ContractsProf Blog

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GLOBAL K: Apples and Oranges?

By Michael P. Malloy

Offshore friends and colleagues are often confused or frustrated by the U.S. approach to resolving financial exploitation or manipulation of consumers. *Why is it assumed that private remedies are the appropriate response to such pervasive problems*, they ask. *How is it that U.S. consumer protection law is so often merely a matter of perfunctory disclosures that noone reads*, they complain. Certainly, much of the run-up to the capital markets collapse of 2008 involved rather blatant abuse of consumers, but when the Great Reccession emerged, only the high end of the economy received massive government support, while affected mortgagors were left largely to whatever remedies or defenses they could fashion from applicable transactional law. One might legitimately wonder at these official responses.

A recent decision, *In re Late Fee and Over–Limit Fee Litigation*, issued by the Ninth Circuit on January 21, 2014, offers an interesting variation on this problem. The case also highlights the limits of ordinary principles of contract law in addressing contemporary issues of consumer protection.

A group of credit cardholders, who had allegedly paid excessive late fees and over-limit fees to issuing banks, brought a class action against the issuers, claiming on a flurry of legal grounds that the fees should not be enforceable. Some of these grounds were regulatory. Others sought to align the judicial treatment of torts remedies with that of contracts remedies. Among other things, the plaintiffs argued that the fees violated usury limits under the National Bank Act, 12 U.S.C. §§ 85–86, or were otherwise excessive under the corresponding provisions of the Depository Institutions Deregulation and Monetary Control Act ("DIDMCA"), 12 U.S.C. § 1831d(a), which applied to state-chartered, FDIC-insured banks. Even if seemingly in compliance with these regulatory statutes, plaintiffs asserted, the fees were so excessive as to be unconstitutionally punitive. They also made a try at arguing that the issuing banks had conspired to fix prices and maintain a price floor for late fees in violation of the Sherman Act, 15 U.S.C. § 1 *et seq*. Furthermore, the plaintiffs alleged, the fees violated the California Unfair Competition Law, Cal. Bus. & Prof.Code § 17200 et seq.

The district court found it hard to accept these challenges given the routine practices of the issuers. In accordance with federal law, the fees had been disclosed in the contracts between the issuers and the cardholders, and were fairly uniform and typically between $15 and $39 – amounts that the plaintiffs argued still vastly exceeded the harm the issuers actually suffered when their customers charged beyond their credit limits or made late payments. The Northern District of California dismissed the action for failure to state a claim.

On appeal, the cardholders argued that the fees should be treated like the punitive damages that were subjected to substantive due process limits in the Supreme Court's 1996 decision in *BMW of North America, Inc. v. Gore* and its 2003 decision in *State Farm Mut. Auto. Ins. Co. v. Campbell*. Hence, even if permitted by federal regulatory law, the fees should be refused enforcement on constitutional grounds. Nevertheless, the Ninth Circuit affirmed, holding that substantive due process principles – developed in the context of jury-awarded punitive damages in *tort* cases – did not apply to liquidated damages clauses in *contracts* cases. As the court explained, “[t]he jurisprudence developed to limit punitive damages in the tort context does not apply to contractual penalties, such as the credit card fees at issue in this case.” It also held that the banks could not be liable for excessive charges under the state unfair competition law, since the late fees and over-limit fees were charged by banks in conformity with federal law. As Judge Nelson observed in her opinion for the court, “[b]ecause we conclude that the issuers' conduct did not violate the National Bank Act or the DIDMCA, there is no derivative liability under the Unfair Competition Law.”

Judge Nelson recognized that the case turned on the relative similarities and differences between liquidated damages and punitive damages. It is a commonplace of *contracts* remedies that “liquidated damages” are enforceable if the damages are likely to be difficult to determine at the time of agreement and the liquidated sum represents a good faith effort by the parties to quantify. *See*, *e.g.*, UCC § 2–718(1). However, if the liquidated damages provision were “unreasonably large,” it would be treated as an unenforceable penalty.

Judge Nelson also acknowledged that “[l]ike the common-law rule against contractual penalty clauses, punitive damages have an ancient provenance.” The key to the case was the plaintffs’ attempt to meld these two historical traditions to invalidate otherwise enforceable contractual fees, on a constitutional basis. This the court refused to do. “[C]onsidering that the penalty clauses at issue originate from the parties' private – albeit adhesive – contracts, they are distinct from the jury-determined punitive damages awards,” Judge Nelson concluded. “Adhesive” though the contracts may be, the court was not prepared to invalidate fees ostensibly permitted by federal law.

Ironically, the problem seems to be that *contracts* law had already long assimilated excessiveness as a ground for unenforceability of a penalty clause *without* the invocation of due process notions. Hence, if a regulatory statute interevened – as the National Bank Act and DIDAMCA provisions arguably had – to permit a standardized fee that might otherwise be argued to be excessive, the question was whether a litigant could resuscitate the excessiveness argument with a jolt of due process. The basic reason for *not* exploring this possibility is that this had only been done in tort remedies theory, not contracts.

I am not sure that that is a very compelling reason. Apparently, neither did the Ninth Circuit. Judge Reinhardt concurred in the judgment “reluctantly.” In his view, the Supreme Court would be “well advised” to apply the prinicples of *BMW of North America, Inc*. and *State Farm Mut. Auto. Ins. Co*. “to prevent disproportionate penalties from being imposed on consumers when they breach contracts of adhesion.” He reluctantly admitted that the opinion of the court was correct in recognizing that due process constraints in the Constitution had not yet been interpreted so widely, but he gave a stirring and persuasive analysis of why it should be.

Judge Reinhardt’s separate opinion deserves the serious attention of *contracts* scholars and practitioners, as a possible map of future developments. Apparently, Judge Nelson, the author of the court’s opinion, agrees with me, because – in an extraordinary gesture – Judge Nelson also wrote separately *to join Judge Reinhardt's concurrence*, “although [she] agree[s] that the district court reached the correct result under currently applicable law and should be affirmed.” Are they suggesting the need for further judicial review?

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