DREHER TOMKIES LLP

ALERT

FOR CLIENTS AND FRIENDS OF DREHER TOMKIES LLP

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NINTH CIRCUIT FAILS TO FIND CREDIT CARD LATE AND OVERLIMIT FEES UNCONSTITUTIONAL

The United States Court of Appeals for the Ninth Circuit recently held in the context of a challenge to credit card late and overlimit fees, that the due process analysis developed in the context of jury-awarded punitive damages is not applicable to contractual penalty clauses. *Pinon v. Bank of Am.,* 2014 WL 211729 (9th Cir. Jan. 21, 2014). Thus, the court upheld the dismissal of the plaintiffs' claims by the United States District Court for the Northern District of California.

Pinon involved a challenge by a class of cardholders who paid credit card fees to the constitutionality of those fees. Specifically, they challenged so-called "penalty" overlimit and late fees, arguing that such fees are analogous to punitive damages imposed in the tort context and are subject to substantive due process limits. The fees under consideration (i) were disclosed in the contracts between the card issuer defendants and their customer plaintiffs and (ii) typically ranged between $15 and $39, amounts that the plaintiffs alleged vastly exceeded the harm that card issuers actually suffered when cardholders exceeded their credit limits or paid late.

In examining the plaintiffs' due process claim, the court noted that liquidated damages customarily are unenforceable as penalties where they exceed actual damages caused by a contractual breach. The similarities and differences between liquidated and punitive damages, the court determined, would govern the outcome of the case. The court described liquidated damages as predetermined sums which parties to a contract agree to pay in the event of a breach. Such damages are enforceable if the damages resulting from the breach likely are difficult to determine at the time of the agreement and the liquidated amount represents a good faith effort by the parties to assess the benefit of the bargain. Penalties, on the other hand, are amounts agreed to in contracts in the event of a breach, but which are designed to punish the breaching party, rather than to estimate probable actual damages. Such clauses, the court noted, generally are not enforceable.

Punitive damages, the court stated, are found in tort and generally are not recoverable for breach of contract. Such damages typically are designed to deter harmful behavior, rather than to compensate, and are awarded in addition to actual damages. For that reason, the court noted, many jurisdictions disallow punitive damages without an award of actual damages. Citing to the United States Supreme Court decision in *BMW of North Am., Inc. v. Gore,* 517 U.S. 559 (1996), the court stated that punitive damages are not designed to be a form of supercompensation for plaintiffs, but instead are to "further a State's legitimate interests in punishing unlawful conduct and deterring its repetition."

While the court recognized that to the extent punitive damages are permitted in contract actions, they are subject to constitutional limits, it rejected the plaintiffs constitutional claims with respect to the late and overlimit fees at issue. Those fees, the cardholders alleged, were purely punitive because the card issuers are compensated for the lost time value and collection costs of any breach of contract by the high penalty interest rates imposed. But, the court stated, because the penalty clauses at issue were within a private contract between the parties, they are distinguishable from jury-determined punitive damages awards at issue in the *Gore* case and *State Farm Mut. Auto. Ins. Co. v. Campbell,* 538 U.S. 408 (2003). The constitutional due process analysis developed in the context of jury-awarded punitive damages, the court concluded, is not applicable to contractual penalty clauses.

While the court upheld dismissal of the plaintiffs' claims, the tone of the opinion suggests a desire for a different outcome. There is discussion of the adhesive nature of credit card contracts and the harshness of the late and overlimit fees and penalty interest rates. As the court states consumers' "small mistakes prove very costly." In fact, the author of the majority opinion also joined the concurring opinion, which, while agreeing with the majority decision based on current law, states that if due process is violated when courts award disproportionate punitive damages in the tort context, it equally is violated when courts enforce the punitive and substantially more disproportionate penalty clauses in contracts of adhesion.

The plaintiffs efforts are reminiscent of earlier challenges under California law. The plaintiff's also claimed that the fees, being unconstitutional, exceeded the authority of the National Bank Act (12 U.S.C. § 85) and Section 1831d, but the court noted that federal law allows such fees so long as they are legal in the issuer's home state. ❑

✧ *Mike Tomkies and Margaret Stolar*

Darrell L. Dreher
ddreher@dltlaw.com

Judith M. Scheiderer
jscheiderer@dltlaw.com

Elizabeth L. Anstaett
eanstaett@dltlaw.com

Charles V. Gall
cgall@dltlaw.com

2750 HUNTINGTON CENTER
41 S. HIGH STREET
COLUMBUS, OHIO 43215
TELEPHONE: (614) 628-8000 FACSIMILE: (614) 628-1600
WWW.DLTLAW.COM

Michael C. Tomkies
mtomkies@dltlaw.com

Margaret M. Stolar
mstolar@dltlaw.com

Robin R. De Leo
robin@dreher-la.com

Susan L. Ostrander
sostrander@dltlaw.com

Susan M. Manship
smanship@dltlaw.com