to justify the conclusion that it does not express the true intention of the parties,” 3) the contract, taken as a whole, was not unconscionable, 4) the contract, taken as a whole, was not unreasonable, and 5) damages were not disproportionate to actual damages).

34 *Brecher v. Laikin*, 430 F. Supp. 103, 106 (S.D. N.Y. 1977).

35 *Southern Roofing & Petroleum Co. v. Aetna Ins. Co.*, 293 F.Supp. 725, 731 (D.C.Tenn. 1968), *In re Dow Corning Corp.*, 419 F.3d 543, 549-50 (C.A.6 (Mich.),2005).

36 *Johnson v. Jones*, 33 Ark.App. 149, 152, 807 S.W.2d 39, 41 (1991).

37 Restatement (Second) of Contracts § 356 (1981) Comment a and b. (“The parties

III. Why Credit Card Late Fees are Penalties rather than Liquidated Damages

A. Credit Card Agreements are Contracts of Adhesion under which Cardholders Have No Meaningful Opportunity to Bargain for Terms.

In the United States, credit card companies make the decision of whether to extend offers of credit based on a person's FICO score – potentially ranging from 150 to 950 – which is mathematically derived from “payment history, amounts owed, types of credit used, new credit and length of credit history,” all contained in one's credit report.³⁸ Credit card companies calculate the interest rate they will offer to the consumer based on the level of risk the consumer poses as a borrower.³⁹

These “offers” are contracts of adhesion, offered on a take-it-or-leave-it basis, in which the consumer has no ability to bargain for individual terms.⁴⁰ The majority of credit card offers are sent via direct mail solicitations.⁴¹ These solicitations generally include an application for credit or a notice of “pre-approval” and a mere summary of the terms of the cardholder agreement, rather than a copy of the agreement in its entirety.⁴² The agreement itself is presented to the consumer as a standardized printed form with numerous pages of small font type.⁴³ The consumer has no opportunity to negotiate with the credit card company on an individual basis.⁴⁴ Resounding evidence of the adhesiveness of credit card terms can be found in the findings of a nationally

representative poll of more than 1,000 adults conducted by the Opinion to a contract may effectively provide in advance the damages that are to be payable in the event of breach as long as the provision does not disregard the principle of compensation. * * * Punishment of a promisor for having broken his promise has no justification on either economic or other grounds and a term providing such a penalty is unenforceable on grounds of public policy.” *Id.* at Comment a. (Emphasis added.)

38 Jessica Dickler, *Settling the Credit Score*, CnnMoney.com, August 6, 2008, http://money.cnn.com/2008/08/06/pf/credit_score_availability/index.htm.

39 *Id.*

40 *Homa v. American Express Co.*, 2009 WL 440912, 5 -6 (C.A.3 (N.J.) 2009) (Credit card contract that is presented on a “take-it-or-leave-it basis” in a standardized printed form where the “adhering” party has no opportunity to negotiate was a contract of adhesion.); *In re Plourde*, 397 B.R. 207, 225-26 (Bkrcty.D.N.H., 2008).

41 In 2004, credit card issuers sent more than five billion direct mail solicitations. Ronald J. Mann, “Contracting” for Credit, 104 Mich. L.Rev. 899, 905, 906, 908 (2006).

42 *Id.* at 905, 908.

43 *In re Plourde*, 397 B.R. 207, 225-26 (Bkrcty.D.N.H., 2008).

44 *Id.*

Research Corporation for the Consumer Federation of America in 2007.⁴⁵

The poll found that:

--91 percent of Americans think it is unfair to raise interest rates or fees at any time for any reason. (76 percent believe it is very unfair.)

--83 percent of Americans think it is unfair to increase the interest rate on one card because of a person's payment history on another card. (62 percent believe it is very unfair.)

--84 percent of Americans think it is unfair to apply interest rate increases not only to new balances but also to past balances. (61 percent believe it is very unfair.)

--85 percent of Americans think it is unfair to increase an interest rate to 30 percent for making two late payments. (64 percent believe it is very unfair.)

--76 percent of Americans think it is very unfair to charge \$30 for making a late payment. (51 percent believe it is very unfair.)

--82 percent of Americans think it is unfair to charge a \$30 fee each month if a balance is over the credit limit when a person is no longer using the card. (64 percent believe it is very unfair.)⁴⁶

Given the apparent attitudes of American consumers, it is clear that if given any meaningful opportunity to bargain for individual terms, consumers would not agree to penalty fees which are standard in the cardholder agreements of every major card issuer.

In these contracts of adhesion, credit card companies reserve the right to unilaterally change the terms of the agreement at any time,

⁴⁵ Congressional Testimony by Travis B. Plunkett, Affiliated with Consumer Federation of America, Consumer Protection; Committee: Senate Banking, Housing and Urban Affairs, Cong. Q., February 12, 2009.

⁴⁶ Id.

for any reason, and the consumer effectively accepts the terms merely by continuing to use the card.⁴⁷ The cardholder’s only recourse to avoid the imposition of the new terms is to cancel his credit card.⁴⁸ In its cardholder agreements, American Express expressly reserves the right to unilaterally change the terms of the agreement, including:

(1) the right, in its sole discretion, at any time, to increase and/or decrease the credit line and cash advance limit; (2) the right to decline any attempted charge even if the charge would not cause the debtor to exceed its credit line or cash advance limit; (3) the right to unilaterally change the mathematical formulas specified in the credit card agreement for calculation of the finance charge if the formula produces mathematically similar results; (4) the right to exclude, in its discretion, certain debit transactions or fees from the calculation of the daily balance to which the finance charge is applied; (5) the right to suspend or cancel the account, or any feature offered with the account, including reducing the credit line to an amount below the outstanding balance in its sole discretion, at any time, whether or not the account is in default and without prior notice to the debtor; and (6) the right to add, modify or delete any benefit, service or feature that may accompany the account at any time without notice.⁴⁹

Consumers often do not receive meaningful notice of a change in terms of the contract.⁵⁰ “When [the credit card company] does provide notice, the notice typically is in the form of a new agreement included in a billing statement together with a variety of other promotional materials.”⁵¹ Most consumers routinely discard these “bill stuffers” without a glance.⁵²

47 “Current credit card agreements provide the issuer with the right to unilaterally alter virtually all of the material terms of the contract, and to even terminate the contract, in whole or in part, with no notice to the consumer.” *Id.*; See also, Mann, *supra* note 41 at 905, 908 (noting that standardized contracts, like credit card agreements, are usually not negotiated and that credit card agreements typically “reserve[] to the issuer the right to amend ... at any time,” with such amendments being “remarkabl[y] frequen[t]”).

48 *Id.*

49 Plourde, 397 B.R. at 225-26.

50 Mann, *supra* note 41 at 908.

51 *Id.*

52 *Id.*

B. Current Late and Over-limit Fees are Not Reasonable Estimations of Damages in the Event of Breach.

Credit card contracts invariably state that if the consumer makes his minimum payment after a certain time on the due date or pays less than his total minimum payment, the customer is assessed a “late fee.”⁵³ Late fees often range from \$35 to \$39 per occurrence in agreements with major card issuers.⁵⁴ Some credit card agreements provide for smaller late fees on low balances.⁵⁵ A late fee will be assessed whether the consumer makes the payment one minute after the cutoff time on the due date, three days later, or waits until the next month.

Once the consumer misses a payment, remits his payment after the due date, or exceeds his credit limit, the fees assessed by the credit card company become a part of his minimum balance due for the next billing cycle, even though the fees themselves do not reflect any additional capital expenditure by the creditor. Thus, if on the due date of the next payment the cardholder only remits his past and current payments due based on the principal and interest, but does not pay the fees, he will incur an additional late fee and an additional over-limit fee (if his balance still exceeds the credit limit) even though he has not borrowed any additional money. Many credit card companies also charge over-limit fees if a late fee causes the cardholder’s balance to exceed the limit.⁵⁶ As a result of this practice of fee-stacking, credit card balances may grow exponentially over time, sometimes resulting in the cardholder paying several times the value of the goods and services he charged to his credit card.⁵⁷

The credit card company’s cost to process the payment is the same whether the payment is made on time, a day late, or even a month late. The company has absolutely no transaction cost if the payment is

53 Gregory Karp, Study: Small Bank Card Fees Less Punitive (Sept. 8, 2008), <http://www.gregkarp.com/blog/2008/09/09/study-small-bank-card-fees-less-punitive/>.

54 For a list of penalty fees charged by various credit card companies, see Gregory Karp, Study: Small Bank Card Fees Less Punitive (Sept. 8, 2008), <http://www.gregkarp.com/blog/2008/09/09/study-small-bank-card-fees-less-punitive/>.

55 Id.

56 Plunkett, *supra* note 45.

57 Id.

not made at all, because there is no transaction to process. Therefore, the credit card company will not suffer any damages from processing the late payment.

Although they are not required to, some credit card companies may call or send a written notification to cardholders, informing them that their payment was not received. In the event of a written notification, it would be one of many mass-produced automatically via a computer program which inserts the customer's personal information from its existing databases, in the same manner the companies mass-produce direct mail solicitations. In the case of a phone call, companies often use automated voice recordings or perhaps a live person to make the collection calls. The cost of any of these notification methods is negligible at best. However, many credit card companies do not send any notices at all, and the charges merely appear on the cardholder's next billing statement, which produces no additional cost. Also, if the consumer's payment is merely late because the credit card company processed the payment after the cutoff time on the due date, or before any reminder could be sent out, there is no additional transaction cost, and no late fee would be justified.

The credit card company may argue that it suffers damages because it could have re-lent the consumer's minimum payment and received interest on that money. However, the credit card company is already accruing interest on the minimum payment—from the cardholder.⁵⁸ When the cardholder fails to make his payment on time, interest is accruing on his total balance, including the unremitted minimum payment, whereas if the cardholder had remitted the payment, he would stop paying interest on that portion of his balance. Therefore, the credit card company would not make any more money by lending the amount of the minimum payment to another borrower.⁵⁹ Most likely, the credit card company is already making the most possible interest

⁵⁸ Late fees in a mortgage contract were struck down in Oklahoma as illegal contact penalties

⁵⁹ Most credit card agreements contain terms providing that if a cardholder makes one or a series of late payments, the interest rate on both new and existing balances will default to the maximum interest rate allowed by law, the "default rate." Mann, *supra* note 41, at 908-09.

on its money by lending to the cardholder.⁶⁰ Other types of loans, such as mortgages, car loans, and student loans, usually garner much lower interest rates for the lenders.⁶¹ (This assumes that the lender is a bank which engages in other types of lending.) If the credit card company is already making the most money that can be guaranteed on the amount of a cardholder’s minimum payment, then it stands to reason that the company is not losing any money, and therefore suffers no actual damages, if the cardholder makes a late payment.

Credit card companies may also argue that the late fees and over-limit fees compensate them for the perceived increase in risk of the cardholder’s nonpayment, evidenced by the fact that he failed to make one or more of his payments on time. However, credit card companies already have a mechanism in place to compensate for the perceived increase in risk—they increase the cardholder’s interest rate.⁶² After a single late payment, a low interest rate may skyrocket to thirty percent or more.⁶³ In some cases, a consumer may pay his credit card bill on time every single month for years, and he may still see his rate increase if he makes a late payment to a completely different and unrelated lender.⁶⁴ The rate hikes, often to the “default rate”, apply to both new and existing balances.⁶⁵

Furthermore, if the credit card company’s goal was for the cardholder to pay off his balance, it would seem counterintuitive to impose compounding \$39 late and over-limit fees each month. The accumulation of fees in addition to a regular monthly payment often results in a “balloon payment” for the consumer to cover the overdue amounts.⁶⁶ These balloon payments get larger each month until the consumer is able to completely pay down all the overdue penalty

60 See Sun-Times Wires, *Your Wallet*, Chi. Sun Times, December 19, 2008, at 42 (citing 5.19 percent average 30-year fixed-rate mortgages).

61 Id.

62 Although credit card issuers argue that the default rate is imposed to compensate them for the increased risk they must bear, this seems inconsistent with the fact that card issuers increase the default rate at times when their cost to purchase the funds has declined. Plunkett, *supra* note 45.

63 Elizabeth Stull, *Bankruptcy Filings Rising, Rochester Area ‘Fortunate,’ Daily Record* (Rochester, N. Y.), Oct. 10, 2008 (page unavailable online), 2008 WLNR 19554846.

64 Id.

65 Mann, *supra* note 41 at 909.

66 Plunkett, *supra* note 45.

fees combined with his average monthly payment. Meanwhile, since the consumer made a late payment, his interest rate will increase retroactively, making even his normal minimum payment much higher.⁶⁷ Penalty fees thus create a self-fulfilling prophecy by making it even more difficult for cash-strapped consumers to pay down their credit card bills, and thereby proving that the consumers who missed that first payment are “risky.”⁶⁸

Credit card companies should not receive any compensation at all for any perceived increase in risk the borrower may pose when he exceeds his credit limit, because the companies have complete control of whether such transactions are even approved. If the credit card companies are able to deny the transactions, but choose not to do so, they have willingly assumed any associated risks.

C. If Credit Card Companies did Suffer Damages, They Would Not be Difficult to Calculate.

Credit card late and over-limit fees also fail the Banta⁶⁹ test because credit card agreements are purely financial, and any projected damages from lost profits or extra transaction costs are easily ascertainable. To mail a late payment notification, the damages would be the cost of postage; if a human representative notifies the cardholder by phone, it would be the hourly employee’s wage for the number of minutes spent on the phone call. If there is no notification, there is no transaction cost at all, which means that a one-size-fits-all fee is inappropriate. Since it is completely within the power of a credit card company to deny over-limit transactions altogether, any additional costs incurred as a result of these transactions would be voluntarily assumed, and should not be assessed against the cardholder; if the credit card company chooses to permit the transaction, it will still benefit by accruing interest on that amount from the cardholder.

IV. Proposed Remedies

A. The Courts Giveth and the Courts Should Taketh Away.

⁶⁷ Id.

⁶⁸ “There is very little evidence that relatively modest problems, like one or two late payments of a short duration - significantly increase a consumer’s chances of default.” Id.

⁶⁹ *Stamford v. Banta*, 92 A. 665, 667 (Conn. 1914).

In the 1990's there was a public outcry protesting late fees. In 1995, consumers banded together in a class action lawsuit against Citibank, one of the major credit card issuers.⁷⁰ In *Sherman*, the New Jersey Supreme Court held that the term "interest" in the National Bank Act refers only to periodic percentage rate charged on outstanding balances and does not include loan terms or charges such as late fees.⁷¹

We determine that the understanding of "interest" as expressed and authorized in the NBA does not include distinctive and contingent loan terms or charges, such as late fees, that are unrelated to interest rates. We hold that late-payment fees are not "interest" within the intent and purposes of the applicable federal statute. Rather, "interest at a rate allowed by the laws of the State . . . where the bank is located" refers only to the periodic percentage rate charged on outstanding balances. Therefore, plaintiff's state-law defenses to the bank's charges do not conflict with federal law, are not preempted, and the late-payment fees are illegal under New Jersey law.⁷²

One might easily agree with the New Jersey Supreme Court, as late fees, which may potentially be higher than the entire balance of a credit card, do not seem to even be related to the amount of money one has borrowed.⁷³ Consider the following: Consumer has a credit card balance of \$25.00. She pays her bill on the due date, but after the cutoff time, incurring a late fee of \$39.00. The late fee would be 150% of her total balance due, and she would still have to pay an additional amount for the regular periodic interest as per her cardholder agreement.

However, even if late fees were determined as a percentage of the cardholder's total balance, certainly such fees were not anticipated, much less expressly authorized by Congress when enacting the National Banking Act. Even if the late penalty was a low percentage of the card's total balance, the resulting fees to cardholders would be outrageous.

American Express is reportedly considering such a scheme: cardholders

70 *Sherman v. Citibank (South Dakota), N.A.*, 668 A.2d 1036 (N.J.,1995).

71 *Id.*

72 *Id.* at 1040.

73 Consider the following: Consumer has a credit card balance of \$25.00. She pays her bill on the due date, but after the cutoff time, incurring a late fee of \$39.00.

would pay either \$39 or 2.99% of their balance as a late penalty, whichever is greater.⁷⁴ Under such a regime, a consumer with a \$10,000 balance would open his bill to find a \$299 late fee, even though his minimum payment due may have only been \$200.

Soon after New Jersey ruled that the National Banking Act's authorization of charging interest did not include late fees, the United States Supreme Court heard a very similar California case against Citibank and came to the opposite conclusion, overruling Sherman.⁷⁵ The Supreme Court reasoned that since the Comptroller of the Currency had "reasonably interpreted the term 'interest' to include late payment fees,"⁷⁶ that the Court should defer to the Comptroller, the official charged with administering the Act.⁷⁷

The text of the National Banking Act reads as follows:

Any association may take, receive, reserve, and charge on any loan or . . . other evidences of debt, interest at the rate allowed by the laws of the State . . . where the bank is located, or at a rate of 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, whichever may be the greater, and no more, except that where by the laws of any State a different rate is limited for banks organized under state laws, the rate so limited shall be allowed for associations organized or existing in any such State under title 62 of the Revised Statutes. When no rate is fixed by the laws of the State, or Territory, or District, the bank may take, receive, reserve, or charge a rate not exceeding 7 per centum, or 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, whichever may

74 Chu, *supra* note 2.

75 *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735 (1996), *Citibank (South Dakota), N.A. v. Sherman*, 517 U.S. 1241 (1996).

76 Comptroller of the Currency defined the term "interest" to include "fees connected with credit extension or availability: numerical periodic rates, late fees, not sufficient funds [NSF] fees, overlimit fees, annual fees, cash advance fees, and membership fees"; 12 C.F.R. § 7.4001(a).

77 *Smiley*, 517 U.S. 735.

be the greater⁷⁸

By adopting the Comptroller’s skewed definition of “interest” and holding that the National Banking Act pre-empts state law in the area of consumer protection, the Supreme Court has left the states powerless to protect their citizens against penalty fees and other abusive lending practices.⁷⁹

When one reads the plain language of the statute, one observes that every time the statute mentions “interest,” the term is always used in connection with a “rate.” A careful reading of the statute indicates that the interest contemplated was a periodic percentage rate, such as the APRs which credit card companies are already charging consumers. Late fees and over-limit fees are often flat fees which are never a defined proportion of a consumer’s balance due, and can in no way be considered a “rate” of any kind. It is hard to imagine that Congress’s legislative intent included allowing forty-seven states to be subject to the intentionally-weakened consumer protection laws of Delaware, Nebraska and South Dakota,⁸⁰ especially considering the deeply-rooted historic resistance to nationalized banking.⁸¹

The Supreme Court could effectively abolish late fees by overruling *Smiley* and adopting an interpretation of the National Banking Act consistent with the plain language –holding that late and over-limit fees are not authorized under the Act—and simultaneously finding that the National Banking Act’s authorization for lenders to export interest rates⁸² does not pre-empt the consumer protection laws of the

78 12 U.S.C. § 85

79 *Smiley*, 517 U.S. 735.

80 Kevin G. Toh, *Are Credit-Card Late Fees “Interest”? Delineating the Preemptive Reach of Section 85 of the National Bank Act of 1864 and Section 521 of The Depository Institutions Deregulation and Monetary Control Act of 1980*, 94 Mich. L. Rev. 1294, 1296 (1996).

81 *Sherman v. Citibank (South Dakota), N.A.*, 668 A.2d 1036, 1040 (N.J. 1995) (citing William Oscar Scroggs, *A Century of Banking Progress*, 50-51 (1924); John J. Knox, *A History of Banking in the U.S.*, 12 (2d ed. 1969)).

82 In a unanimous opinion authored by Justice Brennan, the United Supreme Court held that under the National Banking Act, a national bank based in one state (here, Nebraska) could charge out-of-state consumers interest rates that were allowed by its home state when such a rate is greater than that allowed in the consumer’s state, thereby permitting “exportation” of interest rates. *Marquette Nat’l Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299, 301 (1978).

cardholder's state.⁸³ While it would still be possible for states to impose their own legislation which enables credit card companies to charge late and over-limit fees, clearly, many states—including the twenty-six states that joined in an amicus curiae brief in support of Barbara Smiley—would be more protective of their consumers.⁸⁴

Admittedly, it is unlikely that the United States Supreme Court will overrule its unanimous decision in *Smiley*⁸⁵, especially given that the composition of the Court has not changed substantially since 1996.⁸⁶ However, perhaps after seeing the far-reaching ramifications of its decision, the court would be willing to reconsider its decision.⁸⁷

B. Legislative Remedies

Numerous bills have been introduced in the legislature to curb the abusive lending practices of credit card companies, but precious few even make it out of committees. The Credit Cardholders Bill of Rights, which has proven to be an exception to the rule, recently passed in the United States House of Representatives and is currently up for consideration in the Senate.⁸⁸ This piece of legislation, as passed by the House, is proposed as an amendment to the Truth in Lending Act⁸⁹ that would help even the playing field for consumers in many important aspects. Victories for credit cardholders would include: the ability to opt-out of creditor authorization of transactions that cause a cardholder to exceed his credit limit where a fee would be imposed; limitation on the number of over-limit fees which a creditor may impose in a single

83 For an in-depth discussion of the arguments why the National Banking Act does not pre-empt state consumer protection laws, see Toh, *supra* note 3, in its entirety.

84 Amicus Curiae Brief of The Commonwealth Of Massachusetts And The States Of Arkansas, Connecticut, Florida, Hawaii, Indiana, Iowa, Kentucky, Maine, Maryland, Michigan, Minnesota, Mississippi, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Rhode Island, South Carolina, Tennessee, Texas, Vermont, Washington, West Virginia And District Of Columbia in Support of Petitioner, 1996 WL 88720 (Mar. 01, 1996).

85 517 U.S. 735.

86 There have only been two changes to the Court: Justice O'Connor was replaced by Justice Alito in 2006, and Chief Justice Rehnquist was replaced by Chief Justice Roberts in 2005.

87 As an example, the late fees under consideration by the Court in *Smiley* were \$6, from a card issuer based in a state with very weak consumer protection laws, and since that decision, standard late fees have risen to \$39. 517 U.S. at 738.

88 "The Credit Cardholder's Bill of Rights Act," 2009 House Bill 5244, passed 312-112 on September 23, 2008.

89 15 U.S.C.A. § 1601

billing cycle; a prohibition on retro-active interest rate increases; and the requirement that cardholders be notified forty-five days in advance of an interest rate increase under most circumstances.⁹⁰ The Credit Cardholders' Bill of Rights would also prevent credit card companies from arbitrarily raising interest rates.⁹¹ However, the credit card companies would still be allowed to raise a cardholder's interest rate if the minimum payment was not received within a thirty day grace period following the due date.⁹²

However, while these long overdue amendments to the Truth in Lending Act⁹³ constitute significant progress in the protection of consumer rights, they do not abolish, nor even limit the amount lenders may charge for late and over-limit fees.⁹⁴ In fact, Representative Maloney⁹⁵, the bill's sponsor, used this as a selling-point during the United States House of Representatives' hearing on the bill: "Unlike other proposals before Congress our bill does not set price controls, it does not . . . set rate caps, or limit the size of fees."⁹⁶

Alternatively, Congress could return the power to legislate consumer protection laws to the states by either amending the National Banking Act⁹⁷ or creating new legislation. Given consumers' intense dissatisfaction with the current state of creditor relations⁹⁸ and the states' eagerness to retain the right to legislate this important area of law under their police powers,⁹⁹ it would seem that such an initiative would prove wildly popular. Congress could accomplish this goal simply by amending the National Banking Act¹⁰⁰ to expressly disclaim federal pre-emption of state consumer-protection laws, thereby protecting state powers while

90 2009 H.B. 5244 (§127B(c))

91 2009 H.B. 5244 (§127B(a)(1))

92 Id. at 127B(b)(1)(C)

93 15 U.S.C.A. § 160.

94 2009 H.B. 5244.

95 Representative Carolyn B. Maloney, United States House of Representatives (D-NY).

96 Hearing of the Financial Institutions and Consumer Credit Subcommittee of the House Financial Services Committee; Subject: The Credit Cardholders' Bill of Rights: Providing New Protections for Consumers; /Capitol Hill Hearing/U.S. News Service, March 18, 2008.

97 12 U.S.C. § 85.

98 Plunkett, *supra* note 46.

99 Amicus Curiae Brief, *supra* note 77.

100 12 U.S.C. § 85.

retaining the ability to achieve lender parity between state and federal lending institutions.

V. Conclusion

Credit card late and over-limit fees are penalties, not liquidated damages, which are only artificially agreed upon through contracts of adhesion. Congress must act decisively by amending the National Banking Act so that state courts would be free to prohibit penalty fees in their states, and courts would be able to once again prevent recovery of these contract penalties.